



ANNUAL REPORT 1997

Presented to the government and the finance committee of the kneset
in accordance with section 59 of the Bank of Israel Law, 5714–1954





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A word to the reader

As in previous years, the English edition of the Annual Report is an abridgement of the Hebrew Report. Chapter 1, however, appears in its entirety. Most of the tables in the Hebrew edition are included.



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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 1997, 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 1997 there was a turnaround in the balance of payments, and the inflation rate fell significantly. The current-account deficit contracted considerably, together with a surge in exports; the inflation rate declined to its lowest level in twenty-eight years, most of the reduction occurring in the second half of the year. Alongside these achievements there was a marked slowing of GDP growth, a decline in per capita GDP, a fall in total factor productivity, and a rise in the unemployment rate. In addition, there was a notable increase in capital flows—principally inflows for extending foreign-currency credit in the first half of the year and investments by nonresidents in the second half—and the foreign-exchange reserves rose.

These developments reflected mainly the slower growth of domestic demand, as a result of several factors. The first was the winding down of the expansionary stage of the business cycle, and investment demand in particular. This cycle derives from the influx of immigrants, the maturing of the economic reforms implemented in the past, and the business opportunities created by developments in the political process. The second was the policy of restraint adopted in order to restore the balance of payments to a sustainable path—after a large deficit in 1996 following significant deviations from the planned budget deficit path in the last few years—and in order to ensure that the inflation target was attained. Economic and security uncertainty also contributed to the slowing of economic activity, as did the rise in the real wage in the business sector and the consolidation of the process of structural economic change, with the expansion of high-tech industries and the contraction of the traditional ones. On the other hand, the accelerated expansion of world trade, improved terms of trade, and decline in world inflation enabled achievements to be made in the areas of the balance of payments and prices, while also offsetting the economic slowdown to some extent.

There was a significant change in the implementation of fiscal policy in 1997, and the government attained its budget deficit target. Thus, this policy contributed to the sizable reduction of the current-account deficit, which was a major policy goal for 1997, and to the improved credibility of economic policy. Monetary policy focused on attaining the inflation target and creating the conditions for a declining inflation path, in accordance with the government's decisions,



and by so doing contributed to the attainment of the inflation target for 1997—
at the lower limit of the target range.

In order to return to a sustainable growth path in the next few years, enabling
unemployment to be reduced without incurring instability, policy measures are
required that will support the revival of total factor productivity. The thrust of
these measures should be the attainment of the budget deficit target, alongside a
change in the composition of its expenditure, with a rise in the share of re-
sources directed to infrastructure investment, a reduction of the tax burden and
reform of taxation, and pursuit of a disinflationary policy in order to achieve the
price stability that prevails in the industrial countries, as determined by the gov-
ernment. Efforts should also be focused on expanding structural economic re-
forms, together with greater competitiveness, the acceleration of privatization,
and the introduction of wage agreements that are consistent with all these goals.

Yours sincerely,

Jacob A. Frenkel
Governor, Bank of Israel

Jerusalem
30 March, 1998
3 Nissan, 5758



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