Twenty years of financial liberalisation in Israel: 1987–2007[1]

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I. Introduction

In May 2006, Warren Buffet's US-based Berkshire Hathaway acquired 80% of the stock of Israel-based Iscar Metalworking Companies for USD 4 billion, this being its first acquisition of a firm outside the United States. A while after the acquisition, Mr Buffet said in an interview that "Iscar is a dream deal. It has surpassed all the expectations I had when buying the company and my expectations had been very high". Isaac Tshuva is an Israeli businessman who started his career as a small local real estate entrepreneur and nowadays has the controlling interest in several transnational investment and holding companies. In 2004 Mr Tshuva bought the Plaza Hotel on Fifth Avenue for USD 675 million. These two deals, despite their outstanding value in Israeli terms, are only two examples of the increasing involvement of Israeli business people and firms in the global economy to an extent that would have been deemed inconceivable or impossible 20 years ago.

In 1984, Israel's public debt/GDP ratio reached 284% and the State of Israel was close to debt repudiation. At the end of 2006 the ratio was 87%, and at the end of the second quarter of 2007 the economy's total net liabilities were about USD 22 billion, with a total net debt instrument asset surplus of USD 38 billion.[4] These factors imply an improvement in the financial position of the economy and a rapid increase in its openness, expressed by the growing activity of Israeli residents abroad (Graph 9). Twenty years ago the government was diverting a large part of private savings to its budget via administrative measures: there were many restrictions on financial activity, including foreign exchange activity of both Israelis abroad and non-residents in the domestic economy (Ben Bassat (2002)). The supervision of foreign exchange activity had been very strict, and it was almost impossible to do business without the intervention or the permission of the Israeli authorities. For example, there was a quota on the amount of foreign currency that Israelis could take abroad, and residents could not hold real assets abroad (Michaely (2007)).

Over the last 20 years, Israel has moved from almost complete control and deep government involvement in every segment of the financial markets to a regime with a practically independent central bank (see more about the independence of the central bank in Cukierman (2007)) and free capital flows, having implemented many structural and financial reforms. This transformation eased the constraints that had restricted the financial activity of Israelis abroad and of non-residents in the local economy, improved Israel's position in the global economy and contributed to domestic growth.

Due to growing fiscal expenditure, increasing debt to finance large deficits (Graphs 3 and 4) and an accommodative monetary policy, in 1974–84 the Israeli economy went through a

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4 Data for the end of the second quarter of 2007 are available from the Bank of Israel's website (http://www.boi.gov.il/deptdata/pik_mth/iip/iip07e.htm).

period of high inflation and poor economic performance in terms of growth and productivity, a period known as the lost decade. Following the 1967 and 1973 wars, defence expenditure escalated and so did social expenditure. The substantial financial needs of the government impelled it to expand its already intensive involvement in the financial market in order to reduce its deficit financing cost. In addition, during the lost decade there were large deficits in the current account. The government reacted to these shocks with recurrent devaluations of the shekel, raising the prices of supervised products and cutting subsidies, steps which were not accompanied by the appropriate monetary policy and which caused inflationary bumps.

In 1985, after the inflation rate soared to unprecedented levels and the economy almost reached the stage of debt repudiation, an economic stabilisation programme was implemented. This programme required new standards of fiscal and monetary discipline, expressed in particular through restrictions on increases in public expenditure and legislation that prevented the Bank of Israel from supplying the government's financial needs (known as the No-Printing Law). The implementation of the programme and the adherence to its principles led to the recovery of the economy, which eventually improved the credibility of macroeconomic policy.

The stabilisation programme changed the macroeconomic fundamentals of the Israeli economy. Among these changes, the Israeli money market, capital market, foreign currency market, pension funds, banking system and tax system went through many reforms (Table 2). Based on international experience, the reforms were implemented gradually, in order to integrate Israel into the global economy with minimal shocks to financial stability. The integration process was also supported by the growing interest of investors in emerging economies. However, there is still a need for more financial reform in the future, with the objective of improving the competitiveness of the local economy, making it a more attractive business location for both residents and non-residents, and supporting economic growth.

In the rest of this paper we discuss the macroeconomic and institutional background to the financial reforms, which emphasises the importance of applying new discipline to Israel's economic administration as formulated in the mid-1980s. We then describe what was done during the economic stabilisation programme of 1985 and how it contributed to the implementation of economic reforms, while focusing on what was done during the liberalisation process. We sum up with an example demonstrating the resilience of the economy.

II. Financial restraint and economic stagnation, 1974–84

Fiscal and monetary policy

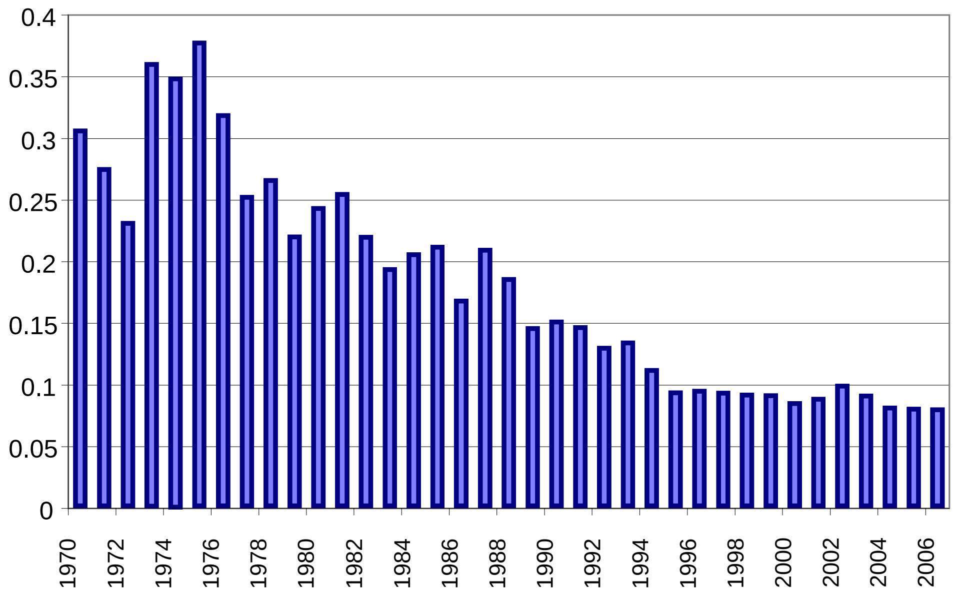
Israel went through a period of high inflation, economic stagnation and financial restraint from the early 1970s until the mid-1980s. This period, known as the lost decade, came after 15 years of relatively low fiscal deficits, low inflation and strong economic growth. In 1985, when the economy almost reached the stage of debt repudiation, a stabilisation programme established new macroeconomic discipline and set the conditions for economic reforms and a price stability regime. The processes Israel went through have characteristics similar to those in the great inflationary periods described in Sargent (1981) – where governments' financial needs led to hyperinflation that ended with the implementation of new fiscal and monetary regimes.

