

Chapter 1

Main Developments

1. THE ECONOMY, INFLATION AND MONETARY POLICY

a. Introduction

In 2003 the Consumer Price Index (CPI) declined 1.9 percent, following a rise of 6.5 percent in 2002. The price decline in 2003 represents a shortfall from the targeted price rise of between 1 and 3 percent starting in 2003 and defined as price stability; this followed an upward deviation in 2002. In the past two years, prices rose at an average annual pace of 2.3 percent overall, as opposed to an average annual rate of 0.9 percent during the years 1999 to 2001. The NIS appreciated against the dollar by 6.4 percent in 2003, following a 9.8 percent depreciation in 2002.¹ The fall in the exchange rate strongly affected the housing component, which went down by 6.7 percent. The price index excluding housing declined at a more moderate rate of 0.5 percent.

The decline in prices in 2003 was partly an outcome of the fall in the exchange rate and partly a delayed response to the continuing weakness in local demand, which was also influenced by the high level of real interest rates in the second half of 2002, reflecting the high degree of uncertainty in that period. The exchange-rate decline in the course of 2003 from the high level it attained at the end of the first half of 2002 is a reflection of the significant improvement, as of March 2003, in several underlying factors: the publication of the economic plan by the new government and its approval in the Knesset, approval of US government guarantees for new Israeli bond issues in the US and the swift and successful conclusion of the war in Iraq. These factors led to a gradual and continuous improvement in most of the relevant indicators used to assess the inflation environment (for details, see Chapter 2). Against this backdrop, the Bank of Israel commenced the process of reducing interest rates, which continued throughout the year. Between January and December 2003, the Bank of Israel interest rate was reduced by 3.9 percentage points (from 9.1 percent in December 2002 to 5.2 percent in December 2003).²

¹ The average of December 2003 as opposed to the average of December 2002.

² The process of lowering the interest rate continued in January and February 2004, with reductions of 0.4 and 0.3 percentage points respectively.

The improvement in the underlying conditions described above and the reduction of interest rates by the Bank of Israel led to a continuous rise in the prices of all local financial assets, reflected in a concomitant decline in the yields to maturity of tradable bonds of all terms, leading to a decline in interest rates on all term deposits and credit and a rise in share prices. Thus, as a case in point, from January 2003 to December 2003 the yield to maturity of a non-linked ten-year bond declined from 11.4 percent to 7.0 percent, the real yield to maturity of a linked ten-year bond declined over the same period from 5.9 percent to 4.1 percent, and share prices rose by more than 50 percent. Housing prices, on the other hand, declined by about 6 percent—a drop that reflected the continuing slump in the construction sector and the decline in the exchange rate against the dollar.

There was also some improvement in real activity in 2003, especially in the second half. Business product in 2003 rose by 1.8 percent, following a 2.8 percent decline in 2002. A rise of 6.1 percent in exports and a moderate rise, of 1.7 percent, in private consumption led to the moderate product growth. Domestic public consumption, which rose significantly in 2002, declined by 0.6 percent in 2003, and the decline in gross local investment continued, although at a more moderate rate than in 2002.

The decline in the CPI in 2003 represented, as stated, a shortfall from the targeted price stability (1 to 3 percent), following an upward deviation in 2002. At the same time, an examination of price developments over a longer period reveals that the average monthly rate of inflation during the years 1999 to 2003 was 1.6 percent in annual terms with no detectable upward or downward trend. However, volatility around this average rate was relatively high (a monthly standard deviation of about 6 percent). This stems partly from volatility in the exchange rate and is primarily the result of the tradition of high inflation in previous years (this subject is dealt with in Chapter 2). The large standard deviation characterizing the monthly price change makes a current evaluation of the inflation environment difficult and is one of the reasons why the response of monetary policy to price shocks is gradual. This response implies, among other things, an acceptance of the possibility of temporary deviations from the inflation target (see below for expansion on this subject).

b. Factors contributing to declining exchange rates and long-term real interest rates

Since March 2003, we have witnessed an almost uninterrupted process of decline in nominal exchange rates and in nominal and real interest rates in the markets. This was apparent, among other things, in decreasing inflation expectations and permitted the Bank of Israel to commence and to persist in a process of reducing the monetary interest rate. The factors that contributed to declines in the nominal exchange rate and in real and nominal interest rates were (in chronological order) the introduction of the economic plan by the new government and its approval by the Knesset, receipt of the US government loan guarantees and the swift and successful completion of the war in Iraq. Below we will try to describe the connection between these developments and

the developments in the exchange rate and of nominal and real interest rates, but first we will briefly describe the nature of transmission from exchange rate to prices.

