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To: The Government and the  
Finance Committee of the Knesset,  
Jerusalem

The Annual Report of the Bank of Israel for 2001 is submitted herewith, in accordance with section 59 of the Bank of Israel Law, 5714–1954. The report comprises six parts which have been prepared by the Research, Monetary, Foreign Currency, Foreign Exchange Control, and Comptroller's Departments, as well as a statistical appendix on a CDROM. The report contains information and analyses based on data from the Central Bureau of Statistics, monetary data, and figures on foreign-currency activities collected in the Bank of Israel.

The year 2001 was a difficult one for the Israeli economy. The decline in GDP and business-sector product was led by a fall in exports and investments, and the unemployment rate rose to over 10 percent. The main causes of the recession were the deterioration in the security situation in Israel and the worldwide slowdown, especially in the US, due to the global crisis in the high-tech industry and the capital markets. The direct impact of these shocks, particularly on tourism, construction, and exports, is estimated as 6 percent of business-sector product.

Fiscal policy in 2001 was characterized by the halt in the process of adopting the norms accepted in advanced economies, and even by some regression in that respect. The relaxation of budgetary discipline, expressed in a marked deviation of the budget deficit from its target, the passage of a series of private laws, and the perpetuation of the heavy tax burden, could undermine the credibility of policy and generate expectations of tax rises in the near future; these will hamper efforts to restore the economy to a sustainable growth path and fulfill its growth potential. As regards the composition of government expenditure, the trends that do not support a return to sustainable growth persisted, and even intensified, in 2001. These included primarily an increase in the share of current expenditure, and of transfer payments in particular, in total expenditure. This trend is expected to continue in the 2002 budget, which also includes statutory tax increases.

Monetary policy continued to focus on attaining the inflation target while maintaining stability, and was expressed in the continuation of the gradual and almost constant reduction of the Bank of Israel's key interest rate. The continuous and measured lowering of the interest rate yielded stability in the financial and foreign-currency markets; the players in the capital and money markets, including the international rating agencies, continued to express confidence in Israel, and the country's credit rating was not reduced. This stability, in the context of the rapid expansion of the budget deficit and the domestic and external shocks, cannot be taken for granted, and its persistence is not assured. It depends on a return to a declining government budget deficit and debt path and on the maintenance of price stability. Commitment to a responsible long-term macroeconomic policy is increasingly important at a time such as this, when there is more uncertainty in the geo-political and economic environment than at any time in the recent past.

In view of the deepening recession, towards the end of 2001 the government decided to revise the growth forecast on which the budget was based, and to cut it significantly (relative to the original budget proposal), while raising the deficit target to three percent of GDP for 2002 and to return to a declining deficit path, to reach one percent of GDP in 2005. In this context, a package of policy measures was adopted: the Bank of Israel's key interest rate was reduced by two percentage points and several structural changes were made in the money and foreign-currency markets, giving the Bank of Israel greater flexibility in deploying monetary instruments, increasing the liberalization of the foreign-currency market prior to the completion of the process at the end of the year and contributing (slightly) to making the exchange-rate regime more flexible. It was envisaged that given these conditions it would be possible to maintain price stability with a lower interest rate, while supporting real depreciation, thereby fostering the rapid recovery of exports once global demand revived.

From the time of the announcement of the package of policy measures until mid-March 2002 the NIS depreciated by some 10 percent against the dollar, and the January–February Consumer Price Index (CPI) rose by a cumulative 1.9 percent. This took place in the context of the approval of the budget which, according to up-to-date assessments, is not consistent—unless further adjustments are made—with the deficit target of three percent of GDP, and will make it difficult to attain a target of two percent in 2003. The changes in the composition of expenditure in the 2002 budget, and especially the steps towards increasing taxes, do not tend to support growth. In these conditions it is doubtful that it will be possible to maintain price stability with the interest rate that prevailed at the end of 2001, and it will be adjusted, as required, in order to maintain stability given the changing circumstances.

The main policy target for next year and those to come is to restore the economy to a path of sustainable growth that will facilitate the expansion of employment and the reduction of unemployment, while maintaining economic stability, including price stability. This should be done while attending to the growing problem of poverty. The macroeconomic policy mix which is in line with these objectives involves some monetary expansion alongside the maintenance of price stability and tight fiscal policy, expressed in a declining deficit and government debt. A mix of this kind will enable price stability to be maintained with a lower short- and long-term interest rate, while supporting the generation of real depreciation. These developments will lead to an increase in investment and exports, and hence in growth and employment. The rise in unemployment and the low labor force participation rate call for the reform of the labor market. The continued decline in total factor productivity makes it necessary to introduce structural reforms intended to make the principal industries more efficient and competitive.

Responsible, long-term fiscal policy means adhering rigorously to the deficit target which the government set for 2002, three percent of GDP, and continued conformity to the declining path, aimed at reaching one percent in 2005. On the basis of assessments currently prevailing regarding the growth rate in 2002, it appears that in order to attain that target for this year expenditure will have to be slashed far beyond the extent noted in the budget approved by the Knesset. It is especially important that the budgetary

adjustment be implemented on the (current) expenditure side, rather than by increasing the tax burden, as a tax hike might encourage individuals and firms to operate abroad, preventing the economy from returning to a growth path. It is necessary to monitor the implementation of the budget in accordance with its targets, and this should be done by means of a mechanism of periodical reporting to the government.