The inflationary process in the economy during the lost decade began to accelerate in the wake of the severe shocks that followed the 1973 Yom Kippur War, which resulted in a drastic increase in defence expenditure to over 30% of GDP (Graph 1). An additional major component of government expenditure during that time was growing social expenditure, intended mainly to preserve high employment and to achieve other political and social objectives (Graph 2, Barkai and Liviatan (2007)). This resulted in an increase in government expenditure to over 75% of GDP during most of the period, high public deficits, and a growing public debt that reached almost 284% of GDP in 1984 (Graph 3). Graph 4 illustrates the inflation rate from 1970 to 1990.

Graph 1

Defence expenditure, 1970–2006

As a percentage of GDP

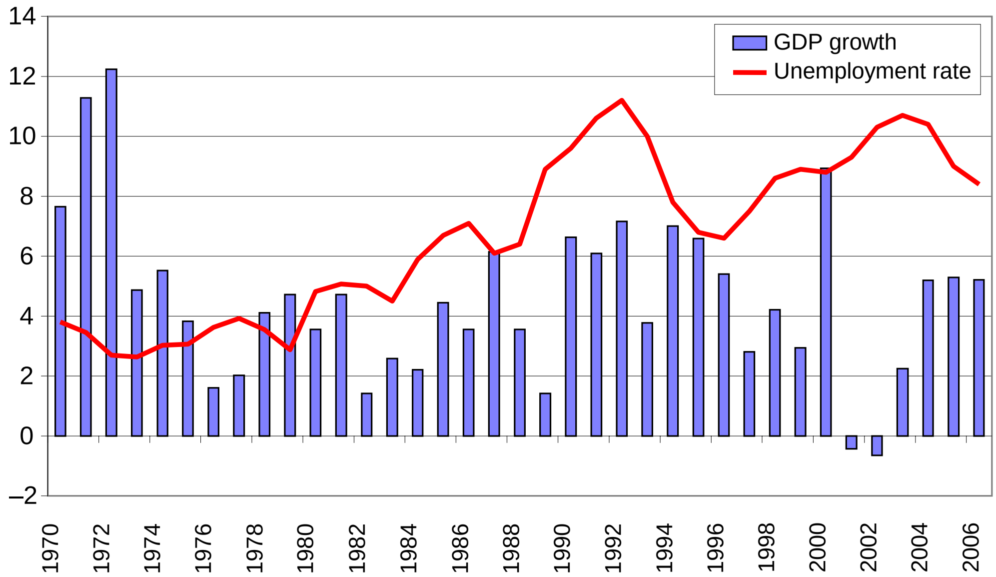


Source: Central Bureau of Statistics.

Graph 2

GDP growth and the unemployment rate, 1970–2006

In per cent

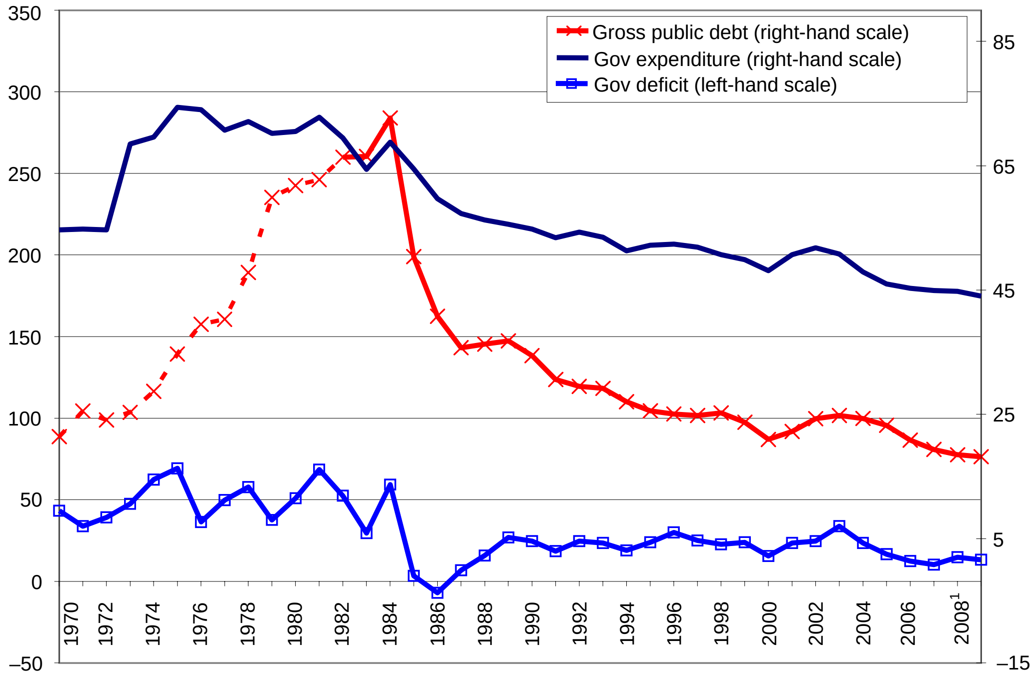


Source: Central Bureau of Statistics.

Graph 3

Fiscal parameters, 1970–2008

As a percentage of GDP



Data for 1970–80: according to old SNA; thereafter according to new SNA. Broken lines indicate extrapolations.

