Bank of Israel

Monetary Policy Report

Second Half of 2020

54 January 2021

Monetary Policy Report

Second Half of 2020

54 January 2021

Table of Contents

Monetary Policy Report
Second Half of 2020

According to the Bank of Israel Law, 5770–2010, the Bank of Israel has three objectives: (1) to maintain price stability, as its central goal; it was established that price stability is defined as an annual inflation rate of between 1 percent and 3 percent; (2) to support other objectives of the Government's economic policy, particularly growth, employment and reducing social gaps, provided that this support shall not prejudice the attainment of price stability; and (3) to support the stability and orderly activity of the financial system. In order to attain these objectives, the Bank of Israel employs various tools, chief among them the decision on the appropriate level of the short-term interest rate. In addition, the Bank may intervene in the foreign exchange and bond markets.

Section 55(a) of the Bank of Israel Law, 2010–5770, establishes the publication of this report, which is submitted by the Bank of Israel to the government and the Knesset Finance Committee twice a year. The report surveys the economic developments that took place during the period covered by the report. It also surveys the policy required—in the view of the members of the Bank of Israel's Monetary Committee, the forum in which monetary policy decisions are reached—to maintain the inflation rate within the range set by the government and to achieve the other objectives of the government's economic policy. A survey of financial stability appears in the Bank of Israel's Financial Stability Report for the period covered.

In accordance with Section 55(b) of the Bank of Israel Law, the current report explains why the inflation rate deviated from the target range determined by the government for more than 6 consecutive months—since the publication of the CPI for June 2019 (on July 15, 2019). The inflation rate during this period declined to below the lower bound of the target range, and the explanations for that are found in this report.

The Monetary Policy Report for the second half of 2020 was prepared by economists in the Research Department, within guidelines set by the Bank of Israel Monetary Committee. This report is based on data that were published up to the interest rate decision reached on January 4, 2021, and thus refers to the CPI through the month of November 2020 .

Summary

Monetary policy: This report reviews monetary policy during the second half of 2020 and the beginning of the first half of 2021.[1] During the reviewed period, against the background of the continuation of the crisis and the deterioration in economic conditions due to the spread of the coronavirus and the steps taken to prevent it, the Monetary Committee implemented several tools with the goal of dealing with the crisis. The steps taken were intended to reduce the adverse economic impact caused by the health crisis, to ensure the continued orderly functioning of the financial markets, to enhance the passthrough from the Bank of Israel interest rate to market interest rates, and to encourage demand and inflation through easing credit conditions, aided as well by the operation of specific and focused credit mechanisms.

[1] The decisions in 2020 were made on July 6th, August 24th, October 22nd, and November 30th, and the decision reached in 2021 was on January 4th.

The July decision included, for the first time, the purchase of corporate bonds in the secondary market, at a scope of NIS 15 billion. In addition, it was decided to renew the special program for expanding the supply of credit to small businesses and to create an infrastructure to expand the range of assets that banks can accept as collateral in order to extend credit. In the October decision, the Committee announced the expansion of the bond purchase program by NIS 35 billion. In addition, a new pillar was decided upon in the program to ease credit terms for small and micro businesses: the Bank of Israel will provide the banking system with loans at a negative interest rate of -0.1 percent, for the first time in Israel, in accordance with the conditions that were set. During the second half of the year, the interest rate was kept unchanged at 0.1 percent. Other than the tools noted above, the Bank of Israel continued during the half year to purchase foreign exchange. Alongside the monetary tools that the Committee implemented, the Banking Supervision Department at the Bank of Israel took several additional steps in the credit market.

Domestic real activity: The data and indicators that were presented to the Monetary Committee in the half year reviewed described the Israeli economy's recovery during the summer months, but also the sharp negative impact on activity during the second lockdown in September-October. During the second lockdown, a sharp decline in activity was seen, but at a more moderate intensity than there had been in the first lockdown. Labor market data indicate that before the second lockdown was imposed, the broad unemployment rate was stable at around 11-12 percent; that during the lockdown it soared to about 23 percent in the first half of October; and that after the lockdown it declined gradually to about 12.7 percent in the first half of December.

The inflation environment: During the second half of 2020, the inflation environment remained low, and the year over year inflation rate was still negative, but slightly higher than at the end of the first half. Inflation in the past 12 months is -0.6 percent, and is -0.2 percent net of energy and fruit and vegetables. One-year inflation expectations from all sources declined during the half year and were below the lower bound of the target range, and expectations derived from the capital market returned to the negative range in October-November. Forward expectations for all ranges remained essentially unchanged in the second half, and expectations for medium and longer terms (more than 3 years) remained anchored within the target range throughout the half year.

The exchange rate: During most of the second half, the shekel strengthened slightly vis-à-vis the nominal effective exchange rate, and in particular – in the last two months of the half year there was significant appreciation. This was mainly due to the shekel strengthening against the dollar. At the end of the half year reviewed, the shekel-dollar exchange rate was at the low level of NIS 3.2/$.

The global economy: During the third quarter the global economy improved, against the background of the decline in the infection rate and easing of the lockdown policies, with considerable variance among economies :there was an improvement in the US, which was stronger than Japan and Europe, and China's economy was notably good due to its success in dealing with the health crisis. The improvement in activity led as well to an upward revision of the IMF's forecast. World trade contracted sharply, and global inflation remained low. With that, in the US it rose slightly to 1.2 percent. Monetary policy in various countries remained very accommodative, and central banks continued to signal their readiness to take additional unconventional steps in order to ease financial terms. Equity indices on capital markets worldwide recovered in the half year, but volatility remains high.

Credit market : Bank credit balances of small businesses and commercial credit remained stable throughout the half year. The credit market continued to function with stable interest rates, with support from a range of steps by the Bank of Israel and the Ministry of Finance. The average interest rate for small businesses even declined slightly. Based on the Business Tendency Survey, conducted by the Central Bureau of Statistics, there is a continued trend of decline in the constraint of raising funds – bank credit as well as nonbank credit – and the indices are approaching pre-crisis levels even though they are still high compared to the pre-crisis period. The bank credit balance in respect of which payments were deferred under the framework for deferring loan payments, which was initiated by the Banking Supervision Department, is around NIS 160 billion, of which 65 percent (NIS 104 billion) are housing loans and about 13 percent (NIS 21.1 billion) was credit to micro businesses. For about 41 percent of the deferred credit balances, payments have not yet been renewed. Activity continues in the fund to provide government-guaranteed credit to small and medium sized businesses, even in the track that is at enhanced risk. The utilization rate of the fund for large companies remained relatively stable.

Financial market developments: In the first half of 2020, the spread of the coronavirus led to sharp declines in financial markets in Israel and abroad. In response, many central banks, including the Bank of Israel, continued in the second half of the year as well to operate various asset purchase programs and to remove credit barriers to groups that needed it. This was to ensure that the markets remained liquid and to support their orderly functioning. The government bond yield curve steepened slightly, alongside higher yields in the nominal (unindexed) curve, similar to the trend worldwide, led by the US. Corporate bond spreads continued to narrow, alongside some increases in equity indices, but returns including equity markets in Israel this year are markedly lower compared with the rest of the world. Financial markets maintained relative stability for most of the second half of 2020, and at the end there were price increases, among other things against the background of news regarding coronavirus vaccines.

Fiscal policy: In discussions on fiscal policy, Monetary Committee members expressed concern throughout the half year about the continued uncertainty deriving from the lack of a budget for 2020 and the nonsubmissison of a 2021 budget for government approval. The deficit reached 9.1 percent of GDP in September, and at the end of the year was expected to be about 12 percent of GDP. About three-quarters of the deficit is attributed to the ramifications of the coronavirus pandemic—half is due to increased expenditure and a quarter due to decreased tax revenues due to the response of GDP to the crisis.

The housing market: After a moderation of the rate of increase of rents in the first half, the pace increased in the reviewed half year, alongside a stable growth rate in the Home Prices Index.

The Research Department‘s staff forecasts: The Research Department published four forecasts during the period being reviewed, in parallel with the interest rate announcements – in July, August, (an unscheduled update), October and January 2021. The forecast for October was joined by a special update in November, which was presented to the Committee, of 2020 growth data, in view of encouraging growth data in the third quarter. For most of the second half, the Research Department‘s macroeconomic forecasts presented two possible scenarios, and during the course of the half year, the expected unemployment rate was revised upward. The two scenarios presented in the January forecast are a scenario including rapid vaccination of the population by May 2021 (hereinafter, the rapid vaccination scenario) and a scenario in which the vaccination is drawn out for a longer period of time until June 2022 (hereinafter, the slow vaccination scenario). As of now, in view of the rapid pace of vaccinations of recent weeks, it appears that as of the date of the publication of the report, the probability of the materialization of the rapid vaccination scenario is markedly higher than that of the slow vaccination scenario.

In the rapid vaccination scenario, GDP is expected to grow by 6.3 percent in 2021 and by 5.8 percent in 2022. The inflation rate in the preceding 4 quarters (ending in the fourth quarter of 2021) is expected to be 0.6 percent, and 0.9 percent in 2022 . The broad unemployment rate (for ages 15+) is expected to decline until the 4th quarter of 2021 to 7.7 percent of the labor force, and to continue to decline gradually to 5.4 percent at the end of 2022. The government's deficit is expected to be 8 percent of GDP in 2021 and 3.6 percent of GDP in 2022, so that the debt to GDP ratio will be 77 percent in 2021 and 75 percent in 2022. This assumes that the government takes policy steps (reducing expenditures and raising taxes) at magnitudes that are in line with the restraint derived from the expenditure ceiling set in law. Without such adjustment, expected expenditure, based on existing decisions, will lead to a deficit of about 4 percent of GDP in 2022.

During the reviewed half year, the Committee discussed the economic risks to the forecast, which depend to a great extent on epidemiological developments – in the features and number of lockdowns, which are liable to be different than assessments, their effectiveness, the level of infection over the winter and the time and pace of the public's vaccinations against Covid-19 – but also on other economic risks, such as additional weakness of activity abroad and government steps, as well as political and budgetary uncertainty.

Monetary policy

In the second half of 2020, against the background of the continuation of the crisis and the deterioration in economic conditions in the economy due to the spread of the coronavirus and the steps taken to avoid it, the Committee implemented several tools to help in dealing with the crisis. The steps taken were intended to reduce the adverse economic impact caused by the health crisis, to ensure the continued orderly functioning of the financial markets, to enhance the passthrough from the Bank of Israel interest rate to market interest rates and to encourage demand and inflation, through easing credit conditions, among other things by utilizing special and focused credit mechanisms.

The uniqueness of monetary policy in this half year is the concentration on the area of credit availability, through implementing mechanisms for dealing also with specific barriers to credit, which generally does not typify classical monetary policy, which acts on aggregate terms. In addition, the use continued of some of the macroeconomic policy tools that were put into operation with the outbreak of the crisis. (For Bank of Israel steps during the crisis, see Figure 1.)

The effects of the coronavirus on economic activity are uneven, and the adverse impact is focused mainly on industries impacted directly by the activity limitations and by the social distancing requirements. Therefore, the negative impact on households whose income depends on such industries is particularly large, and the gaps in risk among the various segments are liable to increase the longer the crisis persists. In this regard, Committee members noted that the characteristic of the crisis emphasizes the marked importance of fiscal policy, but also the importance of monetary policy to financial markets, particularly the credit markets, as well as the need for focused solutions for industries and households that have been negatively impacted.

