

4 Nissan, 5766

2 April 2006

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

I submit herewith the Annual Report of the Bank of Israel for 2005, in accordance with section 59 of the Bank of Israel Law, 5714–1954.*

In 2005, Israel's economic recovery—which began in 2003, after two-and-a-half years of severe recession—continued, and became even more firmly based. GDP grew by 5.2 percent, led again by the business sector, which grew by 6.6 percent. Improvements in the macroeconomic environment and in the state of the economy were reflected in many ways. These included the decline in unemployment from 9.8 percent at the end of 2004 to 8.8 percent at the end of 2005, accompanied by increases in the rates of both employment and labor force participation; the increase in the surplus in the current account of the balance of payments; and positive developments in the capital markets.

Israel's economic growth was bolstered by the continuation of strong global growth and the sustained improvement in the security situation, as well as the steady implementation of a supportive economic strategy. The macroeconomic policy mix combined fiscal discipline, reflected in tight control of expenditure, a considerable reduction in the deficit, and tax cuts, together with an accommodative monetary policy. These made it possible to take advantage of the favorable underlying conditions, and were a key factor in the positive reactions of the financial markets.

The integration of the Israeli economy into the global economy continued apace in 2005: imports currently constitute more than 40 percent of GDP, and exports more than 35 percent; Israelis' investments abroad, direct and portfolio, reached \$10.1

* The balance sheet and profit and loss account will be submitted at a later date.

billion, around 8 percent of GDP; nonresidents' investments in Israel totaled \$10.8 billion; and nonresidents' participation in the NIS/forex market rose to 49 percent. Integration into the global economy is vital for Israel's continued economic growth. However, it also requires economic policy makers to take into account the potential effects of developments in the international markets on Israel's economy, and in particular the reactions of market participants to Israel's economic policies. The latter are reflected mainly in the country risk assessment, which affects Israel's credit rating and decisions regarding investing in Israel.

Against this background, macroeconomic policy in 2005 achieved its three numerical objectives: the rate of inflation, at 2.4 percent, was within the price-stability range; and both the budget deficit at 1.9 percent of GDP and the increase in public expenditure at about 0.3 percent were below their ceilings. Correspondingly the public-debt/GDP ratio declined significantly, although it remains very high in international terms.

Success in the goal of increasing competition in the economy was reflected in the continued progress in privatization, and in reforms in various areas of the infrastructure, including public transport, the ports, the oil refineries and air transport.

In the capital markets, where reforms have been under way for some years, important progress was made on two fronts: a significant start was made on the implementation of the recommendations of the Bachar Committee to reduce banks' holdings in provident and mutual funds, aimed at increasing competition in the capital markets and reducing conflicts of interest; and the process of equating tax rates on income earned on securities in Israel and abroad was completed, thus ending the tax discrimination that had favored Israelis' investment in securities in Israel over such investment abroad.

The incidence of poverty in Israel has risen in the last few years, whether measured in relative terms or in terms of basic needs. This reflects both the long recession that started at the end of 2000, and the cuts in welfare benefits from 2002. The latter were intended to raise the rate of participation in the labor market, which is lower in Israel

than in other countries; raising the rate is an important means of reducing poverty in the long run.

The main goal of economic policy for the next few years should be to sustain and strengthen the continuing growth of the economy. Sustained strong growth will make it possible to raise the overall economic well-being of Israelis, and to tackle social problems, in particular that of poverty. To sustain growth, economic policy will need to maintain fiscal discipline, price stability and financial stability, while promoting infrastructure reforms and intensifying competition in the economy. Alongside all these, a continuous policy focused on reducing poverty is required.

To achieve these goals the government should strive to keep the budget deficit and government spending as a share of GDP on a downward path. This will enable the government's share in GDP and the debt/GDP ratio to be lowered considerably. The lowering of the public-debt/GDP ratio is needed so that a) the heavy burden of interest payments in the government's budget can be reduced, b) the economy can be made less sensitive to external shocks, and c) the government will be able to adopt a countercyclical policy when needed in the future. It is noteworthy that the rating agencies regard Israel's debt/GDP ratio as an important factor in their ratings.

A new central bank law is currently under discussion between the Government and the Bank of Israel, intended to modernize the Bank's legal foundations, as has been done in other developed and emerging market economies in recent years. The new Bank of Israel Law is intended to deal with the independence of the central bank, clearly define its purposes, and determine new frameworks for decision-making and transparency. The main objective of the Bank will be defined as maintaining price stability in the long run in accordance with the target set by the government, while supporting other government targets such as growth and employment, without undermining long-term price stability, while supporting the stability of the financial system. It is proposed that two new bodies be established, a monetary committee and a (management) board of directors, both of which will include members from outside the Bank with the appropriate qualifications. The monetary committee, with the Governor as chairman, will make decisions on monetary policy; the board of directors, chaired by one of its outside members, who will constitute a majority, will

approve administrative issues such as the Bank's work plan, its budget and staff salaries. Each of these bodies will have to report its decisions to the public, so that a system of public checks and balances will be created alongside the Bank's independence.

The implementation of reforms in the various areas of infrastructure, and increased competition, will help increase productivity and thus contribute to growth. The continued development of the financial infrastructure and the removal of barriers to increasing competition in the capital markets and in the banking system, particularly with regard to the household sector, will further contribute to sustained growth.

The reduction of poverty requires a long-term approach. It is important that policies to achieve sustainable growth be accompanied by the allocation of resources to education to ensure that the weaker sections of the population receive a level of education that will enable them to participate in the labor market and achieve their potential. Several steps are required to reduce poverty in the medium term; these should focus on the sections of the population with a particularly high incidence of poverty—low-wage employees, the elderly, the ultra-orthodox and the Arab sector. Such measures, including the Earned Income Tax Credit (negative income tax), and improving the programs for retraining, basic education for adults and job placement, will provide incentives to join the labor force and will increase disposable wage income. At the same time some welfare benefits will need to be adjusted for those unable to participate in the labor force.

Yours sincerely,

Stanley Fischer

Governor, Bank of Israel