In a small economy open to international trade, like Israel's, the exchange rate is known to have an impact on prices: a rise in the exchange rate acts directly to raise the traded goods and services prices included in the CPI, and a rise in these prices contributes to a rise in the prices of non-traded goods and services. This effect is not immediate but gradual: it can spread over several quarters.³ A rise in the exchange rate has, therefore, an immediate impact on the CPI as well as an extended impact that is completed only after several quarters.

In Israel the exchange rate against the dollar has a further effect—on the housing component,⁴ despite the fact that it is nontradable: a rise in the exchange rate against the dollar is immediately and almost completely transmitted to the housing index, which is assigned a weight of more than 20 percent in the CPI (see Chapter 2 for details). For this reason the impact of the exchange rate against the dollar on prices in Israel is stronger than in other small open economies. The rising exchange rate against the dollar in the first half of 2002 was the foremost factor contributing to the high rise of prices in that year, and its decline in 2003 was the foremost factor contributing to the decline of the CPI. Below we will examine the factors that resulted in a significant rise in the exchange rate in the first half of 2002 and its decline since March 2003.

Monetary policy that consistently strives to attain price stability⁵ is the key factor that ultimately determines all nominal values in the economy. This includes the exchange rate, which, in the long term, moves at a rate determined by the gap between the rise of local prices and of prices in countries with which Israel trades. In the short term, however, the exchange rate is also affected by other factors such as changes in the gap between yields anticipated from investment in local assets and yields anticipated from investment in foreign assets. An increase in the relative yield anticipated from local assets leads to capital import and exchange-rate decline. But capital import is affected not only by the relative yield but also by the degree of uncertainty about it.⁶ Increased uncertainty about local yields signifies a decrease in the relative attractiveness of investment in local assets, a development which leads to capital export and thus—local-currency depreciation.

³ A rise in the price of tradables raises the general index. The rise of the latter, though with a lag, brings about wage rises; this, in turn, acts to raise prices of nontradables. However, if the public believes that monetary policy is firmly directed towards the stabilization of prices, wages will react relatively moderately towards price rises, or not at all.

⁴ After the high inflation in Israel's economy in the past, a tradition developed that housing purchase and rental prices are denominated in dollars. As a result of this custom, the changes in the exchange rate have had, and continue to have, a significant short-term influence on apartment prices and rentals.

⁵ In other words, policy that is not accommodative. It is important to note that the effect of monetary policy (interest rates) on inflation and subsequently on the exchange rate is gradual and extends over several quarters.

⁶ The greater the uncertainty about local yields, the more will investors demand compensation by means of higher yields.

The unexpected interest-rate reduction at the end of 2001 produced a temporary decline in anticipated yields from local assets and an increase in uncertainty, both of which contributed to local-currency depreciation during January and February 2002. In the second quarter of that year, when it became apparent that the government could not implement the measures necessary to shrink the budget deficit, considerable uncertainty about anticipated yields from local assets was reflected in the renewed process of a large and continuous rise in the exchange rate. It is important to note that the rise in the exchange rate in the course of the first half of 2002, particularly in the second quarter of the year, was accompanied by a rise in the yields to maturity of indexed and unindexed bonds—in other words by a rise of market-determined nominal and real interest rates. This was the case despite the reduction in the Bank of Israel interest rates at the end of 2001 and a continuous low level of monetary interest in the first months of 2002. This rise of market-determined real interest rates reflected the desire of the public to exchange local for foreign assets, hence increasing demand for NIS credit and decreasing sources of supply,⁷ which in turn affected a rise in real interest rates and a rise in the exchange rate. The notable Bank of Israel interest-rate rise in the middle of 2002 arrested the rise of the exchange rate, but the degree of uncertainty regarding investment in local assets remained high, as did the exchange rate level. This level, also influenced by the expected war in Iraq, remained high until the end of February 2003.