In the July decision, it was decided unanimously to purchase NIS 15 billion of corporate bonds on the secondary market—an unprecedented policy tool in Israel; this was in order to expand large companies' ability to raise credit directly, and to open up bank and nonbank credit to smaller businesses. Within this framework, the Bank of Israel launched a new corporate bond purchase program based on a broad benchmark of securities—investment-grade bonds with only a domestic rating of A- and above. The Committee's discussion before the decision referred to various aspects justifying the intervention, distinguishing between a state of market failure and assistance in reducing funding costs. The Committee was of the opinion that even though there wasn't a market failure at that time, there was room for a plan that would strengthen the passthrough from the monetary interest rate to interest rates in the economy overall, will encourage credit issuances for the business sector and will open up credit resources for all market sectors (Figure 1).

In the July decision, it was also decided unanimously to renew the special program for expanding the supply of credit to small businesses and to create an infrastructure for expanding the range of assets that the banks will be able to pledge as collateral for credit that they receive for that purpose from the Bank of Israel. The Committee discussed the creation of an infrastructure that will enable banks to pledge mortgage portfolios as collateral against the credit they receive from the Bank of Israel within the framework of the plan to expand the supply of credit to small and micro businesses, a step that was essentially realized in the final days of 2020.

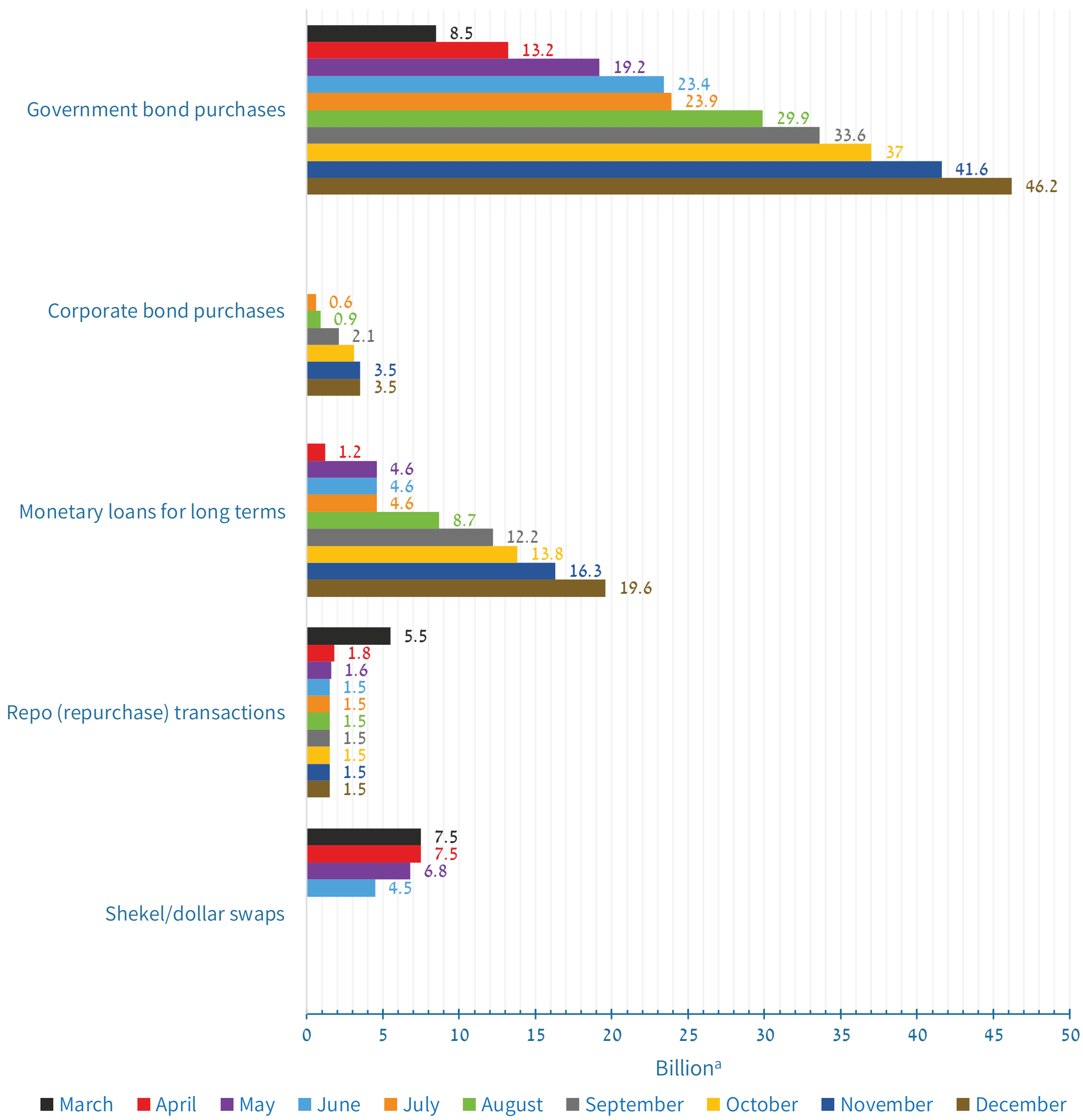
At the time of the August decision, the economic recovery was continuing, and despite the increase in morbidity, additional notable limitations were not imposed on economic activity. The Committee was of the opinion that the tools that the Bank of Israel was operating gave at that time a sufficient response to the needs of the economy, and in that decision it was not decided to implement additional policy tools.

In the October decision, the Committee decided unanimously to increase the government bond purchase program by NIS 35 billion. The October decision was reached immediately with the end of the first stage of the second lockdown, when it became apparent that the economy's recovery in the summer months had halted sharply in the middle of September, with the beginning of the second lockdown. The Committee agreed that data indicated the relative stability and orderly functioning of the financial markets, against the background of policy steps taken in the first half of the year. However, the Committee assessed that considerable credit needs are expected to remain due to the continuation of the crisis. Therefore it was of the view that it was better to be proactive and to initiate policy steps that can prevent possible future difficulties in the markets. In this regard, the Committee discussed the real short-term interest rate, which in Israel is high relative to the world, including the recent growing gap with the US. Committee members agreed that the increase I the scope of government bond purchases, as had been decided upon, was likely to moderate the increase in real and nominal yields as well as to support the increase in expected inflation. The plan, which as noted was expanded in October by NIS 35 billion, was originally launched in March 2020, and at this time it was decided first to purchase NIS 50 billion in government bonds with the goal of reducing the cost of credit in the economy. When the plan was launched, in March, the Committee explained that the purchase plan was intended to impact on the longer section of the yield curve, in order to reduce the costs of credit for companies and households in Israel in view of the decline in their income and the liquidity difficulties they encountered, and to moderate the sharp volatility in bond yields, which characterized the markets at the time (Figure 1).

Figure 1

Bank of Israel Policy Steps During the Crisis

month-end balances, March-December 2020



[a] Quantity denominated in shekels, other than dollar/shekel swaps that are denominated in dollars.

SOURCE: Bank of Israel.

In the October interest rate decision, it was also decided unanimously on a new pillar in the plan to ease credit conditions for small and micro businesses: the Bank of Israel will supply the banking system with loans at a negative interest rate of -0.1 percent, for the first time ever in Israel. The Committee decided to operate a focused unconventional tool, so that the support provided by the Bank of Israel would be fully rolled over to small business borrowers, with the goal of making things as easy as possible for them, recognizing their importance to employment and economic activity. It was decided to provide loans to the banking system at a negative rate of -0.1 percent against loans to small and micro businesses, with the condition that the interest rate on the loans will be convenient—not to exceed Prime +1.3 percent, relatively low compared to the interest rate in the market today—and the term to final payment was extended to 4 years. It was agreed that the new pillar in the program will help those companies, in view of the increased risk and uncertainty regarding their orderly activity and the survival of some of them, particularly as a result of government decisions to prevent the spread of the pandemic. This increased risk is liable to adversely impact the orderly functioning of the credit market and the passthrough of monetary policy to the interest rate in this market segment, and therefore it was decided to implement this tool. This pillar comes in addition to the program launched for the first time in April—monetary loans for a term of 3 years at a fixed interest rate of 0.1 percent. The goal of the new tool, as defined in the Committee's discussions at that time, was an increase in the supply of credit to small and micro businesses, and receiving it was contingent on the scope of credit that the banks would give to those activity segments. That is, in October the term to final payment of the new loans was set for 4 years, in contrast to 3 years under the original program, and the receipt of credit from the Bank of Israel was also conditioned on the limitation of the interest rate on the loans to small and micro businesses to Prime +1.3 percent, in contrast to no conditions on the interest rate under the original plan.

At the time of the January 2021 decision, Israel was notable for its high pace of vaccination, and the number of people vaccinated exceeded 1 million, though due to the high morbidity it was decided to impose a third lockdown and marked restrictions on economic activity. The Committee was of the opinion that the tools being implemented by the Bank provided at that time a sufficient response to the needs of the economy, and in that decision did not decide on implementing additional policy tools.

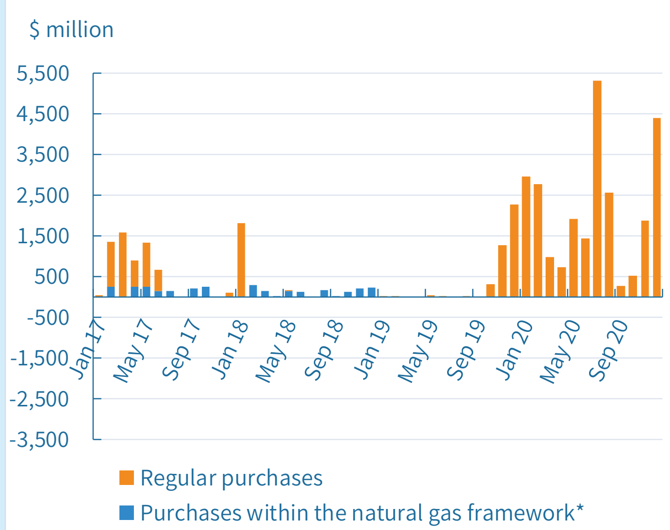
These steps joined the nonconventional tools, the implementation of which was decided on in the first half of 2020—shekel-dollar swaps and repos with institutional investors—tools that in the second half of 2020 almost no new transactions were executed in them. In the March decision, the Committee published a plan for repurchase (repo) agreements, in the framework of which loans are given to institutional investors, and those entities pledge bonds against them as collateral. In the initial stage, only government bonds or makam were able to be used as collateral, and in April it was decided that corporate bonds as well will be able to be pledged as collateral. In the second half, the Bank almost did not carry out any new repos with the institutional investors, beyond the recycling of existing transactions at the low amount of NIS 1.5 billion. In December, for the first time, a few new repos were executed with supervised nonbank entities, such as credit companies, for a short term of up to half a year at an interest rate of 0.1 percent, and at an improved negative interest rate of -0.1 percent, subject to extending credit to small and micro businesses at an interest rate of Prime +1.3 percent (Figure 1).

In addition, in the March decision, against the background of a shortage of dollar liquidity, the Bank of Israel had announced that it would begin to carry out swap transactions in the shekel-dollar market. The bank declared that the transactions would be executed as long as the pressures on dollar liquidity remain high. Therefore no new repo transactions were carried out in the shekel-dollar market in the second half of 2020, in which there were no such pressures (Figure 1).

During the second half of 2020, the interest rate remained unchanged at 0.1 percent, its lowest ever level. The Committee decided in April to reduce the interest rate by 0.15 percentage points to 0.1 percent. In all the decisions in the reviewed half year, five Committee members were of the opinion that the interest rate should be kept unchanged at 0.1 percent. Their view was that the low interest-rate level supports the recovery of economic activity and the gradual return of the inflation rate to the target range, particularly given the additional tools that the Bank is implementing in the credit and foreign exchange markets. One Committee member voted to reduce the interest rate to 0 percent; he was of the opinion that an interest rate lower than 0.1 percent is more appropriate due to the intensity of the crisis and the anomalous adverse impact on the scope of employment. In the January decision, he added that he does not rule out supporting a negative interest rate in the future.

