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

The Annual Report of the Bank of Israel for 2004 is submitted herewith, in accordance with section 59 of the Bank of Israel Law, 5714–1954.

In 2004 the long-term strategy of Israel's macroeconomic policy—intended to place the economy firmly on the path towards the realization of its growth potential and to create the conditions necessary to make growth sustainable while maintaining stability—moved forward. Underlying this is the realization that long-term growth is a necessary, but not sufficient, condition for improving the welfare of the population by raising the standard of living, improving the employment situation, and reducing poverty and inequality. This strategy, against the background of the rise in world trade, the recovery in high-tech industries and the relative calm in the security situation, greatly helped the economy in the process of moving from the recession to growth based on economic and financial stability.

Progress was made along various channels:

- Fiscal policy created a framework of budgetary discipline aimed at gradually reducing the government's slice of the economy and freeing resources for business-sector-led growth. This was to be achieved by cutting public-sector expenditure, meeting the deficit target, reducing the government debt, and lowering tax rates.
- In the monetary area, the maintenance of financial stability in general and price stability in particular as a firm basis for domestic and foreign investment persisted and became more deeply entrenched. This policy, combined with the fiscal policy described above, was reflected in the decline of interest rates to all terms, which supported the revival of economic activity.
- With regard to structural reforms, steps were taken to streamline government services and to introduce competition into areas where this was lacking.
- The main focus of social policy was on providing incentives to participate in the labor force and reducing the dependence on government transfer payments.

The return to growth was led by the business sector, and it brought about a reduction in unemployment, which nevertheless remained high, in addition to which the improvement in employment was expressed mainly in part-time low-paid jobs.

The main challenge facing economic policy in the next few years is to complete the policy measures required—in the framework of

macroeconomic strategy—to realize the economy's growth potential by ensuring long-term growth of the business sector. A long-term policy of limiting the increase in government expenditure and of a downward-sloping government deficit path—that will lead to a decline in the government-debt/GDP ratio—together with the preservation of price stability, is essential for the creation of the economic and financial infrastructure needed for sustainable growth. Concurrent with advances in the sphere of fiscal targets, it is important that employment in the public sector is dealt with too: fiscal restraint in this sector hitherto was based on lowering the wage, but it must go hand in hand with limiting the number of employees in public services in the long term.

Another major factor in underpinning sustainable growth is the continued implementation of reforms intended to increase competition and efficiency both in the financial markets and in the real markets. The recommendations of the Bachar Committee should be put into effect, to increase competition in the financial markets and to create alternatives to the banking system as sources of finance. At the same time reforms in many other areas of the economy should be instituted, such as in the labor market, the education system (along the lines of the Dovrat Committee), electricity, cargo handling at Ben-Gurion Airport, public transport and oil refining. Special attention should be devoted to the physical infrastructures because of their great importance for the growth of the business sector and in the light of the many years of underinvestment in some of them. A special entity should be established to deal with this issue, such as a ministerial committee for infrastructures, which will be responsible for implementing projects and will continuously monitor their progress.

On the social front, it is important that the government continue with its policy to increase the employment rate and bring it closer to the average level in the developed economies, in the context of macroeconomic strategy that has started being implemented. Hitherto this covered incentives for those outside the labor force to enter into it, cuts in transfer payments, and reducing the number of foreign workers. The contraction in the number of permits for foreign workers should continue, and enforcement in this area should be improved so that the number of these workers should fall further. In order to increase the incentive for unemployed workers to participate in the labor force at low wage levels negative income tax should be introduced, essential services to enable them to go to work—such as transportation and child-minding services—should be subsidized, and the system of retraining and job placement should be improved. This should take place in the framework of the Wisconsin Plan, and by means of strengthening the Employment Service. A mechanism should be established to distinguish between those capable of working and those unfit to work, and to ensure a decent standard of living for those outside the labor force not out of choice, such as the elderly or the handicapped. It is important for the government to direct its efforts in this matter in a way that is consistent with its long-term

targets regarding poverty. To expand individuals' ability to participate in the labor force, education should be improved, with special emphasis on the weaker strata of the population. Carrying out the reform along the lines recommended by the Dovrat Committee would help make the education system more efficient, raise the quality of education and reduce the inequality in education.

The time is ripe for a new Bank of Israel Law which will incorporate the norms accepted in many countries, in order to strengthen the macroeconomic infrastructure of Israel's economy. Such legislation would boost the credibility of monetary policy and would at last remove any doubt regarding the proper division of labor between the government and the Bank of Israel within the framework of macroeconomic strategy. The new law should rest on four pillars:

- Defining the major role of monetary policy as maintaining price stability, and subject to that, supporting other economic objectives such as growth and employment.
- Formalizing the complete independence of the Bank of Israel in operating the monetary instruments.
- Establishing a body for making policy decisions in the Bank of Israel—a monetary council headed by the Governor, whose members would have the appropriate qualifications, be free of potential conflict of interests, and independent of the government, the political establishment, and the business sector.
- Formalizing a system of transparency and responsibility incorporating reports to the government, the Knesset and the public.

Yours sincerely,
Meir Sokoler
Acting Governor