12 Nissan 5778
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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 2017, in accordance with Section 54 of the Bank of Israel Law, 5770–2010.

In 2017, GDP grew by 3.4 percent. After two years in which growth was based primarily on domestic uses, this year it presented a more balanced composition as the growth rate of exports accelerated. The rate of expansion of private consumption did not change materially (net of fluctuations derived from the timing of vehicle purchases), but household nonhousing debt increased at a slower rate than in recent years. The Current Account surplus has contracted over the last two years as the rate of investment in the economy increased and the savings rate decreased.

An increase in world trade contributed to the acceleration in exports that was driven by business services. These are human capital intensive exports, which in recent years have been increasing their share of total exports. To some extent, this process is unique to Israel, and its ramifications for the economy are discussed at length in this report. The recovery in tourism also contributed to the acceleration of exports this year.

The strong demand in the economy was reflected in the labor market: the employment rate continued to rise, and the unemployment rate continued to decline, reaching its lowest level in decades. At the same time, several long term factors that had worked in recent years to expand the labor supply, such as the increase in the participation rate, weakened. This combination acted to further tighten the labor market, and with it to accelerate the rise of nominal wages. The economy's proximity to full capacity contributed to the acceleration of imports as well.

The inflation rate for the full year was 0.4 percent. Although it is below the lower bound of the inflation target range, it was the first year since 2014 that the rate was positive. The low level of inflation was primarily due to the appreciation of the shekel, enhanced competition in the economy—among other reasons as a result of government policy and the increase in online purchases—and price reductions initiated by the government. The full employment environment and the increase in global prices of oil and other commodities contributed to the acceleration of the inflation rate.

The Monetary Committee of the Bank of Israel kept the interest rate at its low level, 0.1 percent, and changed the wording of its forward guidance: it currently links the future interest rate path to the entrenchment of the inflation environment within the target range. In addition, the Bank of Israel continued to intervene in the foreign exchange market. The Monetary Committee avoided exceptional accommodative measures, such as those adopted by other central banks, as the economy grew at a relatively rapid pace and is in a full employment environment, and because the Committee assessed that the inflation rate is influenced by enhanced competition, and it also took into account considerations that relate to financial stability. The fact that Israel adopted less accommodative monetary policy than abroad contributed to inflation in Israel remaining lower than inflation abroad. Even though inflation has been low in recent years and short term expectations are below the lower bound of the target, expectations for longer terms are within the range, evidence of the credibility of the inflation target policy.

The government deficit this year was 2 percent of GDP. This is lower than the previous year's deficit and than the ceiling set in the budget, because tax revenues were higher than the budget forecast, primarily due to one-off revenues, part of which were at the expense of revenues that were expected to be received in the coming years. The ratio of public debt to GDP continued to decline, reaching 60.8 percent of GDP at the end of the year. The general government accelerated the growth in its expenditure this year and the share of civilian expenditure in GDP increased, but it remains very low compared to its share in most OECD countries. In addition to the acceleration of expenditure, there was a reduction in tax rates, which deepened the structural deficit. The Numerator Law that was put into effect for the first time this year contributes to transparency in terms of the government's future obligations, but the use of time-limited legislation (temporary provisions) is liable to adversely impact the attainment of its objective.

Home prices increased this year at a rate slower than that of previous years and the number of transactions continued to decline—continuing the decrease that began at the end of 2016 already. Contributing to this were measures adopted by the government in recent years to increase supply and to reduce investor demand. It is important that the government continue to act to create the conditions that allow a high level of supply, including through creating a large inventory of construction plans that are readily available for execution, particularly in areas of high demand, and through taking full advantage of the potential inherent in urban renewal.

Narrowing the gaps between Israel and other advanced economies in terms of GDP per capita and labor productivity, and in terms of incidence of poverty and net-income inequality, are two of the main challenges facing policy makers. An essential part of dealing with them is improving the human capital of the overall population and reducing the gaps among its various groups. To that end, the achievements in the overall education system should be improved, and gaps in achievements between students from various population groups and socioeconomic and geographic backgrounds should be reduced. The role of advanced exports in the Israeli economy and the differences existing between population groups in their scope of participation in these export industries underline the said challenges. These exports are human capital intensive and act in a highly competitive global environment. Israel will not be able to maintain its competitive edge in such an environment without consistent improvement in its human capital, and the various population subgroups will not be able to expand their participation in the advanced industries and benefit from the high wages they offer without an improvement in the achievements of students from all backgrounds.

However, the high tech industries should not be the only focus. The problem of low productivity is actually concentrated in the rest of the economy, which accounts for the bulk of activity and employment. Increasing productivity in the rest of the economy depends not only on improving the achievements in the education system but also on improving human capital later on through active labor market policy, including professional training. In order to increase productivity in the economy overall, broad investment in infrastructure is required—primarily public transportation. Such investment will also help in reducing inequality as it makes it easier for various population subgroups to access employment centers. Taken together, these steps will assist in continuing to integrate into the labor market the population groups that still participate very little in it. Consistent policy in this direction will raise the standard of living for the overall population and will reduce the gaps between its various groups.

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