During the half year reviewed, the Bank of Israel continued to intervene in the foreign exchange market, and purchased a total of about $15 billion[2], in order to moderate the forces acting toward shekel appreciation. More than a third of the purchases were in November, against the background of the appreciation that month (Figure 2).

Figure 2
Bank of Israel Purchases in the Foreign Exchange Market
January 2017 - December 2020



*The program to offset the effect of natural gas production on the exchange rate.

SOURCE: Bank of Israel.

Alongside the monetary tools on which the Committee decided during the period, the Banking Supervision Department adopted several measures that had a marked impact on the credit market and the consistency of the financial system's[3] functioning. It published a range of regulatory easings, which were intended to give the banks the business flexibility required to provide services to the public, particularly providing credit. In May 2020, the Banking Supervision Department announced a comprehensive framework , which was adopted by the banking system, for deferring loan payments—regarding mortgages, consumer credit, and business credit—as assistance to bank customers in

[2] Bank of Israel purchases in July–December.

[3] For an expanded discussion, see the Banking Supervision Department's review published in November, "Israel's Banking System, semiannual review 2020" (translation forthcoming).

dealing with the ramifications of the coronavirus crisis. In July, September, and November, it was decided to expand and extend the framework for deferring loan payments for businesses and households, including mortgages, and the banks implemented it. Within the framework, the banks deferred, from March through the end of December 2020, loans to hundreds of thousands of customers in all activity segments at a total of about NIS 11 billion, and the credit in respect of which payments were deferred totals NIS 161 billion. In October, the credit card companies adopted a similar framework, and it was expanded in November. In addition, a framework was published in December, allowing small and micro businesses that were markedly negatively impacted by the crisis, and meet cumulative conditions, to defer the principal component of the loan, without the bank's discretion. The assessment was that such a deferral is expected to reduce the monthly payment considerably. In addition, leverage ratio requirements for the banking system were reduced by a half of a percentage point, and this was in addition to a decrease in the regulatory capital requirements by 1 percentage point (which had already been decided upon in March). Besides all these, capital requirements were reduced for mortgages in order to prevent an increase in interest rates for the public. In December, it was decided to ease things for mortgage borrowers and to remove the prime rate limitation in the mortgage composition—a process that should contribute to reduced interest payments for borrowers, while maintaining the balance between increasing flexibility in taking out a mortgage and the level of risk to which borrowers are exposed.

The background conditions and main developments facing the Monetary Committee

1. Real activity in Israel

The data and indicators presented to the Monetary Committee during the period being reviewed described the recovery being experienced by the Israeli economy during the summer months and the sharp adverse impact on activity as a result of the imposing of the second lockdown in September-October. At the time of the second lockdown, a sharp decline in activity was seen, but its intensity was more moderate than that of the decline during the first lockdown. The recovery after the first lockdown, which was more rapid than expected, indicates the economy's high capacity to adjust to the period's restrictions. Nonetheless, concern arose that the recovery in the process of exiting the second lockdown would be slower, because the financial situation of the small businesses had deteriorated relative to their situation when exiting the first lockdown. Due to the characteristics of the crisis, its impacts are not uniform: its impact is mainly on industries affected directly by the limitations on activity and by social distancing requirements. Therefore, households whose income depends on such industries are mainly adversely impacted, and the gaps in risk among the various sectors are liable to grow the longer the crisis persists. In this regard, Committee members noted that the characteristics of the crisis emphasize the great importance of fiscal policy, but also the importance of monetary policy to financial markets, particularly credit markets, in finding focused solutions for industries and households that are negatively impacted.

The data presented to the Monetary Committee indicated that during the summer months—after the first lockdown but before the second one was imposed—the Israeli economy had a rapid recovery in economic activity, as indicated by several main indices for examining activity. Real-time surveys by the Central Bureau of Statistics showed an improvement in companies' expectations regarding the scope of their activity.

Electricity usage in August and September reached a higher level than in the corresponding period of the previous year. The Composite State of the Economy Index shows that in the summer months there was stability in economic activity, after negative data in the beginning of the crisis. Based on the data from the Business Tendency Survey conducted by the Central Bureau of Statistics for the third quarter, the net balance rose and reached a higher level than in the second quarter of the year, but its level was lower than in the first quarter and still reflected a strong contraction of activity. Goods exports improved in August and September after declining steeply in July.

The imposing of the second lockdown, in September, led to a sharp decline in activity and demand. The intensity of the response was uneven over the various industries, and was moderate relative to the decline in activity that resulted from the first lockdown. Based on companies' responses to a real-time survey by the Central Bureau of Statistics, the negative impact on revenue in the second lockdown was smaller than in the first lockdown, and a similar picture was conveyed by credit card purchase data—for most of the second-lockdown period the decline in value of purchases was more moderate than in the first lockdown (Tables 1 and 2).

Table 1

National Accounts - data available at the time of the interest rate decisions

(seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

Decision made in		6/7/20	24/8/20	22/10/20	30/11/20	4/1/21
GDP	2020:Q1	-6.8	-6.9	-6.8	-6.7	-7.0
	2020:Q2			-29.0	-28.8	-29.2
	2020:Q3					38.9
Business sector product	2020:Q1	-8.5	-8.6	-8.0	-7.8	-7.9
	2020:Q2			-33.7	-33.5	-33.8
	2020:Q3					44.1
Private consumption	2020:Q1	-20.2	-20.8	-23.8	-23.9	-23.8
	2020:Q2			-44.3	-44.0	-43.7
	2020:Q3					42.3
Fixed capital formation	2020:Q1	-20.7	-20.7	-19.9	-19.5	-18.3
	2020:Q2			-30.3	-30.3	-34.2
	2020:Q3					15.1
Exports excluding diamonds and startups	2020:Q1	2.9	4.1	13.4	13.6	15.4
	2020:Q2			-28.5	-28.6	-29.4
	2020:Q3					41.6
Civilian imports excluding ships, aircraft, and diamonds	2020:Q1	-32.1	-32.0	-24.8	-24.8	-23.5
	2020:Q2			-34.0	-34.0	-35.1
	2020:Q3					-11.6

SOURCE :Based on Central Bureau of Statistics.

Table 2
Development of GDP, imports and uses
(seasonally adjusted data, quantitative rates of change compared to previous period, in annual terms)

	2017	2018	2019	2019:Q2	2019:Q3	2019:Q4	2020:Q1	2020:Q2	2020:Q3
GDP	3.6	3.5	3.4	0.7	4.1	4.6	-7.0	-29.2	38.9
Business sector product	3.8	3.7	4.0	0.1	5.3	5.6	-7.9	-33.8	44.1
Imports excluding defense, ships, aircraft and diamonds	6.8	5.1	5.0	-1.6	6.7	11.6	-23.5	-35.1	-11.6
Private consumption	3.3	3.6	3.8	-0.2	3.2	9.1	-23.8	-43.7	42.3
of which: private consumption excluding durable goods	4.4	3.5	3.7	8.4	0.5	4.8	-19.0	-43.9	31.9
Public consumption	3.5	3.9	2.8	12.0	3.4	-2.7	-13.7	22.6	5.6
of which: public consumption excluding defense imports	4.4	4.3	2.7	7.0	1.0	4.7	-13.2	11.9	17.2
Gross domestic investment	6.0	2.5	3.5	-30.6	41.8	10.9	25.6	-51.6	-16.5
of which: in fixed assets	4.6	5.1	2.5	-8.8	8.8	11.1	-18.3	-34.2	15.1
Exports excluding diamonds	5.2	6.6	5.9	6.9	-10.0	3.4	13.6	-29.1	38.9
of which: exports excluding diamonds and startups	5.5	6.0	5.5	12.9	-3.8	4.9	15.4	-29.4	41.6

SOURCE: Based on Central Bureau of Statistics.

Labor market data indicate that before the imposing of the second lockdown, the broad unemployment rate was stable at around 11–12 percent, but it soared to 18 percent in the beginning of the easings after the second lockdown in October. The second lockdown sharply increased the number of unemployed according to the broad definition, though the increase was moderate relative to the first lockdown. The percent of unemployed out of the labor force increased from 11 percent at the beginning of September to 23 percent in the first half of October, the period of the second lockdown. In the second half of October, with the easing of the lockdown, it declined to 18 percent, and afterward it continued to decline gradually; during November it reached 14 percent, and declined slightly, to 12.7 percent, in the first half of December. The increase in the number of unemployed mainly reflected growth in the number of employed who were temporarily absent from their work for reasons due to the coronavirus ("coronavirus absentees"), while other components of unemployment according to the broad definition were stable. The increase in the number of coronavirus absentees was moderate compared to its increase during the first lockdown. This may also have been contributed to by the increase in government grants provided to employers for keeping their workers. The number of unemployed (according to the broad definition) before the lockdown was imposed, in the first half of September, was 470,000, and in the second half of that month it increased by about 300,000 people due to the imposing of the lockdown.

2. The inflation environment

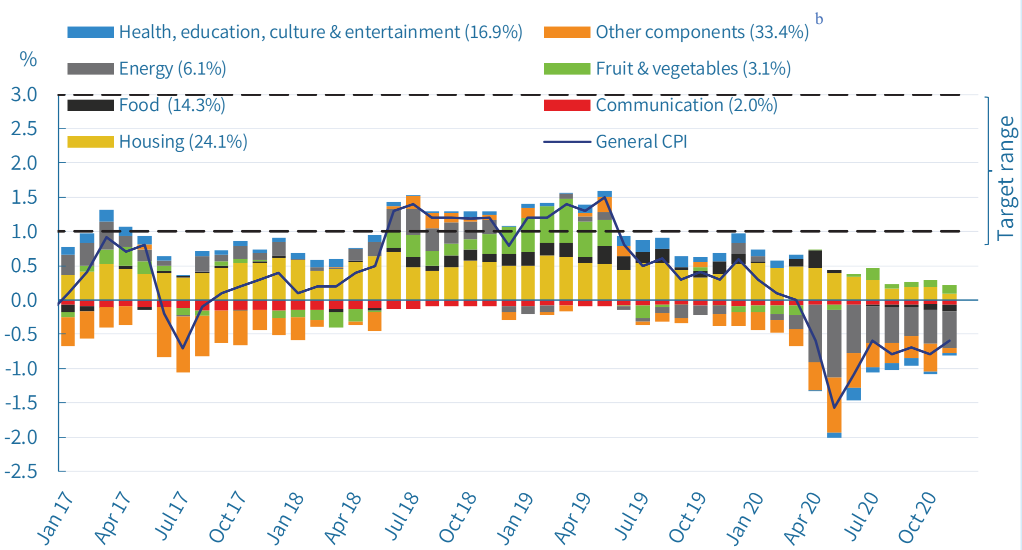
The Committee assessed that the inflation environment was probably impacted by two contrasting trends: there was marked weakness in demand in Israel and abroad, which was expected to work to lower prices, yet at the same time there was an adverse impact on the production chain of various products, which was expected to work toward price rises from the supply side. In accordance with the Committee's assessment with the outbreak of the crisis, and similar to assessments of other central banks—

the demand-side forces are more notable, and thus inflation was low and negative in the surveyed period as well.

The decline in the inflation environment, which began even before the outbreak of the coronavirus crisis, intensified with the onset of the crisis, and during the reviewed period, the inflation rate stabilized at a low level. The year over year inflation rate remained negative and below the lower bound of the target range during the half year. This was after in the years 2018–19 the year over year inflation rate stabilized around the lower bound of the target range for about a year, began to decline at the end of the second half of 2019, and its trend of decline continued in the first half of 2020, until the rate stabilized at the said lower level in the second half (Figure 3).