As of March 2003 three factors operated to reduce the uncertainty concerning the relative yield from investment in local assets and to bring about local-currency depreciation. The first factor (chronologically) was the establishment of the new government and the approval of the economic plan, first by the Cabinet and subsequently by the Knesset. The plan and its approval reflected the awareness by the government of the need for significant adjustments in its budget, immediately for 2003 and principally for the coming years, as continuation of existing trends would lead to a crisis. This restored investor confidence in the government and the economy strengthened the desire to invest in the economy and restrained the desire to invest abroad. One result of this development was an increase in the sources of supply of NIS credit offered to the public and to the private sector, and the creation of conditions for a decline in real interest rates.

The second factor—not unrelated to the first—supporting the declines in the exchange and interest rates was the approval of loan guarantees by the US government. The guarantee approval lowered the cost of foreign-currency credit to the government and improved its financial rating among foreign and local investors. This lessened the uncertainty about overall yields from domestic assets, thus raising the relative attraction of investment in the economy and contributing to an increase in the sources of credit available to the business sector and to a decline in domestic real interest rates.

⁷ The desire of the public to move away from local assets (for example NIS bank deposits and NIS bonds) to foreign-currency assets (such as deposits in foreign currency or overseas assets) signifies a reduction in the sources of supply of NIS credit and, in parallel, an increase in demand for NIS credit to acquire foreign-currency assets. The outcome of this desire is a rise in NIS interest rates along with a rise in the exchange rate.

The third factor was the swift and successful completion of the war in Iraq, which significantly decreased Israel's geopolitical risk and thereby accelerated the decline in the exchange rate and real interest rates determined in the markets. It is worth noting that the growth in capital import to Israel after the war in Iraq is part of the global trend of lowering risk in emerging markets and increasing capital exports to them.

In 2003 the total government deficit amounted to about 5.6 percent of GDP, as opposed to a target of 3 percent. In NIS terms, the government deficit amounted to about NIS 27.7 billion as opposed to about NIS 18.7 billion in 2002. The growth of the deficit from 2002 and its deviation from the target for 2003 did not surprise the markets. Policy measures enacted as part of the economic plan increased public perception that the budget deviation in 2003 was temporary and there would be a decline in the following years. Examination of developments in the government deficit over the months of the year, taking seasonality into consideration, reveals that it declined in the second half of the year relative to the first half, a development that probably supported the credibility of fiscal policy.

Domestic government fund raising (net) in 2003 amounted to about NIS 22.4 billion, as opposed to about NIS 24.4 billion in 2002. The government financed the domestic deficit in 2003, approximately NIS 4.2 billion, using foreign sources.⁸ Thus the government used capital raised abroad this year both to finance the foreign deficit and to finance part of the domestic deficit. It is important to note that use of the guarantee money to finance some of the government's local deficit does not lead to a permanent lowering of interest rates in the economy. Such an operation would mean the printing of local currency, which the central bank would have to absorb—either in the form of an increase in short-term loans or as bank deposits.

c. Monetary policy, inflation targets and past inflation

The second half of 2002 was characterized by a high degree of uncertainty in financial markets. This was against the backdrop of the anticipated war in Iraq, concerns about a continuous rise in the government deficit and government debt and fears of a rating downgrade of the country and the large banks by rating companies.⁹ This was reflected in the persistently high level of the exchange rate, in the rising trend of long-term real interest rates and continuing volatility of these variables and of other indicators relevant to assessment of expected inflation (see detail in Chapter 2). With these considerations in mind, the Bank of Israel maintained the monetary interest rate during the second half of the year at the same high level that prevailed at the end of the first half, assessing that these levels would be sufficient to restore price stability. During the course of the second half of 2002 no one anticipated (neither the Bank of Israel, nor the professional forecasters, nor the markets) that declines in the exchange rate would begin in March 2003 along with a notable improvement in all indicators relevant to assessment of the expected inflation.

⁸ Total foreign fund raising of the government in 2003 amounted to NIS 6.7 billion. The domestic deficit amounted to NIS 26.6 billion and the foreign deficit amounted to NIS 1.1 billion.

⁹ One rating company downgraded three large banks.

Towards the end of the year a degree of improvement was noted in some of the relevant indicators and the interest rate for January 2003 was reduced by 0.2 percentage points. However, in January and the first half of February 2003 there was another worsening in the indicators and, therefore, the Bank of Israel kept rates for February and March 2003 unchanged.

