

The Government and the
Finance Committee of the Knesset,
Jerusalem

It is with pleasure that I submit the Annual Report of the Bank of Israel for 1996, in accordance with section 59 of the Bank of Israel Law, 5714-1954.

The Report, which has been prepared by the Research Department of the Bank of Israel, includes material and analyses based on data from the Central Bureau of Statistics and monetary data of the Bank of Israel.

In 1996 economic growth continued, albeit more slowly than in the last few years. Investment in the principal industries maintained its buoyancy, and the large inflow of long-term capital, including investment by nonresidents, persisted. Slower growth essentially reflects the convergence to a rate which can be sustained in the long term. In the second half of the year the slowdown was even more pronounced, and unemployment rose slightly.

Economic progress in 1996 was affected by security incidents which increased uncertainty, by worldwide developments, by processes related to immigrant absorption and the peace process, and by the policy mix in which fiscal expansion led to monetary restraint.

Fiscal expansion and the significant deviation—for the second year in succession—from the targeted budget deficit increased the current-account deficit and intensified inflationary pressures. In this context, monetary restraint prevented inflation from accelerating and price increases exceeded the upper limit of the government's inflation target only marginally. Capital inflow persisted due to Israel's improved creditworthiness in international capital markets and yield differentials. As a result, and to offset the government injection, the Bank of Israel had to engage in sterilization, using various monetary instruments.

In order to attain the government's economic targets in the future, it is necessary to comply with the fiscal framework set out in the Budget Deficit Reduction Law, and implement a policy intended to achieve the inflation target. Appropriate fiscal policy leading to a more balanced policy mix, together with continued economic reforms, will enable the economy's potential for sustainable growth to be realized, without jeopardizing the achievements of the last few years.

Yours sincerely



Jacob A. Frenkel
Governor, Bank of Israel

Jerusalem,
21 Adar Bet, 5757
30 March, 1997