Figure 3
Contribution of the Main CPI Components to Annual Inflation[a]

January 2017-November 2020



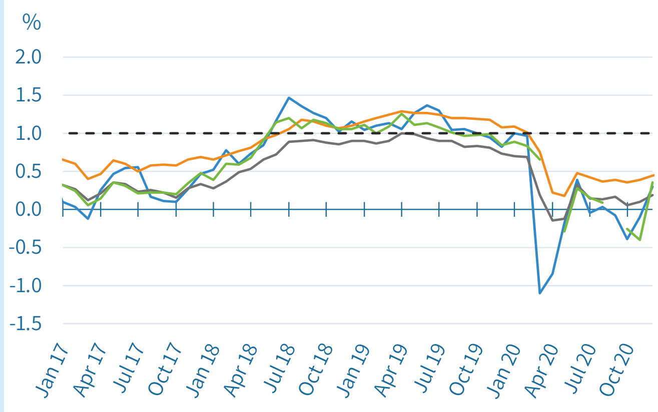
[a] The number in parentheses is the component's weight in the overall CPI index (as of 2019).
[b] "Other components" includes Furniture and Household Equipment; Clothing and Footwear; Miscellaneous; and the Dwellings Maintenance and Transport components minus the sub-components relating to energy prices.
SOURCE: Based on Central Bureau of Statistics.

The inflation environment remained low during the second half, and the year over year inflation rate is still negative, but some increase in it can be seen compared with the rate at the end of the first half. The inflation rate over the preceding 12 months is -0.6 percent. The inflation rate was in a trend of moderation even in the months before the outbreak of the crisis, but due to it, in April and May, it declined sharply (to a low of -1.6 percent in May), and in the reviewed period it stabilized at a low level of -0.6 percent. The moderation of inflation in the coronavirus period encompassed most CPI components. Major contributors to the moderation were the energy, housing, education, food and clothing and footwear components. The negative contribution of the energy component to the CPI moderated compared with the end of the first half, and in the past 12 months it contributed -0.5 percentage points to the CPI (Figure 4). The inflation rate in tradable goods, which declined sharply with the outbreak of the pandemic (-4.7 percent at the low in May), increased in the second half (with the rise in energy prices), and is at -1.8 percent. In contrast, the inflation rate in nontradable items moderated from 0.9 percent in April to 0.1 percent in October.

One-year inflation expectations from all sources declined during most of the second half of 2020 and remained below the lower bound of the target. Expectations derived from the capital market even reached negative territory, but toward the end of the half year returned to being positive. Forward expectations to all ranges remained essentially unchanged over most of the half year, and inflation expectations for the second and third years forward increased toward the end of the half year to 1.2 percent and 1.5 percent, respectively. It may be that their rise reflects optimism—the expectation of exiting the crisis in these time ranges due to the speed of the process of developing a vaccine and the beginning of the actual vaccination against the virus. Expectations for medium and longer terms (more than 3 years) remained anchored within the target range throughout the reviewed half year. The relative stability of expectations in this period was achieved after a sharp decline in March, with the outbreak of the coronavirus crisis, and an increase toward the end of the first half year (Figures 4 and 5).

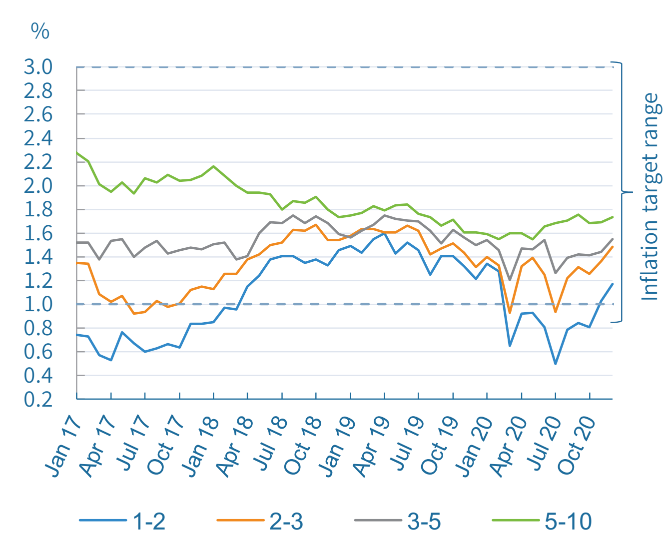
One of the main factors in the sharp decline of the inflation rate with the outbreak of the crisis is the decrease in

Figure 4
One-year Inflation Forecasts from the Various Sources[a]
January 2017-December 2020



[a] Monthly averages.
SOURCE: Bank of Israel.

Figure 5
Forward Inflation Expectations Derived from the Capital Market[a]
January 2017 to December 2020



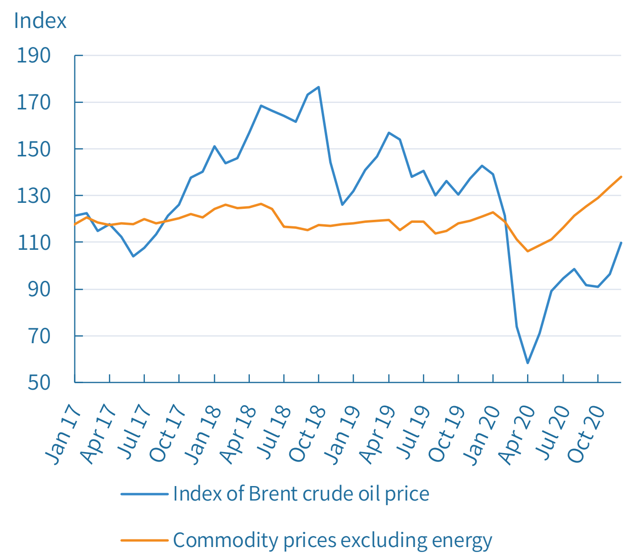
[a] Monthly averages.
SOURCE: Bank of Israel.

energy prices. These declined sharply by tens of percent with the beginning of the crisis and recovered in the second half. Similar trends, albeit at lower intensity, were also seen in commodity process (Figure 6). The CPI net of energy and fruit and vegetables was much less volatile—the intensity of both the decline and of the recovery from it at the beginning of the second half was much less than the year over year general CPI change. In May, the year over year change in the general CPI was -1.6 percent while the partial price index was -0.5 percent. At the end of the reviewed period, the gap between the two indices contracted against the background of the increase in energy prices—the year over year inflation rate was -0.6 percent in November, and the inflation rate net of energy and fruit and vegetables was 0.2 percent. It is important to note that although the inflation environment according to the partial price index was negative during the entire half year, but it was higher than according to the General CPI (Figure 7).

3. The exchange rate

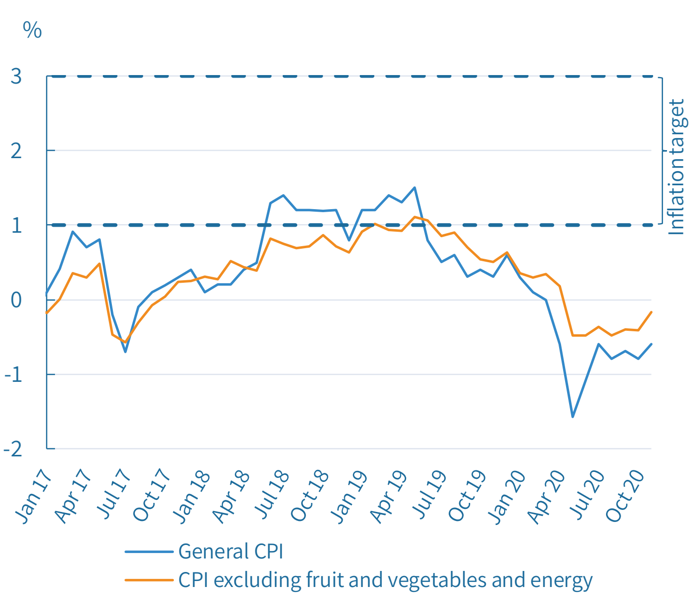
During most of the second half of 2020 the shekel strengthened slightly in terms of the nominal effective exchange rate, and in the last two months of the half there was a notable appreciation. This was mainly due to the appreciation of the shekel against the dollar. At the end of the second half, the shekel–dollar exchange rate was at a low level of NIS 3.2/$. During the second half of the year the shekel appreciated against the effective exchange rate by 2.6 percent and against the dollar by 6.9 percent, while it weakened against the euro by about 1.9 percent. The development over the course of the period was uneven—in September the shekel weakened slightly against the nominal effective exchange rate, in October

Figure 6
Commodity and Oil Price Indices, Monthly Average
January 2017–December 2020 (index)



SOURCE: Based on Bloomberg.

Figure 7
Development of the General CPI and the CPI Excluding Fruit & Vegetables and Energy
January 2017 - November 2020

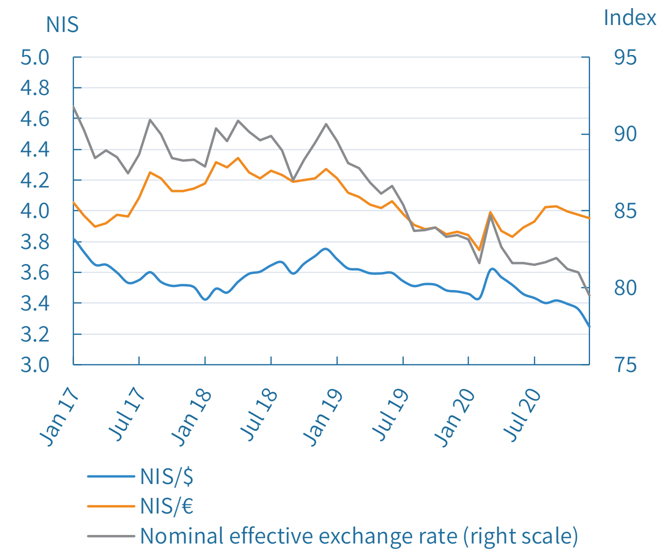


SOURCE: Based on Central Bureau of Statistics.

it strengthened a bit, and in November a notable strengthening was observed. In total, in the second half the nominal effective exchange rate hovered in a relatively narrow range. In its meetings, the Committee emphasized that the Bank of Israel continues to follow the foreign exchange market, and during the half year reviewed, it continued to purchase foreign exchange as needed (Figure 9).

This, as noted, was after a sharp depreciation developed at the beginning of the crisis due to a severe shortage in dollar liquidity. In order to provide the required liquidity, the Bank of Israel began to execute swap transactions, and thus led to a reduction of the volatility and an appreciation of the shekel. Since then, the shekel appreciated against the dollar, and the nominal effective exchange rate declined to a lower level l than what there was before the crisis (Figure 8).

Figure 8
Selected Exchange Rates, Monthly average
January 2017 - December 2020



SOURCE: Bank of Israel.

The Committee assessed that if the shekel stabilizes at this level, it will weigh on exports and on the return of inflation to within the target range, and against this background, the Bank of Israel continued to purchase foreign exchange over the course of the reviewed period.

In the reviewed period, the Committee analyzed the various forces acting in the foreign exchange market. The dollar weakened this year against most currencies, and the shekel was not notable in its appreciation against the dollar, among other things due to the Bank of Israel's policy in the foreign exchange market. The extensive investment in the Israeli economy and Israel is joining the WGBI global index led to an increase in the scope of nonresident investors' holdings of shekel assets. The continued surplus in the current account, together with the strengthening of exports and the weakness in imports during the crisis also strengthened the shekel. The Bank of Israel's foreign exchange purchases moderated the pace of appreciation and reduced the adverse impact of the worsening of global terms of trade among exporters.