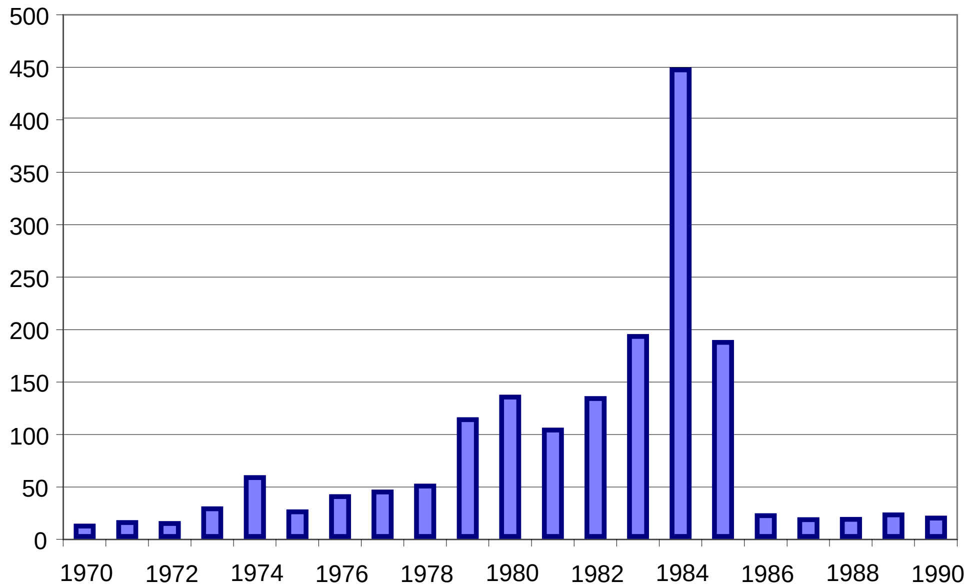
[1] 2008–09: Bank of Israel forecast.

Source: Central Bureau of Statistics.

Graph 4

Inflation in the previous 12 months, end of year, 1970–90

In per cent



Source: Central Bureau of Statistics.

Many papers were written about the proceedings during the era of high inflation (for example, Bruno and Fischer (1984)). These describe the attempts to stabilise inflation and inflation expectations and to soften inflation impacts – including such steps as the cut in subsidies aimed at reducing public expenditure, measures aimed at limiting price increases to a certain rate, and wage indexation mechanisms. However, we would stress the high nominal and real price of the economic developments during those years: high deficits in the current account and the public budget, and high inflation. These developments led to controls being imposed on the foreign exchange market, international financial and current account transactions, and the channelling of a large part of private savings into financing the public debt.

Financial markets

During the lost decade the economy was characterised by fiscal dominance; monetary policy was accommodative, dominated mostly by the fiscal and political considerations of the government, leaving no room for significant actions by the central bank (Barkai and Liviatan (2007)). In addition, because of the intervention of the government in financial markets and due to discrimination in credit allocation and intervention in the money market, the sphere of influence of monetary policy was narrow (Cukierman (2007)). There was no monetary anchor and the government reacted to deficits in the current account by repeated devaluations of the currency, increasing the prices of supervised products and cutting subsidies. The Bank of Israel had to supply the government's credit needs by printing money, and its actions during the great inflationary period were mostly concentrated in stabilising the inflationary alignment by considerable sterilisation, and had a smaller influence on the inflation trend (Barkai and Liviatan (2007)).

The inflationary process was influenced by global factors as well, such as the energy crisis of the 1970s. The Israeli reaction was a far-reaching indexation of prices and wages to restrain the real influence of inflation. The government did not adapt its agenda to the changing local and global economic conditions – the increase in defence expenditure, a slowdown in economic and demographic growth and global stagnation, and the deepening of the economic crisis.

Government intervention in the markets included administrative restrictions, exceptional liquidity rates, credit quotas and exemptions, restrictions on international capital flows and discriminatory tax and interest rates. The government discriminated against borrowing by private firms by means of taxation and controls on private bond issues. For example, institutional investors – for example pension funds and trust funds – had to invest 95% of their total annual net inflow of sources in non-tradable government bonds; 60% of short-term credit and 65% of housing loans were directed by the government (Ben Bassat (2002)).

The array of prohibitions and exemptions, the wide range of interest rates, and the measures taken by the government to secure its control of the financial market made the market structure complex, reduced its efficiency, and increased the expenses of financial intermediaries and regulators. This was expressed in a high average cost of finance. For example, the interest on foreign credit in 1985 ranged from 8.3% for the preferred groups to 33.8% for loans subject to administrative limits (Ben Bassat (2007)).

The foreign exchange market

As stated above, during the lost decade there were strict controls on foreign exchange activity. However, over the years there was a slow easing of those controls, particularly those on current account transactions. Consequently tariffs on imports were lifted, mostly due to agreements signed with Israel's main trading partners.[5] Starting in 1991, protection against imports from other areas was gradually lifted as well.

A change in the ruling party in 1977 introduced a revolutionary liberalisation process in the foreign exchange market that eventually failed. The process included two major components: easing of capital flows and a change in the exchange rate system from a crawling peg to a free float. Opening the economy to capital flows against the background of unstable macroeconomic conditions created large demand for foreign funds and led to great monetary expansion and to further devaluations that only increased the inflationary spiral (Michaely (2007)). In 1979 the Bank of Israel ordered Israeli firms and households to stop taking short- and medium-term credit in foreign exchange. Later on, the prohibition was replaced with a system of fines imposed on short- and medium-term credit in foreign exchange that were removed only a few years later with the implementation of liberalisation in the foreign exchange market. The main lesson learned from this episode was that capital flows cannot be liberalised without associated adjustments of the financial system and of monetary policy.

III. The stabilisation programme, 1985

Towards mid-1985 it became harder for the government to increase its already high debt in order to finance the public deficit, and the Israeli economy almost reached the stage of debt repudiation. The large fiscal deficit (Graph 3) became particularly problematic due to the increasing difficulty of sterilising the large monetary injections by selling government bonds, and the government had to finance its deficit by drawing on its foreign exchange reserves. In addition, the current account deficit continued to be relatively large and resulted in recurrent currency devaluations, and the money printing due to the large government deficit strengthened the inflationary spiral. These circumstances required a determined joint programme which would commit the government and the central bank to a different discipline.

The stabilisation policy was implemented with the assistance of experts from academia, the US government, the Ministry of Finance and the Bank of Israel. It was based on several principles: establishment of fiscal balance and perseverance in fiscal discipline for the future, and ending the ability of the Bank of Israel to increase the money supply to finance the public deficit; dealing simultaneously with the balance of payments and inflation issues within the framework of a nominal anchor. Structural and financial reforms were postponed to a later stage.

