Yaron Amir: From the financial crisis to today - the stability of the Israeli economy

Remarks by Mr Yaron Amir, Governor of the Bank of Israel, at the Annual Conference of the Aaron Institute for Economic Policy, Herzliya, 16 May 2019.

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Summary:

- **The global economy is showing signs of a slowdown, but an analysis of the markets and risks does not indicate a prudential risk level similar to what it was prior to the 2008 crisis.**
- **The leverage rates in Israel are not high by international comparison, and the financial system in Israel is more resilient than in the past. We must continue monitoring and taking measures that will strengthen the resilience of the system.**
- **It is important to maintain the improvement in the debt-to-GDP ratio, which is a strategic prudential asset for the Israeli economy.**
- **The technological improvements that have been adopted, and those that will be adopted in the future, by the financial system have benefits, but also risks that we must manage intelligently.**

In my remarks today, I will relate to the question of whether recent developments in the global economy bring to mind those of 2008. The answer is, No. Even though global forecasts are being revised downward for the first time in a number of years, the intensity of those revisions is much more moderate than prior to the global crisis. From a global point of view, most of the sectors seem less vulnerable than they were prior to the Global Crisis. Regarding Israel, we can say that the economy is in good shape, and the growth forecast currently seems stable. Despite this, there are developments that we must take not of. I previously defined them as “grey clouds on the horizon” that—should they worsen—could also affect Israel.

At the outbreak of the Global Crisis in 2008, there was a sharp and rapid decline in the global economic growth forecasts, and the Israeli economy, like others around the world, was exposed to the financial distress that developed, which was signaled in the stock indices, growth rates, and unemployment rates. While the economy was negatively impacted by the financial crisis, the effect as more moderate that most of the other advanced economies, due to the background conditions that were prevalent in Israel at the time. The economy was robust after four years of rapid growth; the various governments conducted a responsible fiscal policy for most of the time, which led to a prolonged decline in the burden of public debt; and the deficit was near zero prior to the crisis. These were accompanied by conservative management of the financial system, particularly the banking system, which is closely supervised in Israel. This led to a situation where, in contrast to many countries, there was no development in Israel of over-leveraging or asset price bubbles.

These background conditions led to a situation where, despite the drop in the capital market, and increased credit margins and risk premium in the economy, the financial institutions in Israel were resilient. No institution collapsed, and in contrast to the situation in most of the advanced economies, where dozens of banks collapsed and governments were forced to inject immense amounts of taxpayers’ money, the devolution of the crisis from the financial markets to the real economy was avoided in Israel, and the public was spared immense damage. The main policy lessons from the Global Crisis are that **actions should be taken in advance to minimize the risk of crises developing and the intensity of the damage from them.** IMF Chairman Christian Lagarde described this well in coining the term, “The time to repair the roof is when the sun is shining." Another important lesson is that when a crisis does happen, a rapid and wide-scale response by monetary policy is required, using a variety of tools and rapid steps to regain stability.

An in-depth look at the Israeli economy today shows that the economy's financial strength is composed of a number of main layers:

1. **The credit market and macroprudential measures**: Household and small business leverage in Israel is low by international comparison, and household debt in Israel has not significantly increased over the years. The Bank of Israel was among the first central banks in the world to implement macroprudential measures that succeeded in preventing overleveraging despite the low interest rate, and enabled monetary policy to focus on achieving its main goals.