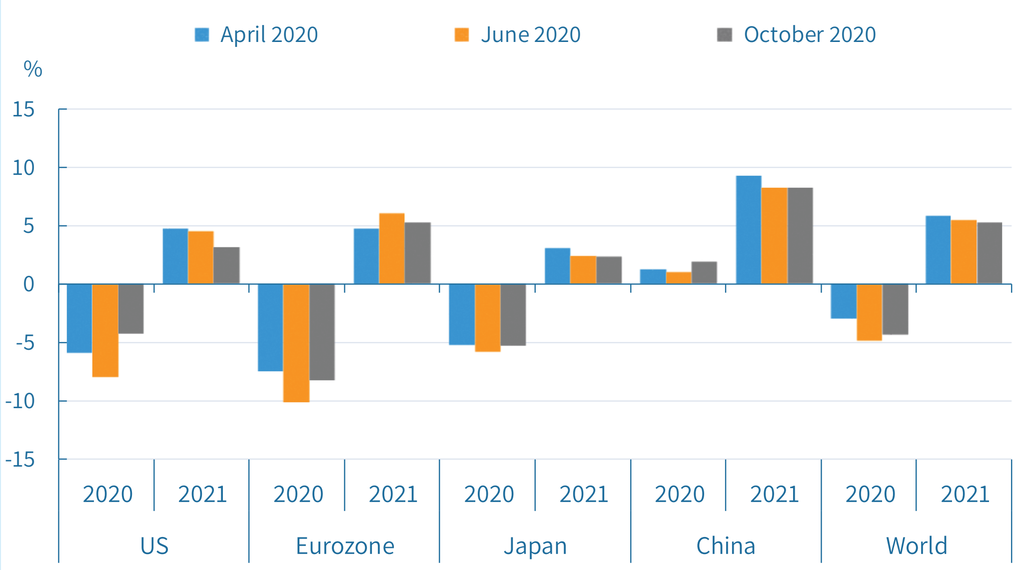
4. The global economy

The global economy contracted in 2020, apparently by about 4 percent, though in 2021 sharp growth of over 5 percent is expected. This is in view of the expected accelerated recovery from the crisis, due to the vaccine that is being distributed sooner than had been expected. Since the beginning of 2020, the eurozone has been notably poor in its economic contraction of about 8 percent, due to the strict and prolonged policy of lockdowns. The US is expected to end 2020 with a contraction of about 4 percent, as

a result of a more moderate lockdown policy. China was notable with positive growth of 2 percent, as it kept morbidity low beginning from the second quarter of the year and against the background of broad government investments and the strength of exports (Figure 9).

The positive impact of vaccine development progress on economic activity was reflected, particularly in European countries and the US, in a rapid recovery of activity in the third quarter. During the reviewed period, pharmaceutical companies Pfizer and Moderna announced better than expected results in Phase III drug trials, and toward the end of the reviewed half year they received FDA approval for use of the vaccines. A considerable portion of the companies that were far along in developing the vaccine established, even before the clinical trial phase, an infrastructure for mass production of vaccines, a step that allowed the distribution to various countries during December already.

Figure 9
IMF Annual Growth Forecasts for 2020 and 2021



SOURCE: Bloomberg.

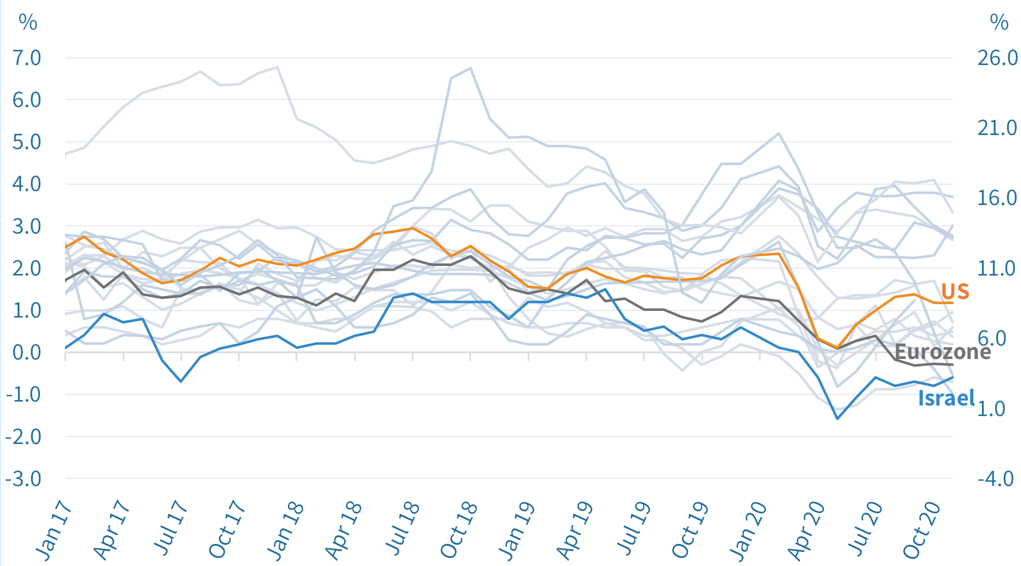
After the global Purchasing Managers Index declined to a very low level in April, mainly due to the weakness in the services sector, which was very negatively impacted by the lockdowns— a consistent recovery began in May, and the Index levels indicate the expansion of activity beginning in July. The recovery in activity was focused on the services and manufacturing industries. There was notably strong growth in the vehicle, banking, equipment manufacturing and real estate industries (which are proyclical) alongside continued weakness in the transportation and tourism industries, which are directly adversely impacted by the social distancing policy. World trade contracted in September by about 3 percent compared to September 2019, after its level in May was about 17 percent lower than in May 2019 and then recovered gradually.

The inflation environment in all economic blocs is below central bank targets—in nearly all of them the inflation rate declined in October, and it is expected to remain low in 2021 as well. With that, in the US, a trend of some increase in inflation is apparent in the reviewed period—the overall CPI is at 1.2 percent, and the core CPI is at 1.4 percent. Note that even a future increase of the inflation rate to over the central bank's target is not expected to lead immediately to a change in policy at the Federal Reserve, the US central bank, due to the switch to an average inflation target. Most of the weakness in inflation in recent months is based in services industries, which were negatively impacted by the coronavirus limitations, while goods prices are increasing at a solid pace (Figure 10).

Figure 10

Annual Inflation in Israel and Other Countries[a]

January 2017 - November 2020



[a] Eurozone, US, Switzerland, Sweden, Denmark, Norway, Czech Rep., South Korea, Canada, UK, New Zealand, Israel, Japan, Chile, Poland, Hungary, Australia, Mexico, China, and Turkey (right scale).

SOURCE: Blomberg.

During most of the reviewed half year, markets maintained some stability, but at the end they began to be very volatile, against the background of increased morbidity and lockdowns, US election results, and the publication of clinical trial results for vaccines against Covid-19. At the beginning of the reviewed period, equities traded lower, in view of the high morbidity in the US and Europe, which drove many countries in Europe to impose a partial lockdown for at least a month. Investors' concerns were also increased by the uncertainty regarding the US elections together with the understanding that a fiscal aid package will not be compiled before them. The publication of vaccine results led to increases on equity indices, together with a moderate rise in government bond yields. It is important to note that the market increases after the announcement of the vaccine's success were led by sectors that had been hardest hit in the past year, alongside weakness in technology stocks, which benefited from the sustained period of lockdowns.

The spread of the virus worldwide led many countries to implement various monetary tools. Central banks enhanced their monetary accommodation and took steps to increase liquidity, including interest rate reductions and asset purchase programs. Central banks of advanced economies implemented mostly nonconventional monetary tools, and less so the classical monetary tool of interest rate reductions, with rates already at near-zero levels in most of them (Figure 11). The Federal Reserve, as expected, kept the interest rate at the 0.0–0.25 percent level during the period reviewed, and continued to implement various programs to support markets and economic activity.

The European Central Bank (ECB) kept the interest rate at -0.5 percent and also continued its purchase program to deal with the Covid-19 crisis (PEPP[4]). However, toward the end of the reviewed period, against the background of the morbidity and the limitations that weigh on growth in Europe, it declared that it will examine adjusting the monetary tools. In a press conference in September, ECB President Christine Lagarde, spoke of the marked decline in growth forecasts[5], and noted that the risks of missing them clearly tend to the downside, and that it is likely that in the fourth quarter growth will return to being negative, compared with the ECB growth rate of 3.1 percent that the ECB had forecast before then. In the middle of November, at an ECB conference, Lagarde said that despite reports of progress with the vaccine, the ECB planned to expand the use of tools to deal with the economic crisis, and thus to encourage growth in Europe.

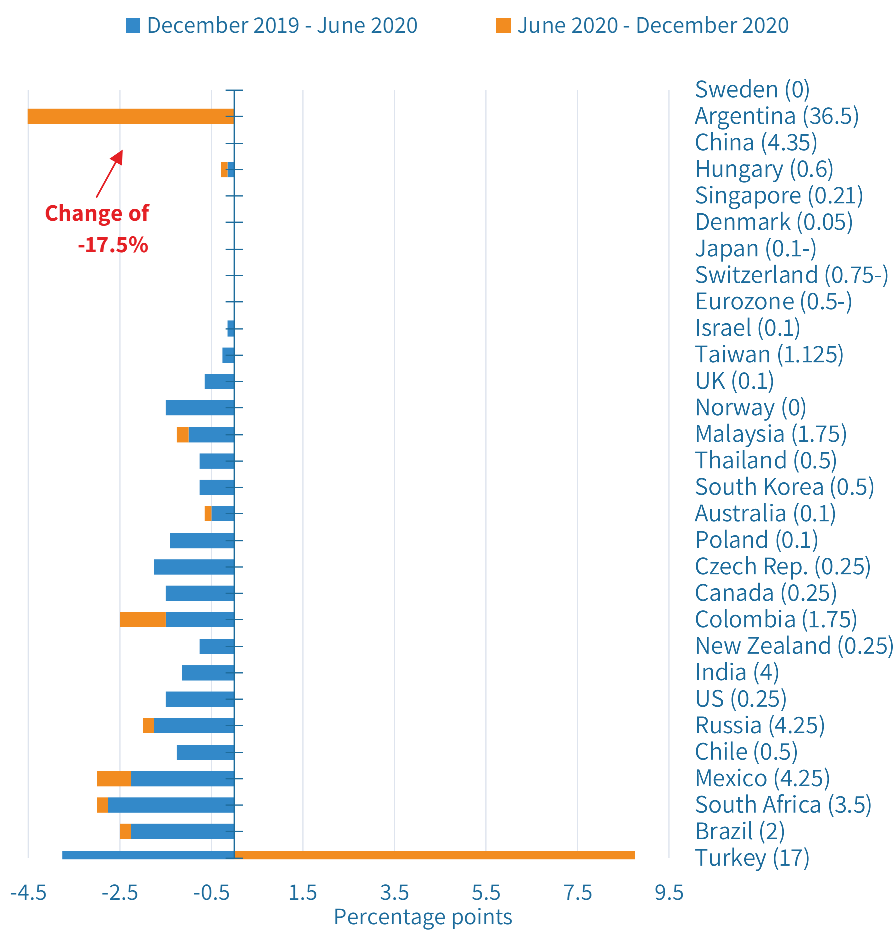
The Bank of Japan kept the interest rate unchanged at -0.1 percent, and will continue to maintain the 10-year yield around 0 percent. The Bank of Japan will also continue its purchase program and the plan to support the interest rate for businesses.

The Bank of England (BOE) kept the interest rate unchanged at 0.1 percent and expanded the scope of the plans to purchase government bonds, so that it will be able to continue with the plans in 2021 as well. This is against the background of weakness in growth and in the inflation rate, which was expected to become worse due to the increasing morbidity and the UK's entering a second lockdown in November. After the BOE's optimistic forecast in August for a rapid recovery, the forecast it published toward the end of the reviewed period was that GDP will only reach its pre-crisis level in early 2022, and that inflation will be low for a prolonged period of time (Figure 11).

[4] Pandemic Emergency Purchase Programme.

