State Comptroller of Israel | Aspects of Dealing with the Cost of Living | January 2024

Ministry of Finance and Bank of Israel

Preparation for an Inflation Outbreak

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Background

Inflation is a general increase in the prices of goods and services in an economy over some time. High inflation, accompanied by uncertainty and unusually high volatility of price changes, adversely affects economic activity and growth. 2022 was characterized by a high inflation environment of 5.3%, compared to the previous years, as part of a global trend that led to a significant deviation from the inflation target range set by the government (1%–3%), similar to the worldwide trend. It should be noted that the inflation rate in Israel in 2022 (5.3%) was considerably lower than in most developed countries during that year.

Key Figures

5.3%

the actual inflation rate in Israel in 2022 (compared to 2.8% in 2021)

1% – 3%

the inflation target range in Israel set by the government since 2003

4.5%

the Bank of Israel basic interest rate in April 2023 (compared to 0.1% at the beginning of 2022)

4.4% (NIS 20.4 million)

the linkage rate of the government spending in the state budget from 2022 to 2023, based on the index change average rate in 2022

3.36%

the interest rate gap[1] in the banking system as of September 2022 (compared to 3.20% in December 2021)

60%

the transmission rate[2] between the Bank of Israel basic interest rate and the interest rate on public deposits as of August 2022

52% (about NIS 530 million)

from the CPI-indexed government debt. 1% increase in the index is expected to increase the total debt by about NIS 5.7 billion and the annual interest and principal expenses by about NIS 460 million

13.5% (about NIS 60 million)

the expected growth rate in the government spending in the biennial budget for 2023–2024[3]. This increase is the highest growth rate in about a decade

1 The gap between the average interest that banks charge for the credit they provide to their customers and the average interest they pay on the balance of their deposits, which reflects the banks' profitability from core banking activity.

2 The transmission refers to the Bank of Israel interest rate increase rolled into the increase in interest paid by the banks on the public's limited time deposits.

3 On February 24, 2023, in Government Decision 237, the government approved the state budget proposal for the years 2023–2024. The budget proposal was placed on the Knesset table on March 23, 2023. The budget law was approved by the Knesset in May 2023.

Audit Actions

From August 2022 to January 2023, the State Comptroller's Office examined the preparations of the various bodies in the country for an inflation outbreak. The audit was conducted at the Bank of Israel – in the Research Division and Banking Supervision Department, in the Ministry of Finance – in the Accountant General Department, in the Budget Division (Budget Division or AGAT), and the Chief Economist Department. Completion examinations were conducted at the National Insurance Institute, the Central Bureau of Statistics, and the National Economic Council.

Key Findings

The Inflation Rate in Israel Vis-a-Vis the Government Inflation Target – the inflation target set by the government has remained unchanged since 2003 and stands at 1%–3%. It was found that from 2003 to 2022, actual deviations of inflation occurred in both directions of the target range (from 1.9% to 3.9%). 2022 was characterized by an inflation environment of 5.3%, higher than in recent years, resulting in a considerable deviation from the inflation target range (2.3 percentage points), similar to the worldwide trend.

It should be noted that from 2019, as part of a strategic plan, the Bank of Israel is reassessing the inflation target to decide whether to maintain the existing target or recommend that the government change it. This derives from a long-term perspective on the policy required due to the changes in the economic environment since the current policy framework was formulated (valid since 2003).

Contingency Plan for Inflation Outbreak – in 2022, the Budget Department of the Treasury and the Research Division of the Bank of Israel conducted ongoing monitoring (each body separately), frequently examining the macroeconomic and economic developments in Israel and worldwide, emphasizing on the implication of the rise in the Consumer Price Index. However, the Budget Department decided not to prepare a dedicated contingency plan for the increase in inflation, stating that no such contingency plan is required because no unusual inflation outbreak has been observed in Israel. Therefore, the Ministry of Finance does not have a contingency plan for fiscal measures to contend with an inflation outbreak.

Analysis of the Inflation Effect on the Government's Expenditures and Revenues – based on the work of the Chief Economist Division in the Ministry of Finance in 2017, it was found that 1% increase in the Consumer Price Index (CPI) would increase the state's expenditures by NIS 2.5–2.9 billion per year. At the same time, state revenues will grow by NIS 1.8 billion. In other words, 1% rise in the CPI would increase the annual budget deficit in the state budget by about NIS 0.7–1.1 billion. However, it was found that as of the audit date, the Chief Economist Department had not prepared an updated assessment of the sensitivity of state revenues to inflation. In addition, there was no indication that the Ministry of Finance has a forecast of the effect of inflation on the government deficit, despite the significant increases observed in the price index, rising from 2.8% in 2021 to about 5.3% in 2022.