2. **Risk-based supervision of the financial institutions**: In the decade that has passed since the crisis, the Banking Supervision Department has worked to strengthen the banking system's capital buffers and its resilience against various shocks is constantly tested by the Department through a variety of stress tests, the findings of which are implemented at the banks under the Department's guidance. For instance, the stress test carried out in 2016 examined the system's resilience to another global crisis, and its results showed that the banks would register heavy losses in the credit portfolio, but that these would not put the stability of the banking system at risk. **I will provide you today with a first peek at the new stress tests conducted by the Banking Supervision Department this year, which will be published shortly:** These tests examined the system's resilience against a serious domestic macroeconomic situation resulting from geopolitical events. The results show that the scenario would have a significant impact on the banking system, but that it is not expected to put the stability or strength of the system at risk, even though some of the banks would register losses. The result shows the efficiency of the demands posed by the Banking Supervision Department on the banks in recent years in strengthening the banks' stability, chiefly the significant strengthening of capital. Despite these results, we must not be complacent. We must continue thinking of where the next crisis may come from, and continue monitoring and strengthening the system's resilience. The stress tests this year also show that the risk in the housing credit portfolio is lower than in the other bank credit portfolios. The quality of the housing credit portfolio has improved in recent years, as a result of the more stringent criteria for providing mortgages (underwriting), resulting from the Banking Supervision Department's directives over the years.

3. **Adapting the regulatory environment to the changing financial environment**: The credit market is becoming more varied, and the increase in competition on the part of institutional investors is changing the structure of private debt in the economy. These make it necessary to adopt a more comprehensive regulatory vision. The current situation is that regulation of nonbank financial entities, particularly regulation over the provision of consumer credit, is not identical to regulation over the banks. While the difference in the nature of activity between the entities justifies certain regulatory differences, it is important to make sure that these differences do not develop into regulatory arbitrage, which may, under certain circumstances, create a systemic risk. In this context, the Financial Stability Committee is an important element in narrowing the regulatory gaps and identifying the risks.

4. **Foreign exchange reserves**: The foreign exchange reserves, which are a financial security buffer for the economy, were increased significantly prior to the crisis, and their level in relation to GDP has been maintained since then.

5. **Fiscal responsibility**: In the past decade, there was an impressive prolonged decline in the burden of public debt. But in 2018, that debt increased slightly. In recent months, there has been an apparent deviation from the deficit target, and the deficit level in Israel is particularly high given the good state of the economy. The Israeli economy got a good illustration of the importance of fiscal discipline during the Global Crisis of 2008, when the fiscal strength prior to

the crisis enabled fiscal and monetary policy to support a recovery. In comparison, during the 2002 crisis, the sharp increase in the deficit and in the debt-to-GDP ratio forced policy makers to adopt a policy of restraint. The economy is currently in good condition, and the prolonged decline in the debt-to-GDP ratio, as well as fiscal responsibility, provide security buffers for times of crisis. In order to maintain this strategic asset, the new government will have to make fiscal adjustments, and it is worthwhile making them while the situation is good, since they will be more difficult to implement if economic conditions worsen. The required adjustments are a mix of streamlining, narrowing the increase in expenditures, and increasing revenues, while expenditures that support growth and increased productivity should be kept. The government must plan the budgets for the coming years such that the path of the debt-to-GDP ratio doesn't diverge, and that it returns to a downward trend over time.

To conclude, I would like to touch on possible future changes in the financial system, and to discuss their possible benefits and their implications on stability. There are advanced financial instruments that deepen the markets and contribute to economic efficiency. In this context, the Israeli market still has where to advance, and we will all be better off for it. I will illustrate this through the example of the securitization market. In Israel, this market is very small, and it is difficult to conduct securitization transactions, since the appropriate legislative, taxation, regulation, and accounting infrastructure is lacking. The lack of securitization negatively affects the efficient allocation of the capital markets and economic efficiency, and the issue should be advanced while providing a response to the inherent risks. The interministerial work on the issue was completed a while ago, and the legislation must now be advanced. In addition, technological innovations are changing, and will yet change, the map of financial opportunities and risks, in the world as well as in Israel. The Central Credit Register and applications developed alongside it, the project to enable easy movement from bank to bank, API open banking that strengthens the customer's control over financial information and creates a new world of financial services, and the establishment of faster payment infrastructure, will enable the broad public to make payments and transfers, and in the future complex transactions, easily, rapidly, immediately, and inexpensively, as new participants enter the payments market and competition increases. All of these changes bring benefits, but also contain risks. The Bank of Israel is determined to support the adoption of financial technologies while maintaining the system's stability and reducing risks.

Thank you.