[5] In October and November, the ECB did not publish updated forecasts.

Figure 11
Changes in Central Banks' Interest Rates in Israel and Other Countries
June 2019–June 2020[a]



[a] In parentheses: central bank interest rates on December 31, 2020.
SOURCE: Bloomberg.

5. The credit market

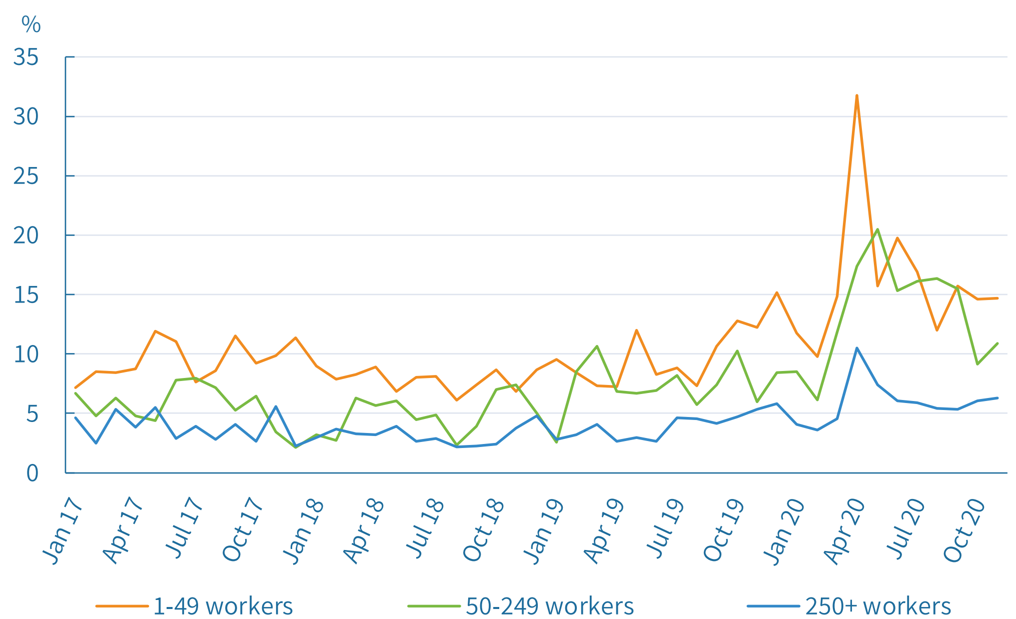
The longer the crisis period persists, the savings that enabled households and businesses that were negatively impacted to bridge over the loss of revenues are decreasing, and they require credit in order to endure this period, and all the more so as the crisis has adversely impacted small businesses and those people earning relatively low wages. Therefore, the Bank of Israel and Ministry of Finance implemented various policy tools in order to ease these credit difficulties (which will be detailed in this section). However, in view of the high uncertainty, and to the extent that the negative impact on demand persists, it is plausible that for considerable portion of the companies the demand for credit for investments will decline.

The bank credit balances, both for commercial credit as well as for small businesses, were stable throughout the half year. The interest rate on commercial bank credit and on credit for small businesses remained stable during the half year. In the households sector—bank credit for housing continued to increase, and consumer credit continued to decline, while the interest rates both on housing credit and on consumer credit remained stable.

Financing difficulties

The Business Tendency Survey conducted by the Central Bureau of Statistics indicates that against the background of Bank of Israel and Ministry of Finance steps, the trend of decline in the difficulty of raising funding continued, for both bank credit and nonbank credit. The indices are approaching the levels of before the crisis, although they are still high compared with the pre-crisis period (Figure 12). The credit spreads in the corporate bond market returned to approach pre-crisis levels. The share of returned checks also came back to near its level of 2019, despite the adverse impact of the coronavirus.

Figure 12
Constraints on businesses in receiving bank credit[a]
January 2017- November 2020



[a] Out of the participants in this survey. The numbers on the right scale indicate the share of companies reporting a severe constraint in receipt of bank credit.
SOURCE: Based on Central Bureau of Statistics.

Government guaranteed funds

In the beginning of March, with the outbreak of the coronavirus crisis, the Ministry of Finance opened, in a fund to extend loans to small and medium sized businesses, a special track for dealing with the effects of the coronavirus on businesses in the economy. The designated track for small and medium sized businesses expanded the scope of eligible businesses relative to the criteria before the coronavirus crisis—it increased the share of guarantees and improved terms for borrowers. The fund was expanded several times. The most notable expansion was on October 13, 2020—from NIS 18 billion to NIS 36 billion. Through January 3, there were 101,962 requests for the fund, of which 58,722 (about 58 percent) were approved. In terms of the financial scope—requests totaling NIS 63.9 billion were submitted, of which NIS 20.1 billion (about 31 percent) were approved. The share of the fund exhausted is currently about 56 percent.

In June a designated track for small and medium sized businesses at heightened risk opened. It provides guarantees at a high rate of 60 percent and is intended to assist businesses that have not had credit approved under the general track, or that the credit they received was insufficient for their needs. Through January 3, there were 4,923 requests for the fund, of which 3,999 (about 81 percent) were approved. In terms of the financial scope—requests totaling NIS 2 billion were approved, out of NIS 4.1 billion that were submitted.

A fund was also set up for large companies in industries that encountered cash flow difficulties during the coronavirus crisis. Through January 3, requests totaling NIS 3 billion were submitted, of which NIS 1.7 billion (about 57 percent) were approved. In recent months, there weren't notable changes in the activity of the fund. (The number of requests didn't change.) It may be that part of the businesses do not view the fund as an appropriate solution for them.

The special plan for expanding the supply of bank credit to small and micro businesses

On April 6, the Monetary Committee decided to implement a plan in which the Bank of Israel extended 3-year loans to banks at an interest rate of 0.1 percent, contingent on their providing credit to small and micro businesses. The program was implemented through the end of May. On July 6, the Bank of Israel announced the renewal of the loan program with no limitation on the amount, and put it into operation until further notice with the goal of increasing the supply of credit to small and medium sized businesses. As part of the program, through the end of December banks were given loans at a scope of NIS 19.6 billion against credit extended to such companies totaling NIS 34 billion. In October, the Monetary Committee decided to launch a new pillar in the plan to ease the providing of credit to small and micro businesses at a scope of up to NIS 10 billion, a pillar that will be operated until the end of June 2021.[6] The first allocation within this framework was made on December 24, 2020 and was based on banks' reports regarding the credit they provided in November.

6 For an expanded discussion see the "Monetary Policy" section in this report.

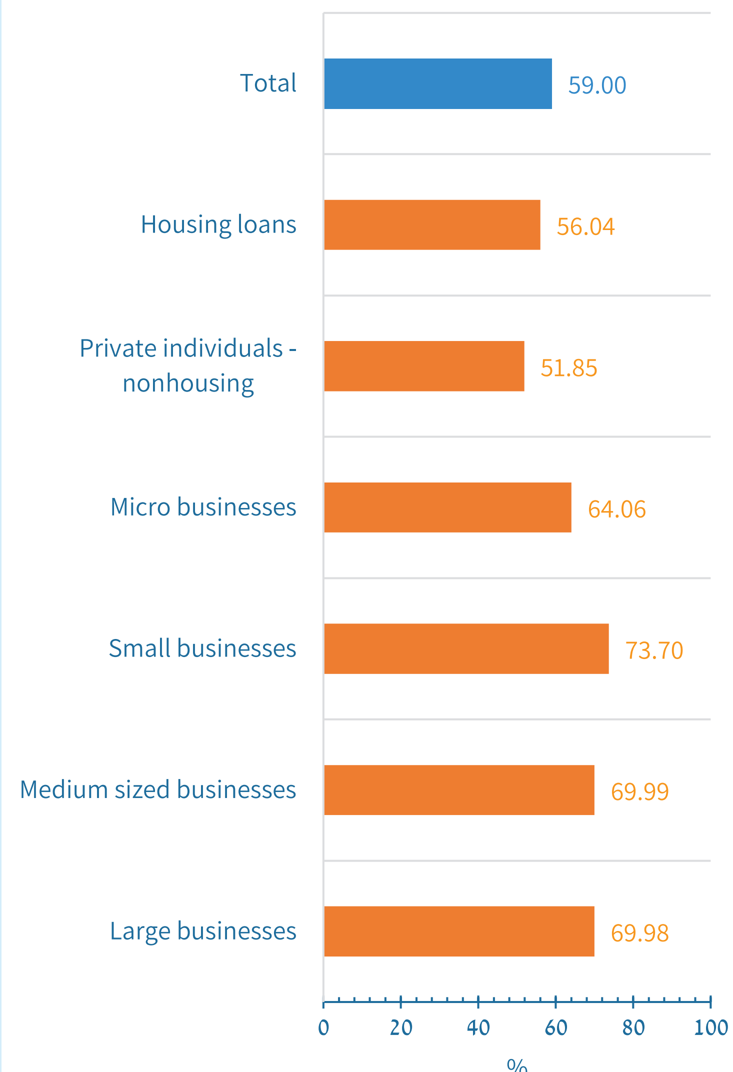
In the last days of the half year reviewed, after creating the legal and operational infrastructure, the July decision began to be implemented—allowing banks to pledge mortgage portfolios too as collateral against the loans they receive from the Bank of Israel in order to provide credit to small and micro companies, in addition to assets with high liquidity, such as government bonds. The use of this tool, which until now was operated mainly by the central banks of the US, Europe and the UK, increases the incentive for banks to extend credit to companies at relatively low cost and without eroding liquidity ratios. In addition, it enables the Bank of Israel to support the rapid flow of credit to the economy to the extent it is needed in the future.

Deferral of loan repayments

On May 7th, the Banking Supervision Department published a framework for the deferral of loan payments, which was adopted by the banking system. The framework allows for the deferral of payments in three activity segments – mortgages, consumer credit, and business credit. The framework was extended several times, allowed deferrals until December 31, 2020, and beyond that – based on the extension published on November 30 – only for a target population that was adversely impacted by Covid-19. On October 1, credit card companies also adopted a framework for deferring loan payments, and on November 30, that framework was extended as well.

As part of the framework, the banks deferred, from March until the end of December 2020, loan payments for hundreds of thousands of customers in all activity segments at a cumulative amount of about NIS 11 billion, and the credit in respect of which payments were deferred totaled NIS 161 billion (Figure 13).

Figure 13
Share of loans for which payments in respect of them were renewed, out of total loan balances
November 2020



SOURCE: Bank of Israel.

6. Financial market developments

In the first half of 2020, the spread of the coronavirus led to sharp declines on financial markets in Israel and worldwide. In response, many central banks, including the Bank of Israel, continued in the second half of the year as well to operate various asset purchase programs and to remove credit barriers to groups that needed it. This was to ensure that the markets remained liquid and to support their orderly functioning.

Financial markets maintained relative stability for most of the second half of 2020, and at the end there were price increases, among other things against the background of progress in the development of coronavirus vaccines and US election results. In Israel, the government bond yield curve steepened slightly, alongside higher yields in the nominal (unindexed) curve, similar to the trend worldwide, led by the US. Corporate bond spreads continued to narrow, alongside some increases in equity indices, but returns including equity markets in Israel this year are markedly lower compared with the rest of the world (Table 3).