Within the framework of the programme, a nominal anchor to restrain price increases was adopted and a commitment to new fiscal discipline aimed at reducing the debt/GDP ratio was undertaken. Accordingly, a large cut in the fiscal deficit was made to stop the need to print money (Graph 3) and the exchange rate was chosen as an additional nominal anchor to restrain inflation; it was first pegged to the US dollar, and later to a currency basket. To protect itself from a drastic increase in real wages which could encourage the inflationary spiral, the government had signed temporary wage freeze agreements with the labour unions, which themselves signed a temporary agreement to freeze prices with the Manufacturers' Association.

An important objective of the stabilisation programme was to reduce the ability of the government to finance its deficit by directing the activity in financial markets and by

5 Israel signed free trade agreements with the European Union in 1977 and the Free Trade Area Agreements with the United States in 1985.

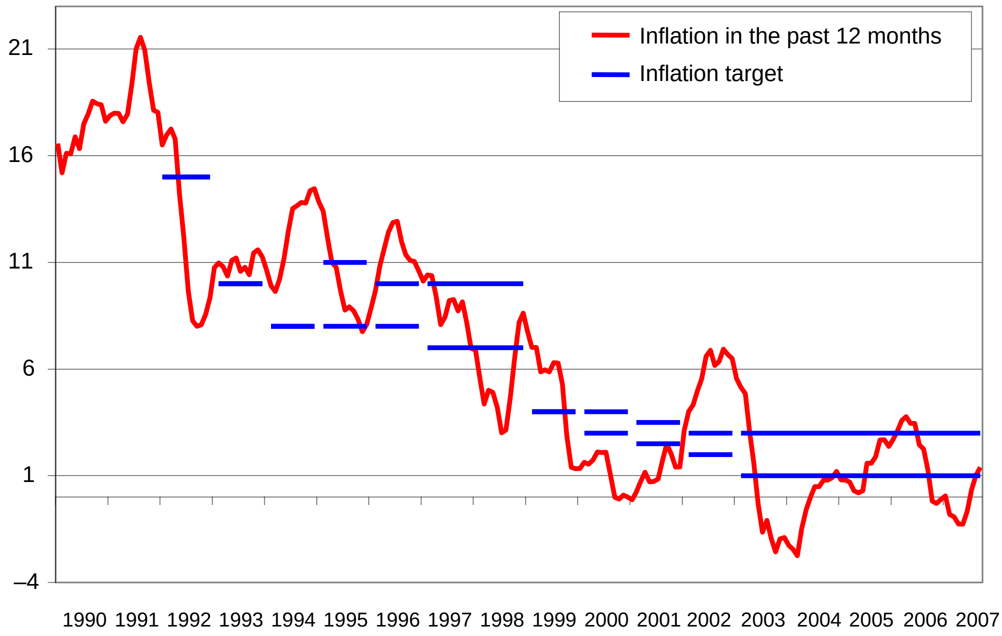
intervening directly in the management of monetary policy, and to give the central bank greater independence in the management of monetary policy. Accordingly, the No-Printing Law was enacted, which prevented the central bank from giving the government credit to finance its deficits, and direct credit was gradually abandoned. The Bank of Israel was also released from supporting government bond prices, so it had a wider basis from which to affect price stabilisation and was eventually able to manage an independent interest rate policy (Cukierman (2007)).

The stabilisation strategy succeeded remarkably well in supporting the disinflation process and in improving macroeconomic fundamentals. In just a few quarters, inflation decreased from 400% to 20% (Graph 5). From 1987 the exchange rate regime became more flexible: a horizontal exchange rate band was adopted for direct intervention on the foreign exchange market, with an upper and lower boundary of ±3% from the central rate. From the early 1990s the exchange rate was replaced as the main monetary anchor by an inflation targeting regime, with Israel being one of the first countries to operate such a regime, and the interest rate became the main monetary policy tool. After the adoption of inflation targeting the flexibility of the exchange rate was further strengthened and the exchange rate band was widened, until its complete cancellation in 2003.[6] Graph 5 illustrates the gradual decrease of inflation rates and the adoption of inflation targets from the early 1990s. These are reflected in the reduction of the public debt from 284% of GDP at the end of 1984 to 199% at the end of 1985.

Graph 5

Inflation in the 12 months and inflation target, 1990–2007

In per cent



Sources: Bank of Israel; Central Bureau of Statistics.

[6] From 1996 the Bank of Israel stopped intervening directly in the foreign exchange market, except for defending the exchange rate boundaries, which was seldom required. The exchange rate band was abandoned in 2005, when the exchange rate regime was practically fully convertible.

The determination of the government to succeed in stabilising the economy and its adherence to the new macroeconomic discipline contributed to the credibility of the programme and of the new economic policy framework, and were highly important to the success of the programme in the short and longer runs. A special US grant of USD 1.5 billion (about 6% of GDP), spread over two years, which the government used only as a financial safety net, boosted confidence in the programme. A further benefit that enhanced the image of the economy was an improvement in US aid in 1985: the conversion of US loans into grants at an annual rate of USD 0.9 billion.

IV. An era of reforms in Israeli financial markets, from 1987 till today

After the 1985 stabilisation programme, Israel's macroeconomic fundamentals gradually improved and so did the credibility of the Israeli economy, for these benefited from the general interest in emerging economies. As a result, the economic conditions needed for far-reaching financial and structural reforms and full liberalisation of the foreign exchange market emerged. These reforms were implemented via a gradual reduction of government intervention in domestic financial and money markets (Gottlieb and Blejer (2002); Ben Bassat (2007); Michaely (2007)). Yet, much remains to be done to increase competition in the financial markets and the banking sector, and to introduce modern financial instruments.

The 20-year transition to a market economy proceeded along a number of channels simultaneously, which contributed to (1) the establishment of strong macroeconomic discipline to consolidate the credence given to the economy by investors (which is also a condition for the development of financial markets and reforms); (2) a strengthening of the stability of the local banking system; and (3) the development of financial instruments to manage foreign exchange risks and to increase activity in the local economy. The government gradually reduced its involvement in the domestic money and capital markets, removed restrictions on international capital flows and laid the foundations for increased competition between financial intermediaries. This shift included many measures such as changes in the money, foreign exchange and capital markets and many changes in the composition of the budget, influenced by privatisation and other structural changes. Table 1 presents the share of directed credit in total bank credit and the differential between the interest rate on short-term credit and on deposits in selected years. The data illustrate the change over time and the reduction in government control of the market. Table 2 presents the main financial and economic reforms during this period.