In order to support the return to a growth path, it is necessary to increase the share of infrastructure investment in the budget. This will contribute to growth by serving to increase business-sector productivity. Investment in the transport infrastructure, the cumulative backlog in which is estimated at 10 percent of GDP, will also help to bring the periphery closer to the center and reduce unemployment by minimizing the dependence of outlying towns on local plants.

The increase in the real public-sector wage is one of the main factors hampering efforts to check the rise in current expenditure. Bringing the structure of public-sector wages into line with an environment of price stability is necessary in order both to strengthen the link between labor productivity and wages and to provide greater budgetary control.

The fact that the tax burden remained high in 2001, and that the government decided in the 2002 budget to impose a surtax on high incomes represents a retreat from the path of easing the tax burden that was intended to stimulate a return to growth. Without a significant reduction of the tax burden, the incentive to transfer business activity to countries with a lower tax rate and a more accommodating business environment will endure. As regards the composition of taxation, it is very important to implement a reform of the tax system, widening the tax base by canceling exemptions on income from wealth, especially financial wealth, lowering the tax on labor, especially for middle-income groups, and eliminating the distortions arising from tax discrimination between investors and investment channels.

Monetary policy will continue to strive for price stability while maintaining financial stability. The cancellation of the ceiling on Treasury bill issues will give the Bank of Israel greater flexibility in deploying the instruments available to it in order to implement monetary policy, and will help to create the infrastructure for a nonbank money market, thereby serving to make policy more efficient. In the longer run, as real economic activity recovers and the economy begins to grow again and approach its growth potential, monetary policy will be confronted with the challenge of maintaining price stability while converging to interest rates similar to those prevailing in the advanced economies.

Lowering and flattening the lower limit of the exchange-rate band contributes slightly to making the exchange-rate regime more flexible by reducing the likelihood that the exchange rate will reach the lower limit of the band, requiring the Bank of Israel to intervene in the foreign-currency market. In the future it will be advisable to abolish the band in order to obviate a potential clash between the need to defend its limits and the maintenance of price stability.

The steep rise in unemployment in 2001 due to the recession, after increasing continuously, alongside the steady fall in the labor force participation rate, especially among those with little education and in peripheral areas, means that in addition to a growth-

oriented macroeconomic policy a concerted effort must be made to deal with the problems of the labor market so as to increase the participation rate and reduce unemployment. The effort to increase the participation rate must also include measures to improve the skills of persons with little education and help them adapt to the changing conditions of the labor market. This should be done by means of a system of vocational training in conjunction with employers, lowering the incentive to leave the labor market embodied in transfer payments, reducing wage rigidities in the business sector, and cutting the number of foreign workers. In the long run the key to enhancing human capital and creating equal opportunity in the labor market rests with improving the public education system. Consequently, when it comes to determining government policy in the area of education, preference should be accorded to improving the standard of education among the underprivileged section of the population, and this should be done by means of differential budget allocation.

The policy of transfer payments currently in force embodies a negative incentive for participation and employment, as it makes it less worthwhile to work than to receive an income supplement and its accompanying benefits. Part of the problem lies in the fact that most of the benefits are contingent upon not working or on having a very low income, so that the reward for work at low wage levels is very small. In order to contend with this problem government policy should focus on implementing employment tests more rigorously, on the one hand, and altering the structure of the transfer payments and their associated benefits, on the other. If this is done the decision to go out to work will result in a smaller and more gradual loss of the transfer payment and benefits.

In order to expand employment of Israelis it is necessary to make it less worthwhile to employ foreign workers. The policy of reducing the number of permits issued to foreign workers should be implemented, the legislative restrictions concerning their employment should be enforced, a fee or tax should be imposed on employers of foreign workers, permits should be issued to workers rather than employers, and the law should be enforced with regard to illegal workers and those who employ them.

Another sphere in which policy measures can help to restore the economy to a growth path is that of structural reform, including privatization coupled with the creation of a competitive environment. No significant progress was made in this respect in 2001. Reforms, primarily in infrastructures (transport, domestic telephone network, fuel, gas, and electricity), will serve to heighten competition, lower costs, and accelerate economic activity.

The reform of the pension system is required both socially and in order to develop the capital market. Currently only some 60 percent of wage-earners have pension insurance, and the rate is lower still among low-income groups. A national pension law should be introduced in order to expand pension coverage among wage-earners and the self-employed up to a minimum level of income, provided the pension money is channeled solely to the capital market, and an actuarial balance is assured. A plan should also be devised to remedy the actuarial deficit of the older pension funds. At the same time, the funds that are based on earmarked bonds should be closed to new members. It is important to ensure that the funds for new employees who join funded pen-

sion schemes in accordance with recent legislation, are actuarially balanced and invest their money in the capital market. A reform of this kind will make pension savings the principal long-term savings scheme in Israel, while serving to develop the capital market and extend pension coverage to the entire working population.

The government decided recently to amend the Bank of Israel Law, and the process of legislation is about to begin. It is important for the changes to express the following principles, which are accepted in most developed countries, and were adopted by the Levin Commission:

- The object of the central bank's policy is to maintain price stability. Subject to this the Bank may support growth and employment, in accordance with the government's economic policy.
- The central bank should be completely independent in selecting and deploying the monetary instruments required for the maintenance of price stability.
- The decision on the short-term interest rate should be made within the framework of a monetary policy council headed by the Governor, whose members are experts and do not have conflicting interests. These members should be proposed by an outside committee, selected by a transparent process, and approved by the government.
- The central bank should explain its policy in a detailed way in the framework of a periodical report to be submitted to the government.

Yours sincerely,



David Klein  
Governor