In mid-February 2003 improvement could be seen in all the indicators relevant to the assessment of the inflation environment (albeit with sometimes significant volatility impeding current assessment of the inflation environment). Against this backdrop, the Bank of Israel began to pick up the pace of interest-rate reduction: In April, May and June the interest rate was cut by 0.2, 0.3 and 0.4 percentage points respectively; in July, August and September the pace of reduction was raised to 0.5 percentage points per month; in October, November and December the interest rate was cut by 0.4, 0.5 and 0.4 percentage points respectively. Overall, from the beginning of the year, Bank of Israel interest rates were reduced by 3.9 percentage points, from 9.1 percent in December 2002 to 5.2 percent in December 2003. In real terms, deducting market-derived inflation expectations, the Bank of Israel interest rate declined from 7.2 percent at the end of 2002 to 3.5 percent at the end of 2003—a development demonstrating that the pace of interest-rate decline exceeded that of declines in inflation expectations.

The decrease in prices in 2003, as stated, amounted to 1.9 percent, despite an inflation target of 1 to 3 percent, a rate defined as price stability, planned for the period that began in 2003. In the first three months of the year prices rose faster than target and their decline commenced in the second quarter of the year. During the third quarter of the year it seemed probable that the pace of price rises in the 2003 calendar year would be lower than target. This raises the question of why the Bank of Israel did not pick up the pace of interest-rate reduction to generate price increases in order to attain its target in the 2003 calendar year even when it seemed probable that inflation for calendar year 2003 would be lower than the long-term target of price stability. The answer is that the purpose of the Bank of Israel is long-term price stability (which it has the ability to achieve), rather than attaining its inflation target for a specific period. Below we will try to clarify the meaning of the expression long-term price stability and to introduce the principles underlying the attempt to achieve it by monetary policy.

In August 2000 the government decided upon an inflation target for the period commencing in 2003 of between 1 to 3 percent, a pace defined as a price-stability target. This was not targeted for any particular calendar period but as a continuous process. Every month the Central Bureau of Statistics publishes the rise (or decline) in the Consumer Price Index over the previous month. Since monthly prices are affected by many incidental factors that cannot be controlled or predicted, it is obvious that the index will occasionally rise by more than 3 percent (the upper limit of the target, in annual terms) or by less than 1 percent (the lower limit of the target). No central bank (or other authority) can bring about a precise monthly rise in the index of between 1 and 3 percent every month, or during any other particular period. The purpose of monetary policy is that over time the deviations of monthly inflation from the center of the target will be minimized (or more precisely, to minimize the average squared deviation of monthly inflation from the center of the target).

It should be said here that past deviations have no operative significance for monetary policy except insofar as they might shed light on future deviations. Thus, if in earlier months inflation was higher/lower than target, there is no point in attempting to correct the deviation by creating lower/higher than targeted inflation in the subsequent months of the year. Such an attempt would increase the deviations from the inflation target rather than minimize them. Since the purpose of monetary policy is to minimize the deviations of inflation from the target, it must try to ensure at any point in time that price rises from then on be as close as possible to the target.

However, the goal of keeping inflation close to target is not the only purpose of monetary policy. Another goal is to avoid, as much as possible, the necessity to perform large or frequent changes in the direction of interest rates. Most economists know and agree that there is considerable trade-off between the volatility of inflation and that of interest rates. Any excessive attempt to minimize the variance of inflation could increase the variance of interest rates. Large fluctuations in nominal interest rates can result in sharp fluctuations in the exchange rate, in real interest rates, in asset prices, in real activity and in employment. Such developments can also damage the financial stability of the economy.

Therefore when a shock causes a major deviation of inflation from the target and requires some corrective measure on the part of monetary policy, adjustment of interest rates must be gradual and as a result the restoration of inflation to the target will also be gradual. (However, once in a while when an inflationary process initially develops, a big change in interest rates might be required even for a gradual return of inflation to target.)

As an illustration of this, when prices rose at an annual rate of 13 percent in the first half of 2002, well over the 2 to 3 percent target for that year, rates in June 2002 were drastically raised, not to correct the existing deviation but to halt the developing inflationary process and to restore inflation to the target range as of July 2002. In other words, there was no intention of bringing about a 7 percent price fall in the second half in order to meet the calendar target schedule of 2002.¹⁰ Similarly, when in the second half of 2003 a rate of price rises lower than target for that year became likely, no attempt was made in the course of the year to correct the annual result by a drastic rise of inflation well over the target.

