



Press Release

Frequently Asked Questions on the Crisis and its Implications for Israel

Attached is a file with a collection of frequently asked questions (FAQs) on the recent financial events. The Bank of Israel will update the information from time to time in accordance with developments in Israel and the world.

How have developments so far affected the stability of the banks and the banking system in Israel?

From a system-wide perspective, the banks are currently enjoying greater stability and are more able to absorb shocks than in any previous period. Furthermore, the banks in Israel are being managed with greater caution and are expanding their liquidity reserves. The damage to the banking system in Israel so far has not been significant from this perspective.

What supervisory measures has the Bank of Israel taken in order to ensure the ability of the banks to deal with the effects of the global crisis on the Israeli economy?

The Bank of Israel is working continuously to strengthen the stability of the banking system. Apart from the ongoing and routine activities that are meant to strengthen the banks' systems of control, management and auditing, the Bank of Israel has endeavored to increase the banks' capital base significantly during the past two years, with the goal of creating a cushion against unexpected losses and events such as financial crises.

With respect to the current global crisis, the Bank of Israel is assessing the situation of each bank on an ongoing basis, as well as that of the banking system as a whole, using a data and information which the banks are required to provide on an expanded scale. The Bank of Israel instructs the banks as to the measures required of them, both regarding the system as a whole and specific banks, and closely monitors the banks' activities and preparedness. In addition, the Bank of Israel maintains ongoing contact with the Ministry of Finance and the Israel Securities Authority in order to obtain an overall picture of the situation, ensure coordination and decide on policies and measures to be implemented in the future.

What scenarios are being assessed by the Bank of Israel and does it have a plan to deal with the various stages of the crisis?

The Bank is assessing a wide variety of scenarios, ranging from the most pessimistic to the most optimistic, and future plans of action have been decided on in order to ensure that the financial system will continue to function and that depositors will not be hurt.

Is there concern for the stability of any of the banking institutions in Israel?

There is no concern for the stability of any banking institutions in Israel.

Are the public's deposits guaranteed against the collapse of a bank?

Israel's banking system is strong, and the Bank of Israel is ready to use all the means at its disposal to help the banks as necessary, in order to support depositors. The Minister of Finance stated that out of concern for the public's deposits and in order to guarantee the public's confidence in the financial system, the government will stand behind the stability of the financial system.

What are the factors that led to the global crisis?

The main factor that initiated the crisis was the accumulation of mortgages in default in the US as a result of the reversal of the trend of US housing prices. This occurred against the background of easy mortgages over a period of several years during which mortgages were provided to homebuyers who did not have sufficient ability to repay them. The losses spread to large financial institutions in a number of countries through the globalized financial markets, which facilitated the creation and marketing of complex financial instruments world wide.

These instruments had a variety of terms to deal with default that had not been in use in the past and some of the instruments were sold and guaranteed by large financial institutions. Large investment houses worldwide held the view that advances in the study of finance had enabled a better understanding of these products and the correct valuation of the products and their guarantees. In retrospect, the risk assessment of these products was extremely deficient. Thus, significant losses were incurred by these large financial institutions and their customers. As a result, uncertainty regarding the financial stability of these institutions spread at a surprisingly quick rate and activity in the markets for more basic financial products—in which these same investment houses are active—was also affected.

How has the crisis so far affected the Israeli financial system relative to its effect on the financial markets and institutions in other advanced economies?

