Jerusalem, 4 Nissan 5777
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To: The Government and the
Finance Committee of the Knesset,
Jerusalem

I am honored to submit herewith the Bank of Israel Annual Report for 2016, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

In 2016, GDP grew by 4 percent—a rapid rate compared with that of the preceding four years. Growth was primarily driven by private consumption, while exports increased slowly. Private consumption accelerated this year primarily because the economy's terms of trade improved markedly in the past two years and the prices of consumer goods declined (relative to the GDP deflator), both of which notably increased households' real income. The robust labor market and the low interest rate environment also continued to support the high level of consumption. Exports grew slowly mainly because world trade growth remained weak. The appreciation in terms of the real effective exchange rate also weighed on exports. The significant surplus in the current account of the balance of payments continued, even if it declined slightly this year. There are advantages to such a surplus, including the strengthening of the economy's resilience to shocks, though its size reflects an insufficient level of investment in the economy.

The expansion of economic activity increased demand for labor. This, along with long term structural factors, further increased the employment rate and reduced the unemployment rate to the lowest level in several decades. There are several signs indicating that the economy is near full employment, and this is reflected in wage increases as well.

Although the economy grew rapidly in an environment near full employment, the inflation rate remained negative, and was -0.2 percent for the year, below the lower bound of the target range. The low inflation rate derived from the low inflation environment worldwide in addition to factors primarily on the supply side—the decline in shekel denominated import prices as well as enhanced competition in the economy. Import prices declined due to the appreciation of the shekel and due to the composition of goods that Israel imports. Competition increased after the government took measures toward that end, consumer awareness increased, and consumers expanded the use of the Internet in order to compare prices and purchase goods in Israel and abroad.

The Monetary Committee kept the interest rate at 0.1 percent and continued to declare that monetary policy would remain accommodative for a considerable time. The Committee did not reduce the interest rate to negative levels because medium to long term inflation expectations remained anchored within the target range, growth accelerated over the course of the year and eased the concern of a deflationary process, only little experience with using negative interest rates had been accumulated worldwide, and due to the need to manage the risks posed to financial stability from the mortgage market. In addition to the foreign exchange that the Bank of Israel bought within the framework of the program to offset the effect of natural gas production, the Bank continued to purchase foreign exchange in order to moderate the appreciation deriving from transitory shocks that do not reflect the economy's underlying fundamentals and are liable—notwithstanding their transitory nature—to have a long term negative impact on exports.

The ratio of public debt to GDP continued to decline this year, reaching about 62 percent of GDP. The government deficit was 2.1 percent of GDP this year, similar to the deficit last year and lower than the deficit ceiling. The deficit was lower than the ceiling primarily because tax revenues were greater than forecast in the budget after GDP grew more rapidly than expected and there was an extraordinary increase in vehicle imports. The government used the surplus tax revenues to make permanent cuts in tax rates in 2015–2016 and to reduce taxes moderately in the 2017–2018 budget. A permanent reduction in tax rates carried out following a transitory increase in tax receipts increases the economy's exposure to risks inherent in negative shocks to the economy.

Home prices continued to escalate this year, driven by strong demand. This demand was affected primarily by demographic needs and the low yields on other assets, even though the interest rate on mortgages increased this year and the volume of new mortgages decreased. On the supply side, activity in the construction industry was at a high level, reflected both in the number of building starts and in the industry's contribution to economic growth.

This year the Knesset approved the Increasing Competition and Reducing Concentration in the Banking Market Law, following the recommendations formulated by the Strum Committee. Even before the Law was approved, the Bank of Israel began to take a range of steps to reduce barriers to entry to the credit and banking markets, including easing the regulatory capital requirements and the licensing processes for new banks and merchant acquirers. The Bank also continued to advance the establishment of a Central Credit Register in accordance with a law enacted in 2016. It is crucial to carefully formulate the various steps to increase competition in the financial industry and to concurrently take complementary steps, in order to ensure that consumers gain from the reforms and that the risks to the stability of the system do not grow excessive.

A notable part of the economy's growth in recent years has been based on a rapid expansion in labor input, a process that derived from, among other things, various population groups increasing their labor force participation. This is a welcome development, though in some sectors the participation rates are still quite low and should be increased. The main challenge faced by policy makers in coming years is to ensure that growth is based to a much greater extent on increasing labor productivity while reducing inequality in the economy. This requires, among other things, an increase in expenditure on education—including technological education—and professional training, as well as in investment in public infrastructures, two areas that significantly lag behind needs.

Expenditure per student in the education system is not sufficient, and can be seen in Israel's relatively low standing compared with advanced economies, both in student achievements and in terms of the inequality among them. This inequality indicates that the system does not sufficiently rectify the gaps deriving from differences in students' socioeconomic backgrounds. Furthermore, new data indicate that some workers—that is, individuals who are already in the labor force—lack basic skills required in the modern labor market.

The low investment in public infrastructures negatively impacts productivity, and apparently also adversely impacts the scope of investment of the private sector. Increased investment in these infrastructures, including expenditure on the planning stages, is not only critical to increasing productivity but also to expanding the stock of homes in accordance with demographic needs over time. This is because public infrastructures, chief among them public transport systems, are critical for increasing urban density, through urban renewal, among other ways. Suitable public transportation will also improve access to employment centers for a range of population sectors and thus contribute to reducing inequality.

To expand expenditure on education and infrastructure, and to bring it closer to the needs of the economy and the expenditure level in other advanced economies, civilian public expenditure should be increased carefully, and the scope of tax revenues should be brought in line with it. These steps will make it possible to improve public services in additional areas, including health, and will contribute to sustainable growth and welfare.

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