Table 3

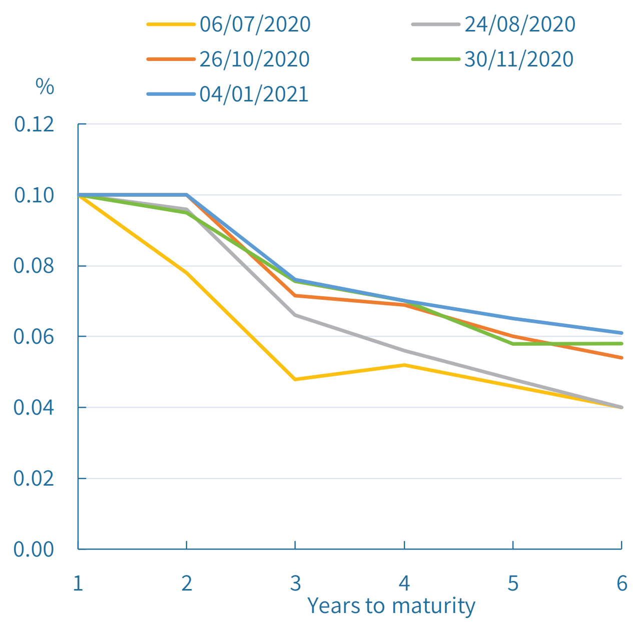
Development in the Domestic Asset Markets

	07/20	08/20	09/20	10/20	11/20	12/20
Yield to maturity (monthly averages, percent)						
3-month makam	0.0	0.0	0.1	0.0	0.0	0.1
1-year makam	0.0	0.0	0.0	0.0	0.0	0.0
Unindexed 5-year notes	0.3	0.3	0.3	0.3	0.4	0.4
Unindexed 10-year notes	0.7	0.7	0.8	0.8	0.9	0.9
Unindexed 20-year bonds	1.4	1.5	1.5	1.6	1.7	1.8
CPI-indexed 1-year notes	0.1	0.0	0.1	0.4	0.1	-0.2
CPI-indexed 5-year notes	-0.5	-0.6	-0.6	-0.6	-0.6	-0.8
CPI-indexed 10-year notes	-0.6	-0.6	-0.6	-0.5	-0.4	-0.5
Yield spread between government bonds and corporate bonds rated AA (percentage points)[a]	1.7	1.5	1.6	1.5	1.4	1.4
Stock market (rate of change during the month)						
General shares index	4.9	3.2	-4.1	1.5	9.9	4.1
Tel Aviv 35 Index	2.8	1.0	-6.2	1.7	9.9	2.5
Foreign exchange market (rate of change during the month)						
$/NIS	-1.7	-1.3	2.3	-0.6	-3.3	-2.8
€/NIS	4.0	-0.6	0.3	-0.8	-0.7	-0.5
Nominal effective exchange rate	0.8	-1.1	0.9	-0.6	-1.4	-1.5

[a] The calculation is based on fixed-rate, CPI-indexed bonds, excluding convertible and structured bonds, with a yield of up to 100 percent and a term to maturity of more than 6 months.

SOURCE: Bank of Israel calculations.

Figure 14
Forward Yield Curve based on Telbor Market Data on Interest Rate Decision Dates
July 2020 – January 2021



SOURCE: Bank of Israel.

Excluding banks, which in the reviewed half year raised about NIS 10 billion less than in the corresponding period of the previous year, there were positive net debt fundings[7] via corporate bonds. That figure including banks is essentially zero. The sentiment around this market continues to improve, as seen in the increase in the share of low-rated issuances (A+ and lower) in the reviewed period to about 50 percent of total issuances, compared with about 20 percent in May. This figure points to an increase in investor confidence and on the possible renewal of the possibility for companies that are not highly rated to restructure debt and to raise new debt. Bond spreads continued to decline, and they are approaching their pre-pandemic levels (particularly in the banking and trade industries). This is against the background of BOI policy to purchase corporate bonds in the secondary market.

In the second half of the year, there was some increase in Israel's equity market, but overall returns in Israel this year are markedly lower in global comparison and are similar to the European index. Global equity indices, unlike in Israel, were higher at the end of the reviewed period than those before the outbreak of the Covid-19 crisis. The reason for the domestic weakness is apparently the high share of real estate and bank stocks in the overall index—these are procyclical sectors that were negatively impacted by the crisis, but they are expected to outperform when exiting from it. Proof of this can be seen in the publication of the reports on the success of the trials to develop a vaccine, toward the end of the half year, when an increase was seen in the bank and real estate stock indices in Israel, by about 9 percent and 14 percent, respectively, alongside a decline in the technology shares index (2 percent). This explanation is supported by the results of a Bank of Israel Research Department study—it was found that the gaps between Israel's Tel Aviv 125 Index returns and the US S&P 500 Index derive from the indices' industry composition, rather than their stock returns (Table 3).

In the mutual funds industry, the net new investments since April continued, though the scopes are still very small compared with the large withdrawals in March (more than NIS 40 billion). Most of the net new investments in the reviewed period were in domestic bonds and foreign stocks, and they were mainly in the last weeks, as part of the improved market sentiment.

Assessments from the Telbor market and projections of professional forecasters reflected an expectation of a more accommodative policy in the future—some positive probability of an interest rate reduction.

[7] Net debt fundings are issuances less expected maturities.

Estimates for a change in the Bank of Israel's interest rate based on the Telbor market and on forecasters' assessments were not markedly changed in the second half. The 3 month Telbor rate is 0.08 percent and 3–6-month forward interest rate is 0.07 percent (Figure 14), while the 9-12 month forward interest rate is 0.06 percent. This means that the Telbor market estimates that in the coming year the Bank of Israel's interest rate will remain positive, and that the probability that in the next three months the Bank of Israel will lower the interest rate to zero is only 20 percent. Forecasters' average projection for the interest rate in twelve months is 0.08 percent. The data apparently reflect an assessment by the market that the Bank of Israel may operate a variety of other unconventional monetary instruments other than the interest rate tools, as it has since done the outbreak of the coronavirus crisis, against the background of interest rates being close to zero (Figure 14).

7. Fiscal policy

The deficit increased sharply against the background of the spread of the coronavirus, due to the limitations imposed on mobility and on activity and the fiscal steps taken by the government. In accordance with the Research Department's forecast, the deficit at the end of 2020 is expected to be about 12 percent of GDP. Approximately three-quarters of the deficit are attributed to the ramifications of the Covid-19 pandemic—half due to growth of expenditures and a quarter due to declines in tax revenues due to the response of GDP to the crisis. In discussions on fiscal policy throughout the half year, Committee members expressed concern about the continued uncertainty: from the economy operating without a budget in 2020, from the lack of an orderly state budget for 2021, and the reliance on an interim budget that was approved in 2018, particularly against the background of additional elections.

The general government deficit (excluding the providing of credit) in the last 12 months (November 2019–October 2020) amounted to 10.1 percent of GDP, and is approaching its expected share at the end of the year, about 12–13 percent of GDP. The domestic deficit since the beginning of the year was NIS 118 billion, compared to NIS 34 billion during the corresponding period of the previous year. After the deficit increased through June, due to increased government spending on aid programs and a marked reduction in tax revenues, its growth since June has mainly been due to the expansion of government aid, with some recovery in tax revenues, which resulted from economic developments.

In view of the restrictive character of the interim budget, the Knesset approved an increase in the expenditure framework by NIS 11 billion, so that the "regular" expenditure framework will be about NIS 411 billion. (The expenditure ceiling for 2020 according to the law is NIS 412 billion.) In addition, to date, additional specific spending budgets totaling NIS 97 billion were approved, in respect of the various aid programs for dealing with the coronavirus crisis.[8] The economic safety net is expected to be operated in 2021 as well, and to that end so far, specific spending budgets totaling NIS 52 billion have been approved. Utilization of the interim budget is about 104 percent of the expected seasonal path, and utilization of the coronavirus budget is at 86 percent of the cumulative amount allowed to be spent by the law through the end of October.

[8] Includes the budget that the National Insurance Institute is expected to pay, totaling an additional NIS 10-12 billion, from its surpluses balance, due to the increase in the number of workers placed on unpaid leave.

Government revenues[9] to date are NIS 28 billion lower than expected according to the January 2020 forecast. The decline in revenues at the beginning of the crisis derived from a decrease in all the main tax components (income tax, domestic Value Added Tax, and import taxes), but since the beginning of June, VAT revenues from employees and the self-employed have recovered, while import taxes, fuel and company advances continued to essentially remain in place.[10]

8. The housing market

After the moderation in the pace of increase of rent[11] prices in the first half, their pace of increase rose for most of the reviewed period, alongside a stable increase in the Home Prices Index. This is seen in the Owner Occupied Housing Services Index, which increased by 1.7 percent in the 12 months through October, by 1.6 percent through September, and by 1.4 percent in July and August. In contrast, the latest data published in the reviewed half year (through November) indicates an increase in the Index of only 1.1 percent, the lowest rate since July 2008. Home prices, as they are reflected in the survey of home prices, increased at a stable annual pace of 2.5 percent, and since the beginning of the crisis the average annual pace of increase is 2.5 percent (Figure 15).

Figure 15
Home Prices Survey and Owned Dwelling Price Index
January 2017– November 2020

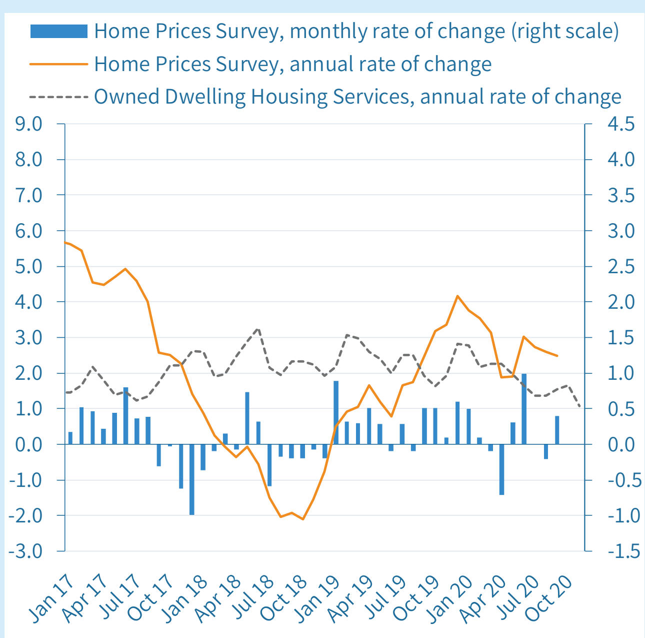
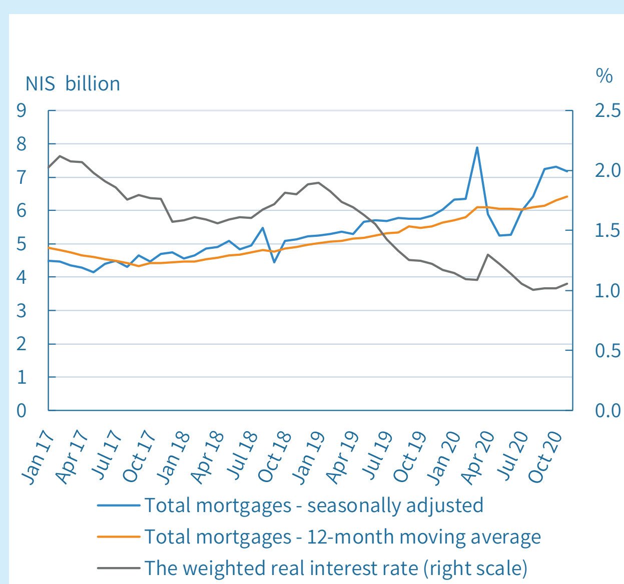


Figure 16
Total New Mortgages
and the Weighted Real Interest Rate on Mortgages
January 2017 - November 2020



SOURCE: Bank of Israel - Banking Supervision Department.

[9] Includes National Insurance payments, health tax, and other revenues such as royalties and dividends from government companies.

[10] Recall that because of the timing of revenues and payment of unemployment benefits and grants, the data in this report do not reflect the ramifications of the marked contraction of activity during the lockdown that began in the middle of September. These will be fully reflected only in November data, when the grant to businesses in respect of lower revenues in September-October is distributed, and the collection of VAT on activity during the lockdown period ends.