Table 1

The outcome of government intervention in the market, selected years

In per cent

Year	Share of directed credit in total bank credit	Net interest spread on short-term credit and deposits
1985	60.5	40.7
1990	25.4	16.4
1995	8.2	9.2
2000	4.0	7.8
2004	5.7	7.1

Source: Ben Bassat (2007).

Table 2

Selected economic reforms in Israel since the 1980s

Sphere	Main parameters	Implementation year of selected measures[1]
Money market	Removal of administrative restrictions on deposits and credit	Since 1987
	Reduction in direct discriminatory credit	1982–90
	Use of new monetary policy tools	Makam nominal bill: since 1987. Auctions for commercial bank deposits: since 1995
	Decrease in liquidity rates, and avoidance of their use as a monetary tool	Since 1987
Capital market	Reduction in requirements for institutional investors to invest in government bonds	Since 1987
	Removal of the constraints on issuing private bonds	Since 1987
	Gradual elimination of the issuance of non-tradable government bonds	1987–2003
Foreign currency market	Liberalisation of the foreign exchange market	1987–2003
	Revocation of tax on capital flows	2003–04
Tax system	Elimination of tax discrimination	Since 1987 (eliminating tax and subsidies discrimination on production factors and goods)
	Taxation of financial income	Since 2003
Pension funds	Programme to attain actuarial balance in pension funds funded by the government, employers and employees	Since 1995
	Raising of retirement age	2004
Banking system	Splitting of non-banking corporations and subsidies	Since the 1990s
	Splitting-off of the management of provident and mutual funds from the banks	2005 (Bachar Reform)
	Splitting-off of underwriting and consulting from the banks	

[1] In some cases implementation was spread over a few years; some of the reforms were partial.

Sources: Ben Bassat (2002); Ben Bassat (2007); Michaely (2007).

The planning and implementation of further financial reforms in the Israeli financial market is still continuing. Current working groups and interministerial committees are working on deepening the financial market and making it more competitive and attractive for investors. Among current matters being promoted are the development of the repo and securitisation markets and a deepening of competition in the banking system. These reforms also contribute to the integration of Israeli financial markets into the global economy and to the economy's financial resilience.

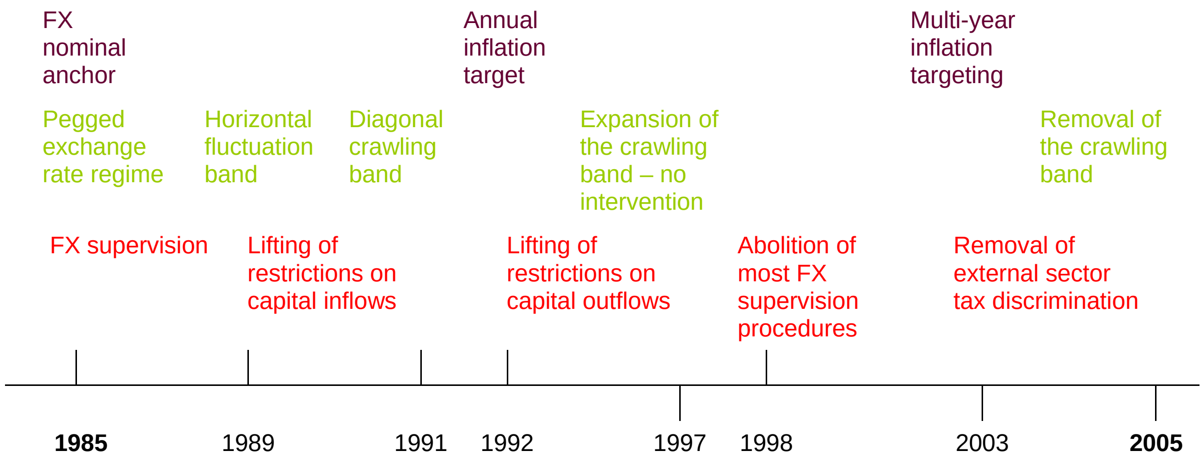
Current account transactions were almost completely free when the liberalisation of the financial account began. Hence, we focus on the reforms that were part of the financial account liberalisation process, and their influence on capital flows and the resilience of the economy. The process which resulted in the full liberalisation of the foreign exchange market in Israel ran from 1987 to 2003, with the objective of abolishing foreign exchange control and achieving full convertibility of the new shekel. This process was part of a strategy to increase the openness of the economy, as it was recognised that the benefits from liberalisation would compensate for its costs – deriving mostly from the required structural and institutional preparations for the development of the capital markets, and from the increase in financial stability risks. The full list of restrictions that still applied to foreign exchange and current account transactions in the Israeli economy in 1987 can be found in Michaely (2007).

The liberalisation process brought the economy from a situation of almost full government control of capital flows and activity in foreign exchange to one of utilisation of relative advantages, free capital movements and much more competitive and efficient capital markets.

The liberalisation of the foreign exchange market was completed in 2003, when all restrictions on capital transactions were eliminated. However, the road to full liberalisation also included a few noteworthy landmarks (Graph 6). In 1993 the export premium programme and a general surcharge on imports were abolished, after which there were no restrictions on current account transactions. In 1998 there was another significant landmark, when the almost full list of restrictions was replaced by a list stating only a few components that remained forbidden – many transactions in the current and capital accounts were permitted from then on, unless they were stated in the list. In the year 2000 the remaining restrictions applied only to the activity of institutional investors, who were allowed to invest only 20% of their assets abroad. In 2003 all restrictions were removed and Israel's foreign exchange regime became totally free.

Graph 6

Twenty years of foreign exchange liberalisation



Source: Ozer et al (2005).