Since the effect of interest rates on inflation is partially deferred by a period estimated at one year to one-and-a-half years, interest rates are determined with an eye on the future. At any point in time expected developments in prices are assessed and interest rates are changed accordingly. One indicator of future inflation developments is past developments but this is not the most important indicator. Accordingly, although the 2003 fall in prices beginning in the second quarter had some impact on the determination of the interest rate, the purpose of the monthly interest-rate decision was not to attain the target for those months or for the calendar year 2003, but to bring inflation in the year or two ahead into line with the target range.

¹⁰ It should be noted that the rigidity of prices downward is stronger than upward. It is easier to raise prices by monetary loosening than to reduce them by monetary restraint.

It should also be noted that in recent years the inter-month pace of inflation is characterized by relatively large fluctuations¹¹ that make it difficult to use present and recent past inflation as indicators of future inflation.

2. DEVELOPMENTS IN THE CAPITAL MARKET

a. Main developments

From March onwards, the majority of the developments in the capital market during 2003 were indicative of a slow but continued decrease in the climate of financial uncertainty. The decrease was reflected *inter alia* by a rise in the prices of financial assets. The result was a resumption of the downturn in yields recorded in the previous year, a trend that was interrupted by the one-time depreciation and large cut in the Bank of Israel's interest rate at the end of 2001 and by the severe slackening of fiscal discipline.

Yields to maturity in the Treasury-bill and government-bond markets fell in 2003, and reverted to the levels prevailing at the end of 2001. In the equity market prices rose sharply, by as much as 50 percent overall compared with the previous year, and daily turnover also increased considerably. These developments followed a drop in prices and low levels of turnover during the previous two years. Activity also increased in the tradable and nontradable corporate bond market, with issues reaching an unprecedented size. Concurrently, the level of risk inherent in Israel's economy as perceived in the capital markets appears to have fallen. The improvement was also apparent from a range of indicators of uncertainty in the capital market and from the financial resilience of the economy, following a major deterioration in these indicators during 2002 (mainly in the first half of the year).

Long-term trends in the development of the public's financial asset portfolio until 2002 resumed in 2003: an increase in the proportion of unindexed assets in the portfolio (exclusive of the public's equity holdings), an albeit small decrease in the proportion of CPI-indexed assets, and a rise in the proportion of long-term assets in the portfolio at the expense of short-term assets.

Due to the reform in income tax for individuals, which equalized the taxation conditions on tradable and nontradable assets for individuals, and as a result of the reduction in the interest rate, the proportion of tradable assets in the financial asset portfolio increased, even when the equity component of the portfolio is not taken into account.

The principal factors affecting developments in the capital market during 2003 were the increased credibility of macroeconomic policy: of monetary policy following the cumulative rise in interest rates in mid-2002; and of fiscal policy, after the new government elected at the beginning of the year formulated an economic program. Contributing to these developments were the outcome of the war in Iraq at the beginning

¹¹ See Table 2.11.

of 2003 and the increased expectations of a rebound in the US economy, which was reflected *inter alia* by an upturn in prices in the US equity market.

Despite the growth in the budget deficit during 2003, net domestic borrowing by means of tradable debt instruments was lower than in the previous year, contrasting with the increased borrowing in 2001 and 2002. The government thereby contributed to a fall in yields in the government bond market. In addition, government borrowing policy in 2003 reverted to the pattern of previous years, following a deviation from this policy (principally in 2002). The term to maturity of tradable domestic debt instruments was extended in 2003 after being reduced in 2002, while the proportion of unindexed borrowing (at fixed-rate interest) increased and the proportion of CPI-indexed domestic borrowing decreased, in contrast to 2001 and 2002. After such activity had been suspended for nearly two years, the government resorted to overseas borrowing, due to the receipt of loan guarantees from the US government and the decrease in Israel's country risk as perceived by capital markets world wide. This made it possible to reduce domestic borrowing to some extent in 2003.

The pension reform was implemented towards the end of 2003, following the reform of the provident funds at the end of the 1980s and the life-insurance savings reform at the beginning of the 1990s. Under the pension reform, the government's issue of earmarked bonds for the pension funds will be reduced greatly, and most of the funds' investments will be directed to the tradable capital market.