One of the main causes of the global financial crisis was the provision of mortgages, primarily though not exclusively in the US, to borrowers with insufficient ability to repay them. As a result, housing prices rose sharply in these countries, as did the prices of financial assets. When the financial institutions began to realize that they had provided mortgages to homebuyers with insufficient ability to repay them and these individuals were forced to sell their homes, a downward trend began in the prices of houses that served as the collateral for not only sub-prime mortgages, but higher quality mortgages as well. The drop in the value of other assets also eroded the collateral for loans that were made by the financial institutions in these countries. These developments, together with the collapse of the markets for mortgage-backed securities, had a multiplier effect that among other things led to the collapse of several financial institutions in the US, the UK and Europe. The large-scale provision of such mortgages in these countries to individuals with insufficient means to repay them was not, however, characteristic of the Israeli financial system and, in any case, the Israeli housing market did not experience the price increases that were seen in the US and the UK (in fact, housing prices in Israel remained stable from January 2002 to August 2007). Therefore, financial institutions in Israel, and in particular the banks, were less exposed to the risk implicit in the developments described above.

Among the large financial institutions worst affected by the crisis in the US were the mortgage banks whose investment in mortgage-backed securities constituted a significant proportion of their assets. The Israeli financial institutions whose activity is similar to that of investment banks in the US (such as mutual funds, provident funds, etc.) are relatively small and their assets primarily include domestic financial assets and government bonds. Therefore, their exposure to the market risk implicit in foreign mortgage-backed securities is relatively small.

Nevertheless, the global financial crisis has affected the Israeli financial system in several ways: it led to a significant increase in volatility and uncertainty in Israel's capital markets, a decline in prices on the Tel Aviv Securities Exchange, and increased bond risk spreads, primarily corporate bonds. At the same time, it is important to mention that the crisis originated in the US and Europe, not in the Israeli economy. Furthermore, in view of the relatively small exposure of the Israeli financial system, primarily the banking system, to the global crisis and in view of the stability and conservatism of Israel's banking system, it appears that public confidence has been maintained. However, it should be mentioned that as a result of the global crisis a decrease in the global rate of growth is expected and even a recession in the US, which can be expected to slow the growth of the Israeli economy to some extent. Nevertheless, the Israeli economy's rate of growth is expected to be higher than that of other advanced economies.

Israel is not directly exposed to the problematic assets that were the source of the global crisis. So why has the volatility in Israeli capital markets nonetheless increased?

Globalization plays a critical role in the correlation between the behavior of capital markets in Israel and that of markets abroad. As a result, a high level of volatility in global markets leads to the same in Israel. For example, when large international financial institutions experience liquidity shortages, they are forced to sell assets of all types and in all locations. In addition, the crisis also tends to reduce global growth, which also affects Israel, primarily through its exports.

Will the rescue plan being implemented by governments abroad succeed in reducing the effect of the crisis on Israel?

Coordinated programs have a good chance of providing immediate solutions to that part of the crisis which involves a lack of confidence and a lack of liquidity in the financial system. The higher the level of confidence among the public and the lower their tendency to panic (which leads to herd behavior), the higher the chances of success.

What role does the Bank of Israel have in the maintenance of financial stability in the economy?

One of the Bank of Israel's most important functions is the maintenance of the stability of the banking institutions and the financial system in Israel. During periods of calm, this is accomplished partly by identifying risks and potential weaknesses and focusing attention on them, and supporting efforts to preserve the stability of the system and reduce risk. This, in addition to the improvement of the financial system's infrastructure. During periods of crisis, the Bank of Israel's responsibilities also include dealing with the crisis in the realm of banking, in which the Bank has the primary responsibility for regulation, and in other realms, in which the Bank assists other regulatory authorities, such as the Ministry of Finance in the case of the insurance and pension systems, the Israel Securities Authority in the case of mutual funds, and the Tel Aviv Securities Exchange.

What lessons can be learned from the crisis with regard to the optimal structure for the financial system in Israel and the optimal structure for regulation of the financial system?

Already at this stage of the global crisis, it is clear that we will need to draw conclusions regarding the optimal structure of the financial system in Israel, including issues related to the regulatory structure for the financial system and the like. However, at the moment, dealing with the effects of the crisis is more urgent. It is also important to absorb the lessons learned abroad from the crisis.

Does the Israeli financial system suffer from a shortage of liquidity?