The sequence of the liberalisation process was designed to integrate Israel into the global markets gradually, with minimal shocks to financial stability. Accordingly, the sequence was set according to the following criteria:

(1) The type and extent of capital movement and liquidity: short-term capital flows have higher volatility and liquidity and they are considered more risky to financial stability. Accordingly, the sequence of liberalisation was to allow free long-term capital imports, including direct investments, and investments in securities and long-term bonds before the shorter-term transactions. Capital outflows gradually became feasible only at a later stage, and again, long-term flows were allowed before their shorter-term counterparts. Restrictions on capital outflows by domestic residents were also removed gradually, starting with those on long-term financial investments; only at a later stage were they removed from shorter-term investments as well.

(2) Sectors of the economy: priority was given to removal of restrictions on the activity of the business sector and of non-residents, because the government considered that these sectors could boost the domestic economy's integration into the global economy and contribute to its growth. Restrictions on the activity of households and institutional investors were removed only at a later stage. Households were permitted first to make financial investments abroad, subject to tax discrimination, which was not applicable to the financial activity of the business sector. The tax discrimination was totally removed only in 2003–04, a while after the restrictions on investments were removed as well. The holding of foreign currency bank accounts abroad by households was delayed to later stages in the process. The institutional investors sector, which represents the main part of households' savings, was left to the end of the process in view of this sector's considerable potential to transfer capital abroad.

V. The influence of the liberalisation process on capital flows

The increased capital flows into the Israeli economy were the outcome of a combination of good luck and good policy. The liberalisation process, alongside other macroeconomic reforms and improvements in the fundamentals of the economy, altered the magnitude and composition of the financial account, increased the economy's accessibility to world markets and improved its credit rating. In addition to the impact of the internal changes mentioned above, the Israeli economy benefited from its inclusion among emerging markets and the growing interest of foreign international investors in such markets.

From 1997, Israel's financial activity vis-à-vis other countries underwent significant changes, reflected both in an increased volume of capital flows and in a growing number of participants. A few simultaneous developments contributed to this evolution: the liberalisation of the foreign exchange market, which offered more possibilities for Israelis to raise capital abroad and to invest abroad; increased exposure of the economy to external factors, which was a part of the globalisation process and which was expressed, inter alia, by increased capital flows to and from emerging markets; and tax reforms that reduced distortions in the taxation of financial assets, contributing to increased investments abroad by Israelis (mostly households and institutional investors). All of these developments came in addition to the fast expansion of the local financial market and of the Israeli high-tech industry and its position as a leading sector in the economy.

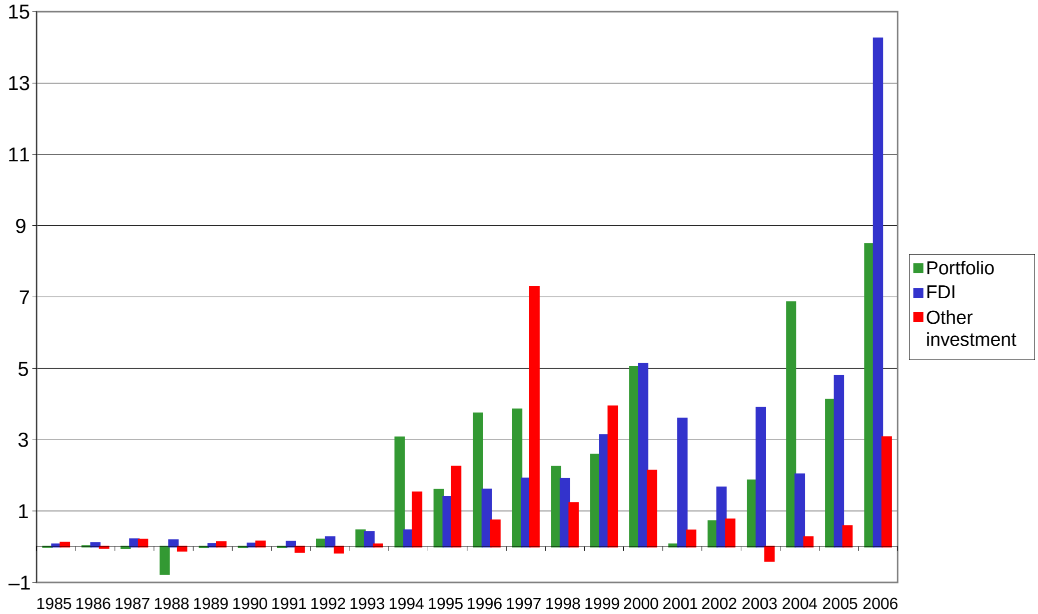
During the liberalisation years, non-resident investment in equity and foreign direct investment (FDI) in Israel grew rapidly (Graph 7), and the proportion of tradable investment and activity in the Tel Aviv Stock Exchange in the economy also increased (Graph 8), all of which contributed to a change in the composition of the assets and liabilities portfolio of the economy. The change in the net external (debt instrument) liabilities position of the economy from positive to negative (Graph 9) shows the increase in investment in debt instruments of

Israelis abroad – the economy had moved from a position of net borrower to net lender – and reflects the greater openness of the economy. Accordingly, there was a substantial increase of more than 160% in the assets of Israelis abroad, mainly in direct investments, tradable bonds and foreign exchange credit, and an increase of over 95% in Israeli residents' liabilities, with the main growth being in FDI and in tradable bonds. Over the years, the share of long-term capital inflows increased and so did the economy's credit rating, providing further witness to its fundamental credibility (Gottlieb and Blejer (2002); Rehavi and Weingarten (2006)).

Graph 7

Non-resident investment in Israel, 1985–2006

In billions of US dollars



Source: Bank of Israel.

