

Jerusalem, 21 Adar II 5776

March 31, 2016

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

I am honored to submit herewith the Bank of Israel Annual Report for 2015, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

GDP grew by 2.5 percent in 2015—similar to the rate of the three previous years. This moderate rate is mainly the result of the global economy remaining subdued, which is negatively impacting demand for Israeli exports. In contrast, the sharp decline in global energy and commodity prices has been good for the economy.

The contribution of the various uses to growth this year was uneven. Exports contracted in 2015, indicating that they were influenced by other factors in addition to the global environment, including erosion of their competitiveness as a result of the appreciation of the shekel recorded in recent years. In addition to exports, contributing factors to the moderate rate of growth included the fiscal consolidation implemented by the government in 2013–14, the standstill in nonresidential fixed investment, and the fact that investment in residential construction stabilized at a high level in the past two years. In contrast, the increase in current private consumption accelerated this year, playing a central role in maintaining the growth rate. The decline in energy prices, which increased disposable income, as well as the extended robustness of the labor market and the low interest rate environment, contributed to the strength of private consumption.

The employment rate continued to increase this year, and the unemployment rate continued to decline, reaching its lowest level in a long time. The change in the composition of demand in the economy—the relative increase in employment-intensive commerce and business services—as well as increased employment in the public services contributed to the increase in demand for labor. Even though labor supply continued to grow, as a result of long-term processes, its pace of growth slowed this year. Demand for labor increased beyond the increase in supply, and this was reflected in a slight acceleration in the rate of increase of nominal wages, among other things. Real wages increased markedly, affected by negative inflation, contributing to the acceleration of private consumption.

The inflation rate in 2015 was minus 1 percent, significantly below the lower bound of the target range. This was mainly the result of supply factors: the decline in global energy and commodity prices, and price reductions initiated

by the government, including a decrease in the VAT rate and in electricity and water prices. Excluding the direct effect of the decline in energy prices and the price reductions initiated by the government, the Consumer Price Index increased by 0.6 percent. The appreciation of the shekel during the year also slowed inflation. One-year inflation expectations were below the lower bound of the target range for most of the year. With that, medium-term expectations were within the target range, and long-term expectations remained near the center of the range. These developments show that even though the public expects that inflation will not return to the target range in the immediate term, it continues to trust the ability of monetary policy to achieve the target over time.

The Monetary Committee reduced the interest rate for March to its lowest level ever, 0.1 percent. In addition, it increased foreign exchange purchases during the course of the year in view of assessments that the shekel was over-appreciated, it examined unconventional policy tools, and in October, it began using forward guidance by announcing that, in its assessment, monetary policy would remain accommodative for a considerable time. The Committee avoided a further reduction of the interest rate, as well as other measures to enhance monetary accommodation, in view of the robust labor market and due to the aforementioned assessment that the negative inflation rate was mainly the result of supply factors of a one-off nature. In addition, the interest rate was near zero, and there were risks from the housing market as home prices continued to rise.

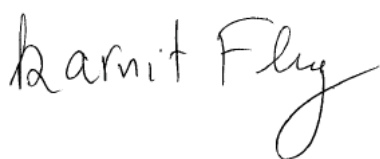
The government's budget deficit was 2.1 percent of GDP—lower than in the previous year, and lower than the ceiling set in the budget. The public debt to GDP ratio continued to decline this year, reaching 64.8 percent of GDP. Tax revenue increased this year, impacted by the vigorous activity in the real estate market, the fact that private consumption led growth, the robustness of the labor market, and the increase in corporate profits. These factors are sensitive to cyclical effects, while the tax reductions implemented this year by the government, in view of the strong tax revenue, are not limited in time. A future decline of the cyclical components may therefore have a negative impact on tax revenue and cause a deviation from the deficit ceiling. This year, it was decided to apply a control mechanism on future budgets (“the numerator”). The actual implementation of the mechanism will improve budget management and the ability to meet budgetary targets.

The Committee to Increase Competition in Common Banking and Financial Services (the “Strum Committee”) submitted its interim report in December, and recommended measures to increase the number of entities providing credit to the public in competition with the banks, which will reduce the cost of credit to the public. Separating the credit card companies from the large banks can contribute to increased competition, but competition will be adversely affected if there are restrictions placed on those banks concerning the issuance of new credit cards of their own. Since the stability of the credit card companies may

have a systemic effect on the entire economy, it is important that supervision over them remains in the hands of the Bank of Israel—which has the professional know-how and system-wide prudential perspective. The recommendation to allow pension savers to borrow money against their pension savings raises difficulties inter alia because this recommendation is inconsistent with one of the objectives of the government—encouraging long-term savings that will ensure an adequate income at retirement age—and because it has the potential of channeling tax benefits intended to encourage pension savings into present consumption. It is noteworthy that even though the total household debt to GDP ratio in Israel is relatively low, the volume of nonhousing credit relative to GDP is high by international comparison. An expansion of this credit will increase the leverage of households, and may increase the risks to them and to the economy as a whole. Therefore, measures encouraging such an expansion should be implemented with extra caution.

At this time, the legislation to establish a credit data register is being completed. This register will reduce the information gaps concerning borrower risk, thereby contributing to increased competition in the provision of credit both among banks, and between them and nonbank entities.

In recent years, growth has relied to a large extent on the rapid expansion of the supply of labor. This expansion reflects a welcome trend, but looking forward it is essential to increase productivity in the economy, which is necessary for a sustainable increase in the standard of living. Alongside the increase in various sectors' participation rate in the labor market, their skills must be developed in order to enhance their earning capacity and reduce inequality in market income. To this end, the education system must be improved, but it is also desirable to expand the government's active labor market policy measures. Raising the level of public services is important for both growth and wellbeing, and requires a proper level of civilian public expenditure, which cannot be maintained over time without adjusting the volume of tax revenues.

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

Karnit Flug
Governor of the Bank of Israel