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30 March, 2004

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

The Annual Report of the Bank of Israel for 2003 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 Activity, and Comptroller's Departments, as well as a statistical appendix on CD-Rom. 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.

There was a turnaround in 2003, and economic activity rallied: GDP and business-sector product rose, after declining in the two preceding years. The recovery was led by the expansion of exports, and to a lesser extent by the growth of private consumption. The turnaround was driven by the global economic recovery and the slight improvement in Israel's security situation, supported by the coordinated change in the policy mix—fiscal restraint and the gradual reduction of the Bank of Israel's key interest rate. Nonetheless, the decline in per capita GDP persisted and the unemployment rate rose. The CPI (Consumer Price Index) dipped by 1.9 percent in the course of the year, falling below the price-stability target; this development was influenced by local-currency appreciation against the dollar as well as by the recession.

Economic developments display the difference in the situation at the beginning and end of the year. Until March there was uncertainty regarding the government's commitment to the deficit targets, alongside political-security concerns and doubts as to the outcome of the war in Iraq. These continued the negative trends of the last two years, among them a steep rise in the public debt/GDP ratio, an increase in the statutory tax rate, and a relatively high interest rate, which was intended to restore price stability while maintaining financial stability. As of March—in the wake of the announcement of the government's economic recovery package aimed at reducing the budget deficit by slashing its current expenditure, the approval of the US loan guarantees, temporary renewal of the peace process, and subsequent rapid conclusion of the war in Iraq—uncertainty abated markedly. The improvement led to a steep fall in Israel's risk premium, and was expressed by all the main monetary indicators, with a decline in inflation expectations and in the nominal and real yield curves. Against this backdrop, and with the aid of positive developments in western economies, it was possible to reduce the Bank of Israel's key interest rate gradually and on an ongoing basis. The successful economic policy mix played a major role in changing firms' expectations which, together with the surge in global stock markets, caused share prices to soar, supporting the recovery of private consumption in the second half of 2003. The decline

in the real short- and long-term interest rates also bolstered the stabilization of investment in the course of the year.

Although the employment rate remained steady in 2003, the unemployment rate continued to rise, reaching an average of 10.7 percent of the civilian labor force. The relatively moderate increase in the unemployment rate, despite the slight expansion of the demand for labor, derived *inter alia* from the determined efforts to reduce the number of foreign workers, which made it possible to increase the number of Israeli workers—especially in construction—for the first time in many years. This year, after a long period in which public-services employment rose, this trend slowed notably, and most of the increase in employment was in the business sector.

The main objective of macroeconomic policy in the next few years should be to utilize Israel's economic growth potential by means of the business sector. In order to return to sustainable growth it is necessary to ensure the stability of prices, ongoing reduction of the public debt/GDP ratio, and balanced current account of the balance of payments. The macroeconomic framework that will support these conditions is a mix comprising a return to declining public debt and deficit paths, open financial markets, and the lowest possible monetary interest that is consistent with price stability. A mix of this kind will also support a low level of long-term interest, thereby serving to augment investment.

The government decided to adopt a deficit target of 4 percent of GDP for 2004, and a new set of targets for 2005–2010 according to which public expenditure will rise by no more than 1 percent a year, with a deficit ceiling of 3 percent of GDP. According to revised assessments, the deficit in 2004 is expected to be close to the target, notwithstanding the fact that the budget reserve—including the part designated to contend with macroeconomic shocks—is already fully committed. A question which is often asked is whether it is advisable to continue reducing taxes in order to stimulate demand and supply. Note, in this context, that progress was made in 2003 in restoring public confidence in fiscal policy by means of the Economic Recovery Package. Tax reductions, which could undermine the government's adherence to the deficit target, could damage its credibility, especially in view of the recurring deviations from the deficit targets of the last few years due to unrealistic revenue forecasts. Consequently, and because Israel's tax burden is no greater than the accepted rate in many advanced economies, it is advisable to avoid reducing the tax rate in the near future, as this could cast doubts on the government's ability to alleviate its debt burden and debt-servicing costs, while at the same time, once circumstances are appropriate, to improve the composition of tax receipts. In view of the public debt/GDP ratio, which is high by international standards, greater emphasis should be placed on the objective of reducing the debt in the medium term.

Moreover, it is incumbent upon the government to plan its budget in a way that is consistent with attaining its target of restricting the growth of expenditure to 1 percent a year. In this context, it is important to place the aspiration to increase efficiency in public-sector employment on the public agenda. To date, the efforts to attain fiscal

restraint have been based on wage cuts, but without making any significant decisions as to the number of public-services employees in the long term. A planned process that is coordinated with the unions and implemented over several years could contribute to efficiency while minimizing the adverse effect on the public services.

For many years there was under-investment in the infrastructure. In order to close the gap between levels of infrastructure in Israel and western economies and boost economic growth, it is necessary to invest about NIS 20 billion each year in the next five years—half this amount in land transportation. Most of the projects should be implemented by government and private companies, while a minority can be financed via the budget. In recent years progress has been made in some mass transportation projects, but not all of them are advancing at the desired rate, and this could constitute an obstacle once sustainable growth resumes. It is therefore recommended that a Ministerial Committee for the Infrastructure be established, which will determine priorities among projects, be responsible for the implementation of plans, remove impediments, and monitor progress on an ongoing basis. It is also recommended that when the budget is in the process of being prepared a special government session be set aside in which entities concerned with projects involving roads, railways, water, electricity, gas and other aspects of the infrastructure are required to give a quarterly progress report to both the government and the public. In many areas, including electricity, ports, air freight, bus services, and oil refining, the level of competition is very low, and it is important to make progress in the structural changes intended to augment it.

As regards social welfare, the government should persevere with its policy intended to increase the employment rate, in order to bring it into line with the average in the rest of the world. Till now this has involved reducing the number of foreign workers and cutting transfer payments. The cost of employing foreign workers should be increased in order to cause their number to continue falling. It is important to complement these measures by policy steps which will give low-income segments of the population an incentive to enter the labor force. These steps should include the reform of transfer payments, as well as the introduction of a negative tax system as well as the subsidization of work-sustaining services, such as child care and transportation of employees, in addition to a compulsory occupational pension at market rates. Work training and placement systems should also be improved and made more efficient. Additional changes aimed at increasing individuals' ability to participate in the labor force, such as increasing the efficiency and quality of education, especially for disadvantaged groups, are also required.

The problem of poverty has grown in recent years. The government must set long-term targets for combating it, as is customary in the advanced economies. It is also important to create mechanisms which will distinguish between individuals who are able to work and those who are not, in order to ensure that transfer payments are directed mainly to the latter. In this framework it is important to extent means tests to include all components of income, including imputed housing services.

In general, in order to boost and entrench growth the government must act in accordance with long-term national targets as regards the budget and debt aggregates, infrastructure investment, increasing competition, raising the employment rate, and combating poverty. All this should be achieved while maintaining price and financial stability. This policy will enable Israel's economic growth potential to be utilized and social cohesion to be intensified.

Yours sincerely,

David Klein
Governor