There are no signs of a shortage of liquidity in the Israeli financial system and in any case the Bank of Israel is prepared to use all the instruments at its disposal if and when such a problem arises in order to inject the required liquidity.

What instruments are available to the Bank of Israel if a liquidity problem develops?

The Bank of Israel has a variety of instruments for the injection of liquidity into the financial system, including daily loan and deposit tenders and money market instruments, such as *makam* and repo.

How is Israel's interbank loan market functioning?

The interbank loan market in Israel is functioning normally, both with respect to its volume of activity and the level of interest paid. In the countries affected by the crisis, there has been a significant and growing spread between the interbank interest rate and the central bank's target interest rate. In Israel, no such spread is visible but if one develops, the Bank of Israel will take the appropriate measures in order to maintain the proper functioning of this market.

The central banks of developed countries are taking measures to inject liquidity directly into the business sector as well. Why is the Bank of Israel not adopting such an approach?

In certain countries, in which large and medium-size firms obtain short-term financing directly from the public in the commercial paper (CP) market, liquidity problems have been created for these firms and the CP market is no longer functioning normally. As a result, the central banks in a number of developed countries saw the need to intervene in this market. In the US, the Fed decided to buy short-term debt instruments from the issuing firms and in other countries indirect support has been provided through repo transactions against collateral, which were carried out primarily vis-à-vis banking institutions.

In Israel, the main source of financing for such firms is the banking system and the issuing of long-term bonds, while the issuing of commercial paper is at most a marginal source of financing.

Are the reserves of the Bank of Israel exposed to the effects of the global crisis?

The foreign exchange reserves of the Bank of Israel are managed according to an investment policy that places quantitative restrictions on the exposure of the reserves to various financial and operational risks. During the period since the beginning of the crisis

in August 2007, the Bank has gradually changed those risk restrictions to adjust them to the changing profile of these risks in the market. Therefore, the composition of the reserves and the system of management have already been adjusted, to whatever extent possible, to the conditions currently prevailing in the global financial markets.

How does the Bank of Israel's policy for the purchase of foreign currency and the increase in Israel's foreign exchange reserves help the economy deal more efficiently with the effects of the global crisis?

The level of foreign exchange reserves is the most important variable looked at by agencies abroad that rate the State of Israel's risk, its financial and economic stability and the ability of the government to service its foreign-currency denominated debt. Following an in-depth assessment, the Bank of Israel decided in March 2008 to increase its foreign exchange reserves to between \$35 and \$40 billion, compared with the previous level of about \$28 billion, through the purchase of a fixed daily amount of foreign currency. The decision was made against the background of the rapid growth in GDP in recent years and Israel's increasing integration into the global economy and the global financial system. The Bank of Israel reviews this policy from time to time in light of changing market conditions. The increase in foreign exchange reserves, when accompanied by responsible policies in other areas, reduces the risk of the contagion effect of the global crisis on Israel's economy.

Why has the banking system recently increased its foreign currency deposits with the Bank of Israel?

As a result of the uncertainty prevailing in the interbank market in countries affected by the crisis, Israeli banks apparently have come to prefer depositing foreign currency with the Bank of Israel although this means receiving a lower interest rate. This is local evidence of the global trend towards avoiding exposure to the credit risk of banks in these countries.

How is the crisis affecting economic activity in Israel?

The crisis is expected to affect economic activity through a number of channels: First, the fall in prices of securities in Israel and abroad has led to an erosion of the value of assets held by the public in Israel and as a result a decrease in private consumption is expected. Second, Israel's economy is small and open, which means that in the case of a slowdown in global growth or a global recession, particularly in the developed countries, there will be a drop in demand for Israeli export goods, which will in turn lead to a drop in the economy's income. This will also lead to a decline in private consumption. The expected reductions in exports and consumption, as well as the difficulty in raising capital and obtaining credit in world markets, are also likely to have a negative effect on investment. The drop in demand for export goods, consumption and investment will also be

manifested in reduced demand for labor, which will lead to slower recruitment of workers and will even have a moderating effect on wage increases.