The planning of a number of structural reforms in the money and capital markets began in 2002—changes in the payments system and in the method of securities clearing (see Appendix 1).

b. Principal trends in the capital market

As with developments in the area of inflation and monetary policy, developments in the capital market during 2003 can be regarded as a continuation of the trends that began in the second half of 2002 (mainly in the last two months of the year): a decrease in financial risk and the risk of inflation, which was reflected *inter alia* by a fall in yields on bonds and Treasury bills. This mainly resulted from the Bank of Israel's interest-rate hike in mid-2002 and the new economic program. Following the rise in the interest rate in the first half of 2002, the credibility of monetary policy in the eyes of the public increased. Against this background, the large rise in nominal and real yields recorded during the first half of the year ceased, with nominal and real yields stabilizing at the relatively high average levels of 12 percent and 6 percent respectively. All yields began to fall in November 2002 and approached the levels of the middle of that year—an average of 11 percent and 5.5 percent respectively. Due to the new government's economic program and the outcome of the war in Iraq, the fall in yields resumed and continued overall until the beginning of 2004. At the end of 2003, the nominal and real yields (an average of 6 and 4 percent respectively) were therefore similar to those at the end of 2001, before the large one-time cut in the Bank of Israel's interest rate.

In the tradable and nontradable corporate bond markets, the volume of issues increased substantially and reached NIS 1 billion and NIS 3 billion respectively. The increase resulted from a number of developments: the reduced financial risk in the economy, firms' efficiency drives, and a relative decrease in the availability of bank credit for firms. In addition, the large redemptions of *Gilboa* dollar-indexed government bonds, resulting from the government's policy of ceasing the issue of these bonds, encouraged financial organizations to issue dollar bonds as a substitute for the bonds that were redeemed.

Prices in the equity market also rose during 2003. In the course of the year, the General Share-Price Index and the Tel Aviv 100 Index went up by a cumulative 50 percent. The increase began in March 2003, after more than two years of falling prices. The rise in equity prices is attributed to the reduced financial risk in the economy, the cuts in the interest rate, the efficiency drives implemented by many firms in the business sector (which favorably affected their financial statements), and to the price rises in the US equity market. However, the upturn in the equity market cannot be attributed to expectations of a rebound in economic activity. This assessment is supported by the absence of share issues in 2003, which are usually related to firms' investment plans.

Average daily turnover in the equity market rose considerably in 2003, and reached NIS 360 million at the end of the year compared with NIS 240 million in 2002.

Uncertainty in the economy and the capital market decreased in 2003, after rising sharply in the first half of 2002 and stabilizing in the second half of the year at a level higher than that at the end of 2001. In March, the reduced uncertainty was reflected by various indicators. Uncertainty regarding inflation decreased, as was apparent from the fall in inflation expectations for the terms of a year to 10 years, from private analysts' inflation forecasts, from the gap between the former and the latter, and from the reduced variability of private analysts' forecasts (which had increased in periods of uncertainty). Uncertainty as regards the exchange rate and the foreign-currency market also appears to have decreased. This is reflected by the fall in the actual implied volatility of the exchange rate, the reduced bid-offer spread, and the reduced implied volatility and probability of future changes in the NIS-dollar exchange rate, which are derived from data on the NIS options sold by the Bank of Israel and on the options traded on the Tel Aviv Stock Exchange (TASE). Uncertainty over Israel's country risk also decreased, judging by the premiums charged in respect of Israel's currency risk and country risk in worldwide capital markets.¹² These premiums are derived from the yield gaps between Israel government bonds and US government bonds, and from the improvement in the credit rating of Israel's capital market in the publications issued by international financial companies.

These developments were also reflected by the development of the public's financial portfolio in 2003. The share of unindexed assets in the portfolio, excluding shares held

¹² Premiums derived from the yield gaps between Israel government bonds and US government bonds.

by the public,¹³ grew from 37 percent in 2002 to 39 percent, and the proportion of CPI-indexed assets fell, albeit by the negligible rate of three tenths of a percent.

These trends constitute a resumption of the long-term trend that was typical of the asset portfolio during recent years, with the exception of 2002,¹⁴ against the background of the disinflation process in Israel's economy. Moreover, the composition of the portfolio by term to maturity shows that developments in 2003 were consistent with stability in the areas of inflation and financial activity: the proportion of short-term assets in the portfolio fell from 34 to 32 percent, and the proportion of long-term assets rose from 20 to 21 percent.

The proportion of tradable assets in the portfolio (excluding shares) also increased, from 23 percent in