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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 2018, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

In 2018, GDP grew by 3.3 percent. The composition of growth was balanced, as in 2017: domestic uses continued to grow, supported by the accommodative monetary policy and expansionary fiscal policy, and exports grew at a pace similar to the growth rate of world trade. The full employment environment and the deterioration in the terms of trade weighed on further expansion of activity, and together with the contraction of residential construction investment led to growth that was slightly slower than in the previous two years. The full employment environment and the deterioration in the terms of trade also acted to reduce the surplus in the goods and services account, and thus supported the depreciation of the real exchange rate, after its continued appreciation in the past decade.

The employment rate continued to increase this year, and the full employment environment was well reflected in the labor market—the unemployment rate continued to decline and reached its lowest level in several decades, the increase in wages accelerated, and the share of labor income in GDP increased markedly.

Although at the end of 2018 annual inflation was 0.8 percent, slightly below the lower bound of the target range (1–3 percent), beginning from the second half of the year it stabilized in the lower part of the target, after more than four years of being below it. The increase in inflation was supported by the full employment environment, an increase in oil prices worldwide, and the depreciation of the shekel. One-year inflation expectations also stabilized in the lower part of the target beginning from the second half of the year. These developments explain the decision by the Bank of Israel's Monetary Committee in November to increase the interest rate to 0.25 percent, after it had remained at 0.1 percent for almost 4 years. Note that even after that increase, monetary policy continues to be accommodative, and supports the continued increase of inflation toward the midpoint of the target range. Since February, the Bank of Israel purchased foreign exchange only through the program to offset the impact of natural gas production on the exchange rate, and in November the Monetary Committee announced that purchases through the program will be discontinued in the beginning of 2019.

The budget deficit was 2.9 percent of GDP, one percentage point higher than the deficit in 2017 and in line with the ceiling established in the budget. The deficit increased because public expenditure continued to expand this year while the share of taxes in GDP declined due to the exhaustion of the effect of one-off revenues in 2017. The increase in the deficit halted the trend of decline in the public debt to GDP ratio, which reached 61 percent this year. The government's increasing expenditure in recent years, at the same time as reducing statutory tax rates, works to increase the structural deficit to a level that is undesirable for it to remain at for an extended period. The risks inherent in such a situation will increase if the growth rate slows. This highlights the need for fiscal adjustments, which are advisable to be made when the economic situation is expedient. Postponing them could necessitate more significant adjustments precisely when fiscal expansion is needed in order to support activity. As the government's plans for the coming years involve large expenditures, fiscal adjustments will apparently require that the government increase the efficiency of its activities, change its priorities, align the growth rate of expenditure with the budget-aggregate growth rates it determined for the coming years ("the numerator"), as well as increase tax revenues—in view of the low civilian expenditure in Israel. It is important to maintain expenditures that support growth and enhance productivity.

Home prices declined this year for the first time after approximately a decade in which they increased rapidly. Contributing to the halt in the increase were steps taken by the government in previous years to markedly expand supply as well as to reign in demand. The number of building starts declined in the past two years, and the government should create the conditions that will allow an appropriate number of building starts over time, particularly in areas with high demand. This is especially in view of the forecasts regarding the additional homes that will be needed in the coming years.

The ratio of total private debt (business sector debt and household debt) to GDP increased by one percentage point this year. Business sector debt increased rapidly primarily due to the expansion of bank credit to companies in the construction industry. With that, the ratio of business sector debt to GDP is low compared to the rest of the world and to the past. Household debt expanded at a pace similar to that of 2017, although the growth rate of nonhousing debt slowed this year, after years in which it rose rapidly, while housing debt increased rapidly. The household debt to GDP ratio is also low in an international comparison, even though it has grown over time.

This year, several processes came to fruition that were intended to enhance competition in the household and small business credit market, among other things through increasing the number of players. These steps—together with the credit data system that will be launched soon and other initiatives being promoted by the authorities—are expected to yield benefits in the coming years already.

GDP per capita in Israel remains lower than in other advanced economies. Not only is the economy failing to reduce the gap, but in recent years GDP per capita has been growing slower than in those countries even though the employment rate in Israel increased rapidly. Moreover, demographic and other processes are expected to act to slow the potential growth rate in the coming decades. All these highlight the need for an overall policy to increase productivity in the economy. Such policy should lead to improvement in several areas—human capital, infrastructure, and the business environment.

Regarding human capital, steps to improve education at all levels should be emphasized, beginning from the earliest ages (0–3), in order to allow a prolonged improvement in the achievements of all students and to provide them with the basic skills required for the future job market. Special efforts should be focused on reducing achievement gaps among students from the various population groups and socioeconomic backgrounds, as those gaps are very high in international comparison. Broad investment in infrastructures is required, primarily public transportation and metropolitan mass transit systems. The government must continue to act to improve and simplify regulation, and to persist in efforts to enhance competition in the economy and increase the openness to competing imports in various sectors.

Besides steps to increase productivity, policy should be adopted for increasing employment rates among the sectors that still have low participation in the labor force, and affording them the skills required to do so. Comprehensive and persistent policy in these areas will contribute to increasing the standard of living for all population segments and to reducing inequality in the economy.

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Governor of the Bank of Israel