27 Adar Bet, 5763
31 March, 2003

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

The Annual Report of the Bank of Israel for 2002 is submitted herewith, in accordance with section 59 of the Bank of Israel Law, 5714–1954. The report comprises six parts which have been prepared by the Research, Monetary, Foreign Currency, Foreign Exchange Activity, and Comptroller's Departments, as well as a statistical appendix on a CD-Rom. The report contains information and analyses based on data from the Central Bureau of Statistics, monetary data, and figures on foreign-currency activities collected in the Bank of Israel.

The recession persisted in 2002. GDP and business-sector product fell for the second year, the decline being led by the continued reduction of exports and investment, and for the first time of private consumption, too. The Consumer Price Index rose by 6.5 percent, most of it in the first half of the year. The main causes of the recession in Israel were the continuation of the security situation, the slump in the industrial economies and world trade, and the crises in the high-tech industry and global capital markets.

There were marked differences in economic policy in the first and second halves of 2002. In the first half of the year the policy mix was expansionary: the budget deficit grew appreciably, far exceeding the target, which was adjusted upward at the beginning of the year to 3 percent of GDP, and the Bank of Israel's key interest rate was set at a low level. This policy mix ran counter to the understanding reached by the Bank of Israel and the government, according to which the 2 percentage-point reduction in interest should have been combined with fiscal measures in order to prevent a rise in the budget deficit, making it possible to attain the deficit target of 3 percent of GDP in 2002, 2 percent of GDP in 2003, and its continued decline to 1 percent of GDP in 2005. In response to this mix, there was marked local-currency depreciation at the end of December 2001 and January 2002, and inflation expectations approached the upper limit of the inflation target. After a period—from mid-February to the end of March—in which the exchange rate remained stable, the policy mix's lack of credibility and the exacerbation of the security situation led to an increase in the demand for foreign exchange and additional rapid local-currency depreciation, to the extent that financial stability was imperiled. Credibility was harmed further when it became clear that the budget deficit was continuing to grow uncontrollably, and when a proposal was suddenly raised to amend the Bank of Israel Law which would have curtailed the central bank's independence in managing monetary policy, setting multiple targets which would have precluded it from acting consistently to maintain price stability. In order to check the deterioration in the financial sphere, the policy mix was altered radically: The Bank of Israel raised its key interest rate by a cumulative 4.5 percentage points until the end of June, and the government adopted an economic emergency package comprising an increase in the tax burden and cuts in government spending, alongside another rise in the deficit target, to 3.9 percent. These measures led to relative stability in the foreign-exchange market in the second half of the year, although the long-term interest rate remained high and there was considerable volatility in the foreign-exchange market.

The main policy target for the next few years is to restore the economy to a sustainable growth path which will enable employment to rise while maintaining economic stability—including that of prices—and tackle the growing problem of poverty. In the present circumstances, policy must prevent any further deterioration in the level of economic activity and employment while maintaining financial stability. However, it will be possible to benefit to the full from Israel’s growth potential only when the security-political situation improves and there is a significant amelioration in the western economies, expressed in renewed demand for the product of the high-tech industry.

The main components of the policy intended to attain these objectives are a macroeconomic mix based on fiscal restraint which will enable some monetary expansion, together with reforms of the labor and capital markets, the budget, and infrastructure investment. Note that fiscal policy should operate within a framework of long-term targets, alongside a change in the rules governing expenditure to ensure that there is consistency between the various long-term objectives, namely, the reduction of the public-sector debt, the government expenditure/GDP ratio, and the tax burden, while adhering to the declining deficit path, in accordance with the government decision and the law. Operational changes, aimed at strengthening the connection between planning and implementation, should be made in the Budget Deficit Reduction Law. This law should be reinforced so that fiscal discipline can be maintained and private legislation can be incorporated in it in accordance with the government’s priorities.