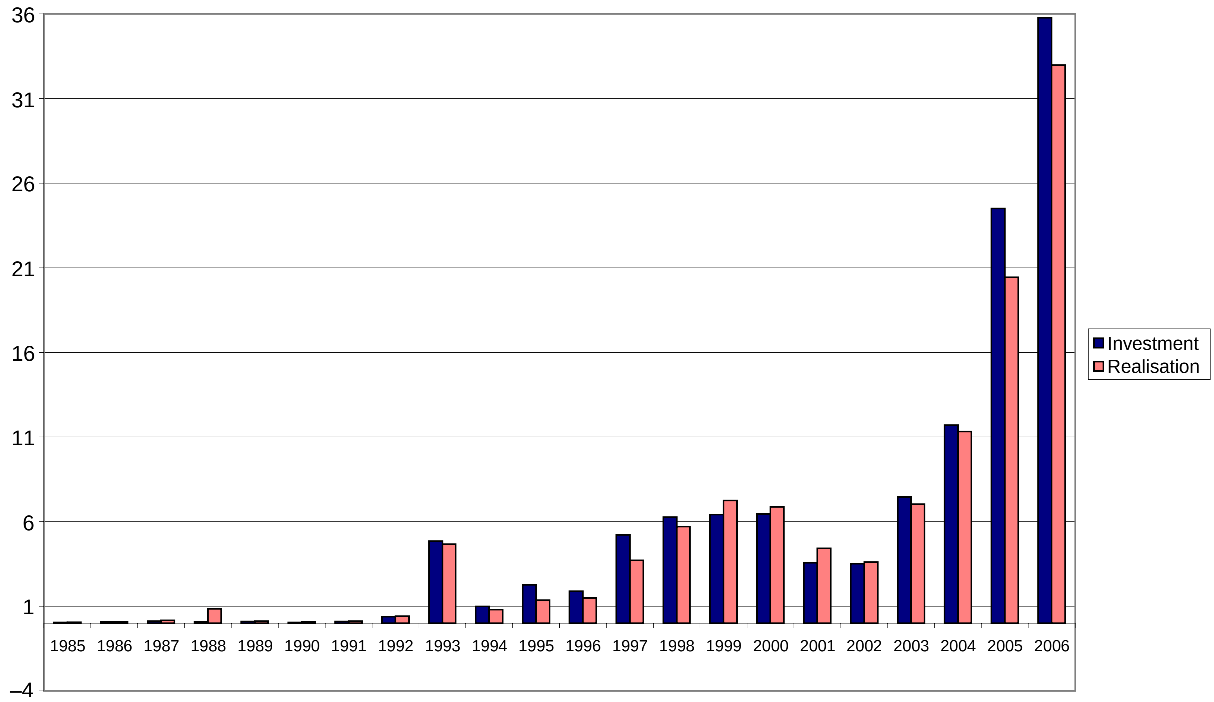
One main outcome of the increased exposure of the economy to capital flows and other financial reforms is the enlargement in the number and variety of participants in financial activity. For example there has been an expansion in the Israeli private non-banking sector, which has boosted the raising of capital abroad and decreased the dependency of residents on the traditional financial intermediaries, such as the Israeli government and domestic banks. As a result, the traditional intermediaries' share in Israel's total external liabilities has declined, while the share of the private non-banking sector has risen (Rehavi and Weingarten (2006)).

Following international experience and the unsuccessful liberalisation process of the 1970s, the gradual removal of restrictions on foreign exchange activity was followed by a shift from supervision by the central bank to documentation of the activity of financial entities (Ozer et al (2005)). The slow process of foreign exchange market liberalisation enabled the Bank of Israel to progressively develop a data infrastructure that documents the activity of Israeli residents in foreign currency markets and non-residents' activity in local markets. The reporting network includes reports from various financial intermediaries, primarily banks, on their activity abroad and in foreign currency, as well as direct reports from corporations and individuals whose volume of activity exceeds a certain threshold.

Graph 8

Tel Aviv Stock Exchange, non-resident turnover

In billions of US dollars

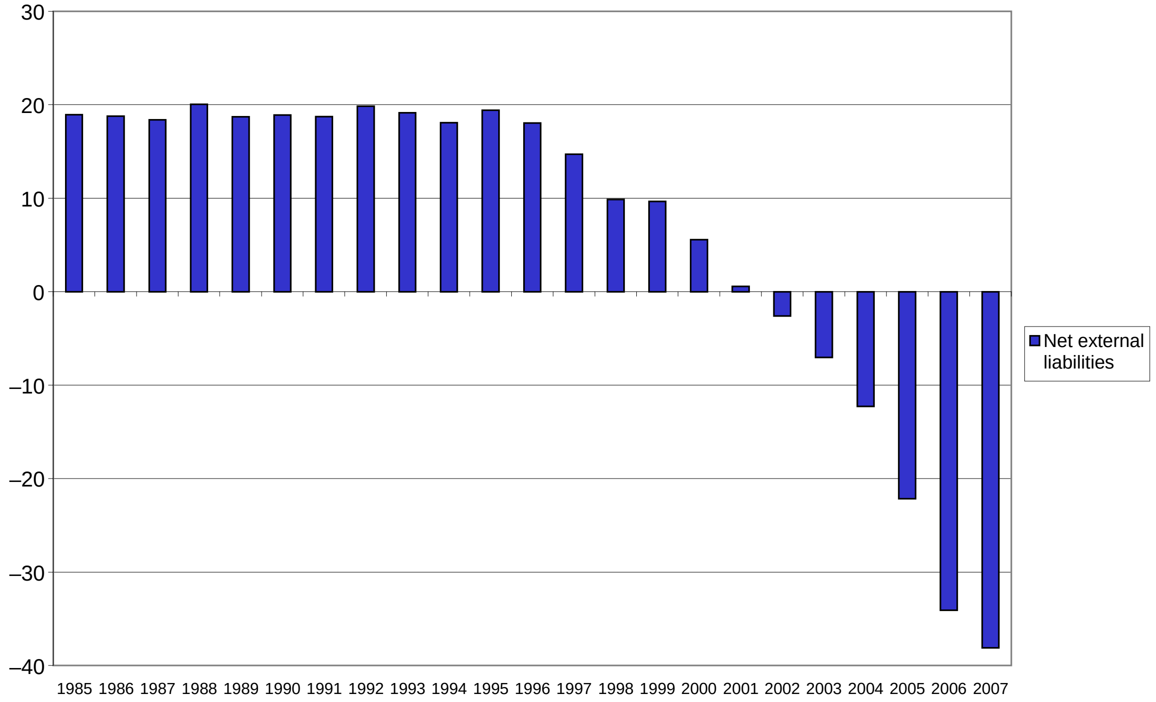


Source: Bank of Israel.

Graph 9

Net external (debt instrument) liabilities position

In billions of US dollars



Source: Bank of Israel.