[11] The cost of rent reflects the Owner Occupied Housing Services Index.

Carmen real-estate database data and the estimated number of new home transactions indicate that after a decline in the months of the first lockdown, they remained relatively stable in September and October, but at a more moderate level than the months of June–July.

The upward trend in mortgage volumes, which began in May, continued throughout the entire half year, following a marked decline at the outbreak of the crisis. Mortgage volume (seasonally adjusted) was NIS 7.2 billion in November (Figure 16). An examination of the loan tracks shows that the share of unindexed, fixed rate loans increased slightly, in parallel with a slight decrease in the share of unindexed loans at variable interest rates (and stability on the other tracks). The weighted real interest rate on mortgages was stable, and the gap between it and the real yield on 10-year government bonds narrowed slightly. An examination of the risk indices shows that the average LTV[12] ratio remains stable at 54.5 percent. The PTI[13] ratio also remained stable, at 25.5 percent.

9. The Research Department's macroeconomic forecast

The Research Department published four forecasts during the period reviewed, together with the interest rate announcements—in July, August (an unscheduled update), October, and January. In addition to the October forecast, there was a special update in November, which was presented to the Committee, of growth data in 2020, in view of the encouraging growth data in the third quarter. Throughout most of the second half, the Research Department's macroeconomic forecasts presented two possible scenarios, and during its course, among other things, the forecast unemployment rate was revised upward.

In terms of the two scenarios presented in the January forecast—a scenario that includes rapid vaccination of the population by May 2021 (hereinafter, "the rapid vaccination scenario") and a scenario that includes a vaccination process that continues for a longer period of time, through June 2022 (hereinafter, "the slow vaccination scenario"). For now, given the rapid rate of vaccination over the past few weeks, it appears that as of the time the report was published, the probability of the materialization of the rapid vaccination scenario is considerably higher than that of the slow vaccination scenario (Table 4).

In the rapid vaccination scenario GDP is expected to grow by 6.3 percent in 2021 and by 5.8 percent in 2022. The inflation rate for the next four quarters (ending in the fourth quarter of 2021) is expected to be 0.6 percent, and 0.9 percent in 2022. The broad unemployment rate (ages 15+) is expected to decline by the final quarter of 2021 to 7.7 percent of the workforce, and to continue to decline gradually to 5.4 percent at the end of 2022. The government's deficit is expected to be 8 percent of GDP in 2021 and 3.6 percent of GDP in 2022, so that the debt to GDP ratio will be 77 percent and 75 percent of GDP, respectively. This assumes that the government will adopt policy measures (reducing spending and raising taxes) of magnitudes consistent with the restraint derived from the expenditure ceiling set by law. Without such an adjustment, the expected expenditures based on existing decisions will result in a deficit of approximately 4 percent of GDP in 2022.

In the slow vaccination scenario, GDP is expected to grow by 3.5 percent in 2021 and by 6 percent in 2022. The inflation rate for the next four quarters (ending in the fourth quarter of 2021) is expected to be 0.1

[12] The Loan to Value ratio (the share of the mortgage out of the total value of the mortgaged asset.)

[13] The Payment to Income ratio (the share of mortgage repayments out of total household income.)

percent and in 2022 to be 0.8 percent. The broad unemployment rate (ages 15+) is expected to decline to 11 percent by the final quarter of 2021, and to continue to decline to 7 percent at the end of 2022. The government's deficit is expected to be 11 percent of GDP in 2021 and 6 percent of GDP in 2022, so that the debt to GDP ratio in each of the two years will be 82 percent GDP.

As for the two scenarios for 2020 presented in the October forecast[14] - in a scenario where control of the epidemic will be achieved, GDP was expected to contract by 5 percent in 2020 (4.5 percent in the August forecast, a figure that was updated in November to 4.5 percent), and the broader unemployment rate was expected to be about 17 percent of the workforce in the last quarter of 2020 (11.5 percent in the August forecast). In contrast, in the more severe scenario, there was an estimate of a contraction of 6.5 percent of GDP (7 percent in the August forecast, a figure that was updated in November to 5 percent) and a broad unemployment rate of about 20 percent (13.6 percent in the August forecast) (Table 4). Some of the Monetary Committee members assessed that the contraction of GDP in 2020 will be even lower if the control scenario is achieved,

For 2021, in the control scenario, growth of 6.5 percent (6 percent in the August forecast) was expected, compared with only 1 percent in the more severe scenario (3 percent in the August forecast). The broad unemployment rate in the control scenario was expected to be 7.8 percent (7.7 percent in the August forecast), while in the more severe scenario it was expected to be 13.9 percent (12.1 percent in the August forecast) (Table 4).

The deficit and debt to GDP ratio in the control scenario were expected to be about 13 percent and 73 percent in 2020, respectively (13.2 percent and 75 percent in the August forecast), and about 8 percent and 76 percent in 2021 (8.2 percent and 78 percent in the August forecast). In the more severe scenario, the deficit and debt relative to GDP were expected to be 13 percent and 75 percent in 2020, respectively (14.6 percent and 78 percent in the August forecast), and in 2021 an 11 percent deficit and a debt to GDP ratio of 83 percent (12 percent and 87 percent in the August forecast) was expected (Table 4).

In July, when the Research Department was still presenting one central forecast, a significant update was introduced in its forecast. This is due to the increase in morbidity data, which later delayed the return of economic activity to routine, and due to global developments. The growth forecast for 2020 was then revised downward by 1.5 percentage points (to -6 percent), and for 2021 it was revised upward (to 7.5 percent). The decline in GDP that was expected for 2020 encompassed all uses, except for public consumption, impacted by the additional fiscal measures adopted to encourage activity and employment. The assessments in July were for a slower recovery in the labor market - a 0.5 percentage point increase in unemployment in the final quarters of 2020 and in 2021. The inflation rate expected in the forecast was revised downward by close to 1 percentage point for 2020 and remained unchanged for 2021 (Table 4).

During the half year, the Committee discussed the economic risks to the forecast, which depend mostly on epidemiological developments—the features and the number of closures, which are liable to differ from assessments, the effectiveness of the closures, the level of morbidity in winter and the rate of the public's vaccination against COVID-19—but also on other economic risks, such as further weakening of activity abroad, government measures, and political and budgetary uncertainty.

[14] The October forecast is presented as a comparison to the August forecast (and not the July forecast) because it was only in the August forecast that the Research Department presented for the first time two scenarios, and not just one central forecast as had been done until then.

Table 4

Research Department Forecast

(Rate of change in percent, unless otherwise noted)

Forecast for year:	2020						2021							2022	
Date of forecast	07/20	08/20		10/20		01/21	07/20	08/20		10/20		01/21		01/21	
Scenario		Control	Severe	Control	Severe			Control	Severe	Control	Severe	Rapid vaccination	Slow vaccination	Rapid vaccination	Slow vaccination
GDP	-6.0	-4.5	-7.0	-5.0	-6.5	-3.7	7.5	6	3	6.5	1	6.3	3.5	5.8	6.0
Private consumption	-6.5	-7.5	-10.5	-8.9	-10.5	-11.0	8.5	9	6.5	9.9	4.9	12.5	7.5	8.0	10.5
Fixed capital formation (excluding ships and aircraft)	-13.5	-7.5	-8.5	-7.7	-8.2	-7.5	5.5	4.5	1.0	3.9	0.3	3.5	-1.5	8.5	7.5
Public consumption (excluding defense imports)	4.5	7.0	7.0	-7.1	7.1	3.0	2.5	1.0	1.5	0.9	1.2	6.5	6.5	-1.0	-1.0
Exports (excluding diamonds and startups)	-13.0	-4.0	-6.5	-3.6	-4.4	1.5	7.5	4.0	2.0	3.9	1.3	3.0	2.0	4.5	4.5
Civilian imports (excluding diamonds, ships and aircraft)	-14.0	-7.5	-10.0	-8.0	-8.7	-12.0	6.5	7.0	4.5	6.5	4.9	11.0	6.5	1.5	10.5
Unemployment rate (ages 25-64, yearly average)	6.2	4.9	5.9	4.2	4.5		7.4	6.9	9.2	6.9	9.4				
Employment rate (ages 25-64, yearly average)		74.9	74.2	75.5	75.2			72.6	70.8	72.6	70.6				
Broad unemployment rate (ages 15+, yearly average)		13.9	15.0	15.7	16.6	15.8		9.5	12.6	10	16.7	9.6	12.5	6.2	8.5
Broad unemployment rate - end of year (ages 15+, yearly average)		11.6	13.6	16.7	20.2	16.3		7.7	12.1	7.8	13.9	7.7	11.0	5.4	7.0
Government deficit (percent of GDP)				13.0	13.0	12.0				8.0	11.0	8.0	11.0	3.6-4	6.0
Inflation rate[a]	-1.1	-1.0	-1.5				0.7	0.4	0.9	0.6	0.1				

Date of forecast	07/20	08/20		10/20		01/21	
Scenario		Control	Severe	Control	Severe	Rapid vaccination	Slow vaccination
Inflation in the coming year[b]	-0.1	0	-0.6	0.3	-0.2	0.6	0.1
Inflation in 1 year from now[c]	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1

[a] Average of CPI in the final quarter of the year vs. the avergae CPI in the final quarter of the previous year.

[b] Over the 4 quarters ending in the corresponding quarter of the next year.

[c] In the corresponding quarter in the next year.

SOURCE: Bank of Israel.

10. The expected paths of inflation and growth

Due to the spread of the pandemic, the Committee was of the opinion that the inflation environment will remain low for a considerable time, and that the decline in inflation was the result of a combination of two opposing trends: there was significant weakness in demand in Israel and abroad, which was expected to lead to price declines, yet at the same time there was a negative impact on the production chain of various products, which was expected to work towards price increases from the supply side. According to the Committee's assessment at the outbreak of the crisis, and similar to the estimates of other central banks, the forces from the demand side are more significant, and indeed inflation during the reviewed period was low and negative.

The rate of convergence of the inflation rate to its target will be slower than assessed at the beginning of the crisis and before it. The Committee estimated that inflation would approach the target's lower area, but may still remain below it until the end of 2022.

With regard to growth, Committee members estimated that against the background of worsening morbidity, activity in 2020 would contract markedly, and unemployment would remain high. The Committee projects that activity will improve in 2021, but at the end of the year the level of unemployment will still be higher than it was before the crisis.

The Committee estimated that the strengthening of the shekel against the dollar in the last quarter of 2020, against the background of a significant weakening of the dollar worldwide, is liable to adversely impact exports, and is expected to act toward a further slowdown in the inflation rate.

The Committee members emphasized that in view of the coronavirus crisis, the future paths of inflation and activity are uncertain because the global and domestic crises are unprecedented in scope and characteristics, making it difficult to assess their economic effects and intensity. Future developments depend on, among other things, the speed of recovery. The Committee noted that it will continue to monitor developments in the domestic and global economies, and would take policy steps to support real activity, the stability of financial markets, the credit market, and the return of inflation, even if only slowly, to around the target range.

Toward the publication date of the report there have been changes in risk characteristics. The uncertainty related to the epidemic appears to have contracted markedly, against the backdrop of the beginning of vaccination in major economies, as well as in Israel. In contrast, political and fiscal uncertainty in Israel seems to have increased. The vaccination against the coronavirus increases optimism about the economy's rapid return to a path of growth in the coming year in accordance with the rapid vaccination scenario in the Research Department's forecast. However, the negative impact on the economy, particularly the labor market, is expected to be prolonged. In discussing fiscal policy, Committee members expressed concern over the continued political and budgetary uncertainty in view of the economy operating without a budget in 2020 and the lack of an orderly state budget for 2021, especially against the backdrop of holding a fourth election in Israel in the coming months in a relatively short period of about two years.