The Linkage Mechanism to the CPI in Forming the State Budget – in 2003, the government decided that the procurement budgets of the government ministries are not automatically increased according to changes in the CPI. Since then, government decisions have determined that a "nominal freeze of the state budget" shall continue. Consequently, the procurement budgets of the government ministries are not automatically increased according to changes in the CPI. For example, even though the CPI increased by 19% from 2009 to 2022, the transition coefficients for purchasing budgets in the state budget were 0% in these years.

It was found that, on the one hand, the government decision from 2003 has nominally frozen the transition coefficients used to build the state budget, and this decision is ratified each time the state budget is approved. On the other hand, the government decision regarding the 2023–2024 budget updated the overall expenditure, considering the rise in inflation, and essentially rendered the decision on a nominal freeze meaningless. For example, in the formulation of the 2023–2024 budget, the "transition coefficient" of the purchasing budget remained at 0%; however, the budget framework as a whole was increased by 4.4% to account for price adjustment.

The Existing Exposure of Government Spending to the CPI – in 31% (11 government ministries) of the government ministries, which manage about 41% (about NIS 187 billion) of the state budget, the budget exposed to the index is from 51% to 80% of the ministry's total budget, in 25% of the ministries (9 government ministries) which manage 24% (NIS 109 billion) of the state budget, over 80% of the ministry's budget is exposed to the CPI[4]. In addition, over 50% of the government debt is linked to the CPI. This exposure constitutes a budgetary risk for both the short and long term. This is because an increase in the index will increase interest expenses and debt repayment in the state budget by hundreds of millions of NIS and will also affect the state budget in the long term due to government debt growth.

Concentration of Data Regarding the Exposure of Government Ministries' Engagements to the CPI – the audit raised that procurement processes financed through the state budget have several linking mechanisms. For example, there are

[4] These budgets are not automatically adjusted in the budgeting process, and they receive a transition coefficient of "0" from year to year.

procurement processes that government ministries conduct directly – the linking of payments is done in full. In contrast, in the procurement processes of local authorities, which involve the participation of government ministries, there is no obligation to link the agreement. Payments can be linked to situations where the change in the index was higher than 4%. However, the Accountant General Department in the Ministry of Finance does not centralize all the information regarding the extent of exposure of the state budget regarding index-linked engagements. For example, the Infrastructures and Projects Division in the Accountant General Department does not monitor the state budget's exposure to the various linkages of contracts executed under the PPP[5] method, and the Central Procurement Administration does not monitor the exposure of central procurement tenders regarding linkages.

Linkage of Support Clauses in the State Budget – it was found that budgeting of the support clauses in the state budget, as part of which government ministries support the activity of thousands of public institutions (as defined in section 3a of the Budget Foundations Law – a body that is not a state institution operating for purposes of education, culture, religion, science, art, welfare, health, sports or a similar purpose) does not include a linkage mechanism. Although state support for public institutions is voluntary, the absence of a linkage mechanism in an inflationary environment may lead to erosion of the financial support transferred to public institutions and, as a result, potentially impact their functioning and ability to fulfill their purpose.

The Fiscal Policy Measures Taken in an International Comparison – the fiscal policy measures taken in the surveyed countries (France, Italy, Great Britain, Spain, and Germany) are divided into three: (a) measures to reduce the prices of specific products or services; (b) measures to increase the income of vulnerable populations; (c) measures to increasing state revenues to fund the measures above. It was raised that while in Israel only one step was taken to reduce energy and fuel costs, in the rest of the surveyed countries, three types of measures were taken as detailed above. The main measures published by the Ministry of Finance in January 2023, which focused on reducing energy and fuel costs, were not accompanied by prior consultation with the Chief Economist Department and the Bank of Israel[6].

The Interest Gap in the Banking System Between Interest on Credit and Interest on Deposits – from the banking system's standpoint, the increase in interest and inflation benefits the banks in the short term since they generate increased interest income. However, it could negatively impact the future due to concerns about a decline in credit quality, reducing borrowers' ability to continue meeting their loan repayments. It was found that in 2021–2022, there was a significant increase in the interest gap (3.20% in December 2021 and 3.36% in September 2022) compared to 2019–2020,

5 Infrastructure projects carried out by the government in collaboration with the private sector.

6 In this context, it should be noted that the energy crisis is more acute in the surveyed countries compared to Israel, and that energy prices in these countries, like other European countries, have risen much more sharply compared to the increase in energy prices in Israel.

with a decrease in the interest gap (2.91% in December 2019 and 2.84% in 2020). The increase in the interest gap in the first half of 2022 was due to both inflation and the increase in the Bank of Israel interest rate.