Monitoring capital flows and trends in new shekel/forex markets contributes to the management of monetary policy and the maintenance of financial stability; in particular it contributes to early identification of developments essential to the decision-making process, especially in small open economies. Therefore, in its meetings, the monetary policy forum at the Bank of Israel receives a detailed summary of the financial stability of the economy and of the past and expected trends and developments in the foreign exchange market, based, among other things, on data on foreign exchange activity. In addition, the participants receive an evaluation of the economy's exposure to economic risks, applying to the activity of both residents and non-residents.

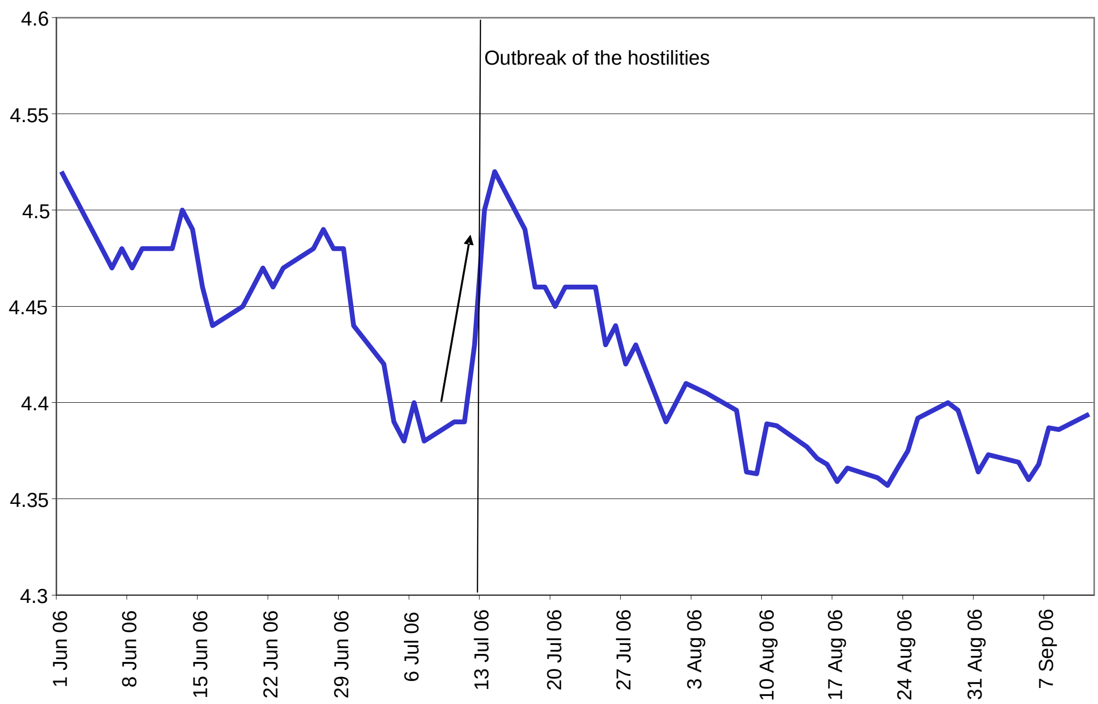
VI. Free capital movements and the resilience of the economy

Since 1987, the Israeli economy has experienced a few major events which undermined financial stability and were reflected by substantial depreciation and a marked increase in exchange rate volatility. Three examples of such events are the worldwide financial crises in 1998, local developments that affected the yield-versus-risk ratios in the economy in 2002, and the impact of the Second Lebanon War, in 2006. We will focus on the impact of the last event.

The Second Lebanon War began in mid-July 2006 and lasted 32 days. The war led to a slowdown in economic activity in the north of Israel and also had an impact on the rest of the country. During the period of the war, business production fell by an annualised 4.1% and aggregate GDP fell by an annualised 0.8%, due to the growth in public spending and the slowdown in economic activity. However, the slowdown was scarcely apparent in domestic uses and mainly influenced exports and inventories.

Graph 10

The new shekel/US dollar exchange rate during the Second Lebanon War



Source: Bank of Israel.

In spite of the war in the north, financial markets (foreign currency and domestic bonds) showed steadfastness throughout the second half of 2006, with annual GDP growth of 5.1% (Graph 2). In the first few days of the war the new shekel depreciated by 3% (Graph 10), and exchange rate risk, measured by the implied volatility of (mainly short-term) new shekel/dollar options, rose by 2.5% to 8%. Three weeks after the hostilities began, the exchange rate and implied volatility reverted to their prewar levels, and summarising the whole of the period of the war, exchange rate risk was steady.

During the Second Lebanon War the Bank of Israel published a few press releases in order to calm the markets and to strengthen confidence in Israeli markets and the credence of economic policy. The reaction of investors, foreign and domestic, throughout the war was milder than it had been during earlier crises, when households had reacted by buying significant quantities of foreign currency (Bank of Israel (2007a,b)).

During the above-mentioned events, the Bank of Israel refrained from intervening in the foreign exchange market, but reacted vigorously with the interest rate tool or with relevant press releases to strengthen public confidence in economic policy with a view to counteracting processes that could undermine financial stability.

VII. Conclusion

The economic events of the past 30 years in Israel give an example of an economy that moved from a situation of almost complete government control over financial markets, with economic institutions serving the government's financial needs, to an economy with strict fiscal discipline, an independent monetary policy and open and free financial markets. The gradual move to a market economy in Israel has expanded its economic resources and increased its growth potential.

Since the implementation of the stabilisation programme in 1985, fiscal discipline has been maintained despite frequent changes of government and high defence risks, and a continuous process of economic reforms has been pursued. Evidence of the improvement in the credence of the economy and its adherence to stable economic policy is provided by a Standard & Poor's announcement regarding the decision to raise Israel's long-term foreign currency sovereign credit rating from A– to A at the end of November 2007:

"The ratings are moreover supported by Israel's prosperous economy and strong political commitment to long-term fiscal consolidation … Fiscal consolidation intensified in 2007, and the general government debt burden continued its downward trend to 82% of GDP at year-end 2007 ... Israel has additional borrowing flexibility due to the loan guarantee program by the United States, its key ally ...".

Much has to be done in the future to make the Israeli capital market more compatible with international standards. Continuing the gradual economic reforms that began 20 years ago is essential to achieving increased capital market efficiency and stability. However, these things can be achieved only if the economy continues to adhere to strict fiscal rules and a responsible monetary policy that will reinforce its credibility and contribute to growth and resistance to financial risks.

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