

25 Adar II, 5768

1 April 2008

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

I submit herewith the Annual Report of the Bank of Israel for 2007, in accordance with section 59 of the Bank of Israel Law, 5714–1954.

The Israeli economy performed very well in 2007. GDP rose rapidly, by 5.3 percent, led again by the business sector, continuing the high growth of the previous three years. The improved macroeconomic picture was reflected both in the labor market, with an increase in both the number of employees and the labor force participation rate and a decline in unemployment to 6.7 percent in the last quarter of 2007, as well as in positive developments in the capital market.

The growth of the Israeli economy was based on the continuing strength of the global economy, together with the sustained implementation of Israel's pro-growth economic strategy.

The government continued to maintain fiscal discipline. The budget deficit declined essentially to zero, at the same time as the government continued to implement its long-term program of tax reductions. As a result of the growth of the economy and the balanced budget, the debt/GDP ratio dropped sharply. Nonetheless, it remains too high.

Inflation measured over the previous twelve months fell below the target range of 1–3 percent in the first half of 2007, and monetary policy during that period was aimed at gradually returning it to within the range. The situation changed towards the end of the year, when despite the steep appreciation of the shekel against the dollar, inflation accelerated to above the upper limit of the target range, due mainly to the rapid rise in world fuel and food prices.

In the last two years the relative poverty rate stabilized, and based on the absolute index (the ability to buy a fixed basket of goods) it actually fell (based on the most recent data available, to June 2007). This welcome change can be attributed in part to the continued economic growth that led to improved conditions for everyone in the labor market, including the previously unemployed less-educated who found employment.

The financial crisis that erupted in the US in the middle of the year initially had only a limited effect on the Israeli economy. However, as it persisted into 2008, its effects were felt in Israel's capital markets too, as reflected mainly in falling prices on the Tel Aviv Stock Exchange. As the global financial crisis deepened, there were

stronger indications of a significant slowdown of growth in the US and to a lesser extent also in Europe, which is expected to slow the expansion of world trade. In light of these developments, Israel's growth in 2008 is also expected to be slower than in recent years.

The main goal of economic policy for the next few years is the strengthening of the base for sustainable growth that has been established in recent years. Economic growth is essential to enable an overall improvement in the economic condition to be attained and to tackle the social problems Israel faces. The path leading to sustainable growth is a path of continued fiscal consolidation, price stability, and financial stability. The maintenance of financial stability presents a special challenge this year, in light of the global financial crisis and the expected slowdown in the growth of the global economy and world trade.

No less important is the need to improve the performance of the education system, and to regain the momentum of structural reforms intended to enhance infrastructure and boost competition. The financial infrastructure needs to be developed further, and policies to reduce the vulnerability of the financial system need to be strengthened. In addition, the government's policy initiative to reduce poverty should be pursued, with the emphasis on increasing employment among sections of the population that currently participate less in the labor market.

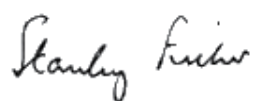
To achieve its policy objectives, the government should continue to maintain fiscal discipline and keep a low deficit. This would allow a reduction in the debt/GDP ratio, ease the heavy burden of interest payments in the budget, increase the economy's resilience to external shocks, and enable the government to pursue a counter-cyclical fiscal policy in the future. The challenges of fiscal policy are all the greater because of Israel's security requirements and the pressing need to deal with social issues, including education, but the challenges need to be met.

The new Bank of Israel Law should be enacted as soon as possible. The new law should provide a firm legal basis for the central bank's independence, should clearly state the Bank's objectives, and establish new mechanisms for decision making and public transparency. It should clearly specify the Bank's main purpose as the maintenance of price stability in accordance with the target set by the government. In addition, the law proposes that the Bank should support the government's other economic goals, particularly growth and employment, so long as that does not undermine long-term price stability or the proper functioning of the financial system. The proposal is that the law should specify the establishment of two new bodies—a monetary committee and an administrative council—both of which will include appropriately qualified members from outside the Bank, while avoiding possible conflicts of interest. The monetary committee, headed by the Governor, will make decisions in the field of monetary policy. The administrative council, which will have a majority of external members, one of whom will serve as chair, will deal with administrative issues such as the Bank's work plans and budget, and staff salaries. Both bodies will be obliged

to report their decisions to the public, to create a mechanism of transparency, control and public checks and balances alongside the Bank's independence.

In 2007, for the first time, the government adopted quantitative targets for the reduction of poverty and increased employment. The aim of reducing poverty should be pursued constantly and consistently. This will require measures to ensure equality of opportunity in the labor market. Hence the need for the efficient allocation of the necessary resources to education, to ensure the availability of the appropriate level of education to all sections of the population, and particularly the weaker ones.

Yours sincerely,

A handwritten signature in black ink that reads "Stanley Fischer". The signature is written in a cursive, flowing style.

Stanley Fischer
Governor, Bank of Israel