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

I am honored to submit herewith the Bank of Israel Annual Report for 2014, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

GDP grew by 2.8 percent in 2014. Excluding the effects of one-off factors—the start of natural gas production in 2013, and Operation Protective Edge this year—the growth rate in the past few years has stabilized at a fairly low level of between 2.5 percent and 3 percent. Growth in Israel has been moderate in recent years due primarily to the ongoing slowdown in growth in most advanced economies. This slowdown has been uneven—the US continues to grow and recover, while growth in Europe remains weak—affecting Israel mainly through a negative impact on demand for Israeli exports and on investment in the economy.

Despite the slow growth, the unemployment rate continued to decline this year, reaching its lowest level in decades, and the employment rate continued to increase. Long-term factors that are increasing the labor supply, including higher educational attainment as well as policy measures taken in recent years, have supported these developments. Labor market flexibility is another factor, as it moderates the effect of the level of economic activity on employment in the short term. The flexibility was reflected this year in a decline in hours worked per employee and only a moderate increase in real wages, despite the unexpectedly low inflation rate.

The inflation rate in 2014 was negative, at –0.2 percent, below the lower bound of the target range. Contributing to the low level of inflation this year were the sharp decline in global oil prices, the appreciation of the shekel until August, and the negative output gap, i.e., the difference between the relatively low level of activity and the expansion on the supply side in the economy, in particular the abovementioned increase in the labor supply. This gap—as well as other supply factors, including structural changes, such as increased competition in the communications market—led to an atypical moderation in the increase of nontradable goods prices, a development that also contributed to the decline in the inflation rate.

This year, the Bank of Israel Monetary Committee acted to support the level of real activity and bring inflation back to within the target range over time, in accordance with the flexible inflation target regime under which the Bank of Israel operates. In order to achieve these targets, the Bank of Israel reduced the monetary interest rate to its lowest-ever level, 0.25 percent (in late February, 2015, it reduced it further, to 0.1 percent), thereby narrowing the difference between it and interest rates abroad. In addition, the Bank continued to intervene in the foreign currency market. These measures contributed to the shekel's depreciation in the later part of the year—after a long period of appreciation—and thus supported the relatively strong growth in exports in the fourth quarter of the year and the activity of the tradable sector and of the economy in general. The measures also contributed to an increase in inflation expectations (excluding one-off factors), a development that will help return inflation to within the target range over time. Central banks in many countries are currently facing the complex challenge created by the combination of moderate activity, very low inflation, and a monetary interest rate that is close to zero and even negative.

In the past two years, fiscal policy makers have reduced the structural deficit by raising tax rates and meeting the expenditure ceiling. In 2014, the general government deficit was 2.6 percent of GDP, and the central government deficit was 2.8 percent of GDP, in line with the original budget plan and despite the sharp increase in defense spending due to the need to finance Operation Protective Edge.

Home prices continued to increase this year, continuing the process that began in 2007. In the past two years, the government initiated a range of measures to increase the stock of homes, but many of them have not yet been realized in full. In contrast to these measures, the Zero VAT plan was liable to have increased demand for homes; ultimately, it was not approved, but during the deliberations on the plan, there was a temporary reduction in the number of transactions. The number of building starts remained elevated this year as well, and the number of building completions reached its highest level in years. To maintain a high and sustainable level of building starts, especially in areas in high demand, the government will have to continue to address all the relevant aspects of supply—planning, marketing of land, facilitating the evacuation of IDF bases, and urban renewal—while dealing with additional issues necessary for building starts, including development of urban infrastructures and incentives for municipal authorities to approve construction in their jurisdictions. This year, the Supervisor of Banks took another step to reduce the risk to the banking system from housing credit, ordering an increase in the capital cushions that the banks must allocate against this credit.

In the short term, economic policy makers will have to continue dealing with the challenge presented by the ongoing global slowdown and the low levels of export demand and interest rates. Fiscal policy will need to act while continuing to reduce the debt burden, and monetary policy—while maintaining financial stability. The issues relating to financial stability are discussed in a separate report that the Bank of Israel began publishing last year on this matter.

In the longer term, the government will have to act to increase productivity in the economy, to enhance the integration of diverse population groups into the labor market, and to improve the level of public services, especially education. To achieve these objectives, the government will have to enhance its ability to implement the reforms it initiates. Improving public services will also require striking the proper long term balance between civilian and defense expenditure. All these will help to increase the economy's competitiveness, accelerate its growth, spread the benefits of growth across the population, and reduce poverty and inequality.

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