The severe global crisis finds the Israeli economy at a favorable jumping-off point, which is the result of responsible macroeconomic policy in recent years and the relatively calm security situation. The Israeli economy's favorable fundamental conditions, and in particular the surplus in the current account of the balance of payments, will act to moderate the effect of the global crisis on economic activity.

Has the Bank of Israel changed its forecast for growth in 2009?

The global crisis has led to reduced forecasts of global growth, and particularly of growth in the advanced economies. The growth forecasts of the Bank of Israel and the IMF predict a drop in Israel's rate of growth in 2009, while per capita income will continue to increase. An important reason for this is the slowdown in global economic activity. An additional reduction in the forecasts of global growth and trade will likely lead to an additional downward adjustment in the Bank of Israel's forecast of growth.

The slowdown in the economy's rate of growth in 2009 is expected to result in an increase in the rate of unemployment, which has fallen continuously in recent years. However, it should be mentioned that the predicted effects on the economy are much less than those predicted for global economic activity.

What are the assessments regarding the development of inflation in the near future?

In general, the global crisis is expected to significantly moderate the rate of price increases during the coming year or two. The moderating effect on price indices in the near future will be relatively weak but will strengthen over time.

The main factors expected to moderate inflation are the decline in global energy and food prices, which has already occurred to a large extent, and the expected drop in domestic demand. The drop in global energy and food prices is acting to moderate the increase in the cost of production and thus reinforces the moderation of price increases. The drop in the value of the public's financial assets (the prices of shares and bonds and at a later stage perhaps the price of housing) is acting to reduce the demand for private consumption and a decrease is expected in the demand for exports and perhaps investment.

An additional factor that is expected to moderate demand (primarily investment by firms) is the fear of bankruptcy which is manifested in, among other things, the difficulty encountered by some firms in obtaining credit. This could lead to a reduction in investment and production, a decline in the demand for labor leading to an increase in unemployment and a lower rate of increase in wages, which in turn will also affect the demand for consumption.

How is monetary policy in general, and the latest reduction in the interest rate in mid-October 2008 in particular, strengthening the economy's ability to deal with the effects of the global crisis on Israel?

The maintenance of price stability is the main condition for the stability of long-term economic activity. In the special circumstances of a downturn in demand, the reductions in the rate of interest help by partially offsetting recessionary forces without creating inflationary pressure.

The primary instrument of monetary policy is the rate of interest. When the Bank of Israel reduces the rate of interest, the commercial banks in turn reduce the rate of interest they charge their customers for credit. A lower rate of interest lowers the price of credit to firms (manufacturers, service providers and others) for financing their operations, as well as the price of credit to households. Therefore, the lowering of the interest rate by the Bank of Israel in mid-October 2008, following which the banks lowered their rates of interest, made credit cheaper and therefore enabled firms to increase the liquidity they need for operations and made it easier for them to finance their activities. The reduction in the rate of interest also made it easier for households to obtain credit and thus also supported economic activity.

Since overall the pressure on prices is expected to moderate, both as a result of the decline in the prices of imported goods during this period and as a result of domestic activity, the reduction in the rate of interest is not expected to significantly hinder the attainment of the inflation target during the coming year.

A lower rate of interest, which also implies a lower return on shekel assets, is likely to raise demand for foreign currency and therefore to increase the exchange rate. A higher exchange rate (relative to domestic prices) implies increased revenues in shekel terms for exporters and therefore will offset the possible effect of lower global demand for exports.

A lower short-term rate of interest, as set by the Bank of Israel, is likely to also have an effect on longer term interest rates, which play an important role in firms' investment decisions and affect the rate of interest on mortgages and thus facilitate economic activity in general and activity in the housing market in particular.