The point of departure for fiscal policy is problematic: the rising trend and high level of public expenditure, the public-sector debt, and the tax burden are reflected in the low credibility of budget policy, as expressed in both the yields on government bonds and the stance of international credit rating agencies vis-à-vis Israel. All these make it essential to adhere to the deficit target and ensure that it is attained, making financing available for investment by the private sector, and helping to avert the threat of a financial crisis. As is known, the 2003 budget that was approved by the Knesset is inconsistent with attaining a deficit target of 3 percent of GDP because of the overestimation of expected revenues and the increase in the defense budget. According to updated estimates, even if all the Ministry of Finance’s recommendations regarding the adjustment of the 2003 budget are accepted, the deficit could reach some 4 percent or more of GDP. The restoration of confidence in fiscal policy by reducing current expenditure and making structural changes in the public services could serve to stimulate private consumption and investment, as the reduction would allay apprehensions of future tax increases and enable long-term interest rates to decline. The reduction of current expenditure will make it possible for the government to sell fewer bonds to the public, so that savings can be used for investment and loans to stimulate private-sector activity rather than to finance the government's current expenditure. This would have an expansionary effect on economic activity and reduce the government's debt-servicing costs. In order to reinforce this effect it is necessary to change the composition of government expenditure—increasing the share of those components which stimulate growth, especially infrastructure investment, while refraining from raising taxes. This should be done in conjunction with other policy measures, chief among them reforms of the labor market, the infrastructure, and the money and capital markets.

In the labor market, it is necessary to act to increase the employment rate while reducing the gap between the rate in Israel and that in the OECD countries. Steps must be taken to reduce the number of foreign workers, most notably by making it more expensive to employ them than Israelis, thereby increasing demand for the latter. Structural reforms should also be made as regards social benefits, the education system, vocational training, and placement, thereby increasing business-sector employment. A prominent result of the structure of the economy and the protracted recession of recent years is the expansion of poverty. In order to deal with this problem it is necessary to prepare a long-term program using various instruments—including the reform of transfer payments—in order to increase the employment rate among the working-age population, and thereby to reduce poverty.

In the infrastructure, long-term goals should be set which will express the reduction of the gap between Israel and the west as regards the various aspects of the infrastructure, adopting a program that relates to the budgetary aspect, extra-budgetary investment, and increasing competition and efficiency of use of the infrastructure. Determining a blueprint for infrastructure investment by the government, government corporations, and private companies, allocating resources for funding it, and monitoring its implementation by the economic-social cabinet will enable the program to assume its rightful place in the government's priorities.

In order to enable the extent of infrastructure investment to be increased substantially, it is necessary to act in order to enlarge the sources of finance available to the business sector which takes part in this investment. This is contingent on reducing the deficit, thereby lowering the government's borrowing needs. In this connection, progress should be made with reforming the pension system in order to divert pension fund money to the capital market, thus helping to create long-term sources for financing infrastructure investment projects. If loan guarantees are received from the US government, a mechanism should be established whereby they can be earmarked for financing an increase in infrastructure investment. The loan guarantee tranches should be disbursed in step with the implementation possibilities of the planned infrastructure investment.

Progress should also be made in reforming the money and capital markets so as to support sustainable growth by developing and deepening the nonbanking financial intermediation system. It is important to extend pension coverage to all employees and self-employed persons—constituting a significant change as regards the social aspect, too—while maintaining an actuarial balance and channeling pension fund money to the capital market. Currently only about 60 percent of employees enjoy pension insurance, and the rate is far less in the low-income segment of the population. It is advisable, therefore, to introduce legislation that makes pensions obligatory for all employees and self-employed persons up to a given level of income, provided the issuance of earmarked bonds is stopped and the actuarial balance of the pension funds is assured. A recovery plan should be prepared to deal with the actuarial deficit of the veteran pension funds, while at the same time closing the funds that rely on earmarked bonds to new members. A reform of this kind will make pension savings Israel's principal long-term savings path, contribute to developing the capital market, and extend pension coverage to the entire working population.

Yours sincerely,

David Klein
Governor