The Transmission Between the Bank of Israel Interest Rate and the Interest that Banks Pay on the Public's Limited-Time Deposits – "Transmission" refers to the Bank of Israel interest rate increase transmitted into the interest paid by the banks on the public's limited-time deposits. It was found that, unlike the rise in the Bank of Israel interest rate, which the banks fully transferred to the banking credit given to the public, the increase in the interest rate paid by the banks on public deposits[7] was partial and was only about 60%, as of August 2022. This partial transmission also contributed to the banks' profits significantly. It should be noted that the transmission rate for new limited-time deposits of up to three months increased considerably during 2022, from about 25% in April 2022 to about 50% in December 2022. Therefore, the Bank of Israel's interest rate increased from 0.35% to 3.25%; however, the interest paid to the public for its bank deposits increased only from 0.06% to 1.55%.

Bank Assets – Comparison Between Fair Value and Presentation of Value in Financial Statements – investments in bonds made by the bank classified as redemption bonds are presented in the banks' books at a discounted cost and not at market value. It was found that the uncredited losses from adjustments to fair value in Bank A for held-to-maturity bonds are about NIS 1,177 million and about NIS 669 million in Bank B. Therefore, the potential loss not yet recorded in each bank concerning those held-to-maturity bonds is about 1%–2% of the balance of equity of the two banks above.

Increasing the Issuance of Zero-Coupon Bonds – the scope of zero-coupon bond issuance, which serves as a kind of substitute for the public's deposits with the banks, has increased considerably from NIS 45 billion in the third quarter of 2022 to NIS 109 billion in the last quarter of 2022 (an increase of about 142%).

7 For different repayment periods.

Key Recommendations

- It is recommended that the Bank of Israel complete its reassessment of the inflation target with a long-term view ,considering the changes in the economic environment in Israel and worldwide, particularly in light of the inflation development after the Covid-19 crisis. If necessary, the Bank of Israel should formulate recommendations to the government.

- It is recommended that the Ministry of Finance prepare economic plans for the government in consultation with the relevant professional bodies, including various departments in the Ministry of Finance and the Bank of Israel. This is while considering the recommendations from relevant international entities such as the OECD.

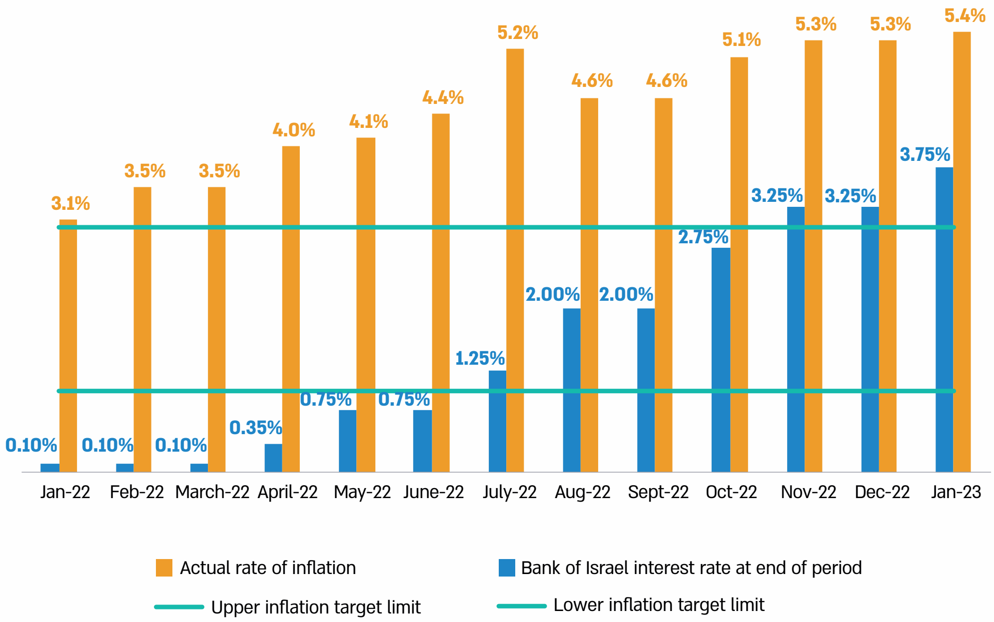
- It is recommended that the budget department consider complementary and targeted fiscal measures to assist companies and households severely affected by the rise in inflation. This should be done alongside measures for fiscal tightening to prevent inflationary pressures.

- It is recommended that the Budget Department establish a systematic process to determine the transition coefficients for purchases and reserves for price increases. Thus, even with a significant price increase, the budget will allow the government to realize its goals and priorities by allocating the available resources.

- It is recommended that the Accountant General map all government engagements and participations while following up on the scope of active contracts linked to the price index, the contracts' method of indexation, and the flow of expected payment growth following a sharp price index increase. Furthermore, it is recommended that the Accountant General formulate a coherent policy for responding to the various types of contracts and risk management, following the budgetary exposure of contracts linked to different indices.

- The supervisor of banks should increase the transmission between the increase in the Bank of Israel interest rate and the interest paid on public deposits, thus reducing the interest rate gap.

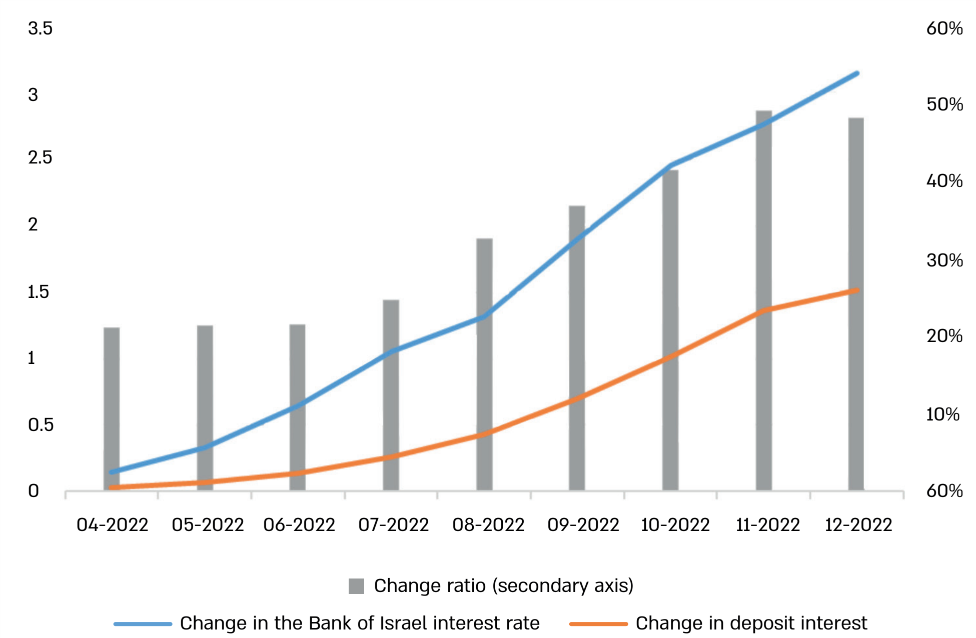
The Government's Inflation Target Range, the Bank of Israel Interest Rate, and the Actual Inflation Rate in 2022



According to data from the Bank of Israel and the CBS, processed by the State Comptroller's Office.

* The inflation rate is calculated at the end of each period based on the change in the Consumer Price Index in the last 12 months.

The Cumulative Monthly Change in Interest on New Deposits for a Limited Time of up to Three Months, in the Bank of Israel Interest Rate, and the Ratio Between them (the transmission), April 2022 – December 2022



Source: Bank of Israel, **Analysis from the Bank of Israel 2022 Report**, Transmission from the Monetary Policy to Deposit Interest in Israel, March 2023, pp. 2–3.

* Average interest rate of the Bank of Israel per month, and average deposit interest for new deposits for a limited time of up to three months, non-indexed fixed interest, overall banking system, households without private banking.

Summary

High inflation, accompanied by uncertainty and high unusual price volatility, adversely affects economic activity and growth. 2022 was characterized by an inflationary environment of 5.3%, higher than in previous years. This is part of a global trend resulting in a significant deviation from the upper limit of the inflation target range set by the government (3%). It is essential that the various bodies in Israel prepare to contend with rising inflation. The audit found that the Bank of Israel took various monetary measures, including raising the interest rate and issuing zero-coupon bonds, while the government took some fiscal measures. It was also found that there was an increase in the interest rate gap in the banking system in the first half of 2022, stemming from both inflation and the increase in the Bank of Israel interest rate. As opposed to the rise in the Bank of Israel interest rate, which was fully transferred to the bank credit offered to the public, the increase in the interest rate on public bank deposits was only partial and stood at about 60% as of August 2022.

It is recommended that the Ministry of Finance prepare for a changing inflation environment while taking targeted measures to reduce the possibility of an inflationary spiral on the one hand and support populations worthy of promotion affected by the rise in inflation on the other hand. The bank supervisor should ensure the banking system's stability on the one hand and, on the other hand, prevent the banks from earning excessive profits due to increased interest rates at the expense of savers.