23 Nissan, 5767

11 April 2007

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

I submit herewith the Annual Report of the Bank of Israel for 2006, in accordance with section 59 of the Bank of Israel Law, 5714–1954.*

The year 2006 was a good one for the Israeli economy. GDP grew rapidly for the third year in a row. GDP growth of 5.1 percent was led by the business sector, which grew by 6.4 percent. Improvements in the macroeconomic environment were reflected on many fronts: among them the decline in unemployment to 7.7 percent at the end of 2006, accompanied by increases in the rates of both employment and labor force participation; the increase in the current account surplus of the balance of payments to almost 5 percent of GDP; and declining interest rates and increases in stock price indices in the capital markets. These economic achievements are all the more remarkable given the background of the Second Lebanon War, which took place during the summer.

Israel's economic growth was bolstered by the continuation of strong global growth, particularly in the high-tech industries, and the continued implementation in Israel of an economic strategy that supports sustainable growth. The government maintained fiscal discipline as reflected in a considerable reduction in the deficit, while continuing the implementation of a long-term tax reduction plan. These policies made it possible to bring the public-debt/GDP ratio down sharply, although it still remains too high.

Inflation rose above the upper boundary of the price stability target range during the first half of the year, and in later months fell below the lower boundary. This was

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

principally due to changes in the shekel/dollar exchange rate, as well as energy prices, which raised inflation in the first half and then subsequently lowered it. Monetary policy acted to bring inflation gradually back to within the target range over a 12-month horizon.

The incidence of poverty in Israel has risen in the last few years, measured in relative terms. An alternative "absolute" measure of poverty, based on the ability to purchase a basket of essential goods and services, or a fixed basket of goods and services, showed (according to the latest available data, of 2005) a decline, after rising in the previous three years. This change in trend was due to continued economic growth, which improved conditions in the labor market for all workers, including those with low levels of education, among whom the employment rate increased.

The main goal of economic policy for the next few years is to sustain and strengthen the continuing growth of the economy, which will make it possible to raise the overall economic well-being of Israelis, and to tackle social problems. To do so, macroeconomic policy will need to continue its path of fiscal consolidation and to maintain price and financial stability. In addition, reforms are needed to improve the functioning of the education system and restart the drive for structural reforms that are intended to improve the infrastructure and enhance competition in the economy. Further, policy should focus on reducing poverty, with an emphasis on expanding employment among those populations with low participation in the labor market.

To achieve these goals the government needs to maintain fiscal discipline over time, including by keeping the budget deficit low. This will enable the debt/GDP ratio to decline, and hence reduce the heavy burden of interest payments in the government's budget, enhance the economy's resilience to external shocks, and allow the government to adopt a countercyclical policy when needed. The challenge in managing fiscal policy is enhanced in light of security developments and given the need to advance the treatment of social issues, including education.

In order to bolster the effectiveness of monetary policy, it is important that legislation of a new central bank law is completed, as has been done in other countries in recent years. The new Bank of Israel Law is intended to anchor 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 accordance with the target set by the government, while supporting the government's other economic targets such as growth and employment, so long as doing so does not undermine long-term price stability. In addition, the Bank will support the stability of the financial system. It is proposed in the new law 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, while avoiding potential conflicts of interest. 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 structural reforms in the areas of infrastructure, which will increase competition, and help increase productivity in the business sector and growth, should be continued. Development of the financial infrastructure and further increases in competition in the capital markets, particularly with regard to the household sector, should be strengthened; this will also support economic growth.

Social policies for the reduction of poverty require a long-term approach. This requires equal opportunities in the labor market, and it is therefore important that resources allocated to education, and their efficient use, should ensure a proper level of education for all, and in particular for the weaker parts of society. Several steps are required to reduce poverty and increase social mobility, including a focus on the sections of the population with a particularly high incidence of poverty—the ultra-orthodox and the Arab sectors. Measures that would increase disposable income include the Earned Income Tax Credit—which the government recently decided to implement gradually—and improving the programs for vocational retraining, basic education for adults and job placement services, which will increase earning capacities. All of these will provide incentives to join the labor force for those able to do so. Resources will also have to be allocated to those unable to work, and to improve the mechanisms for testing the ability to work.

Yours sincerely,

Stanley Fischer
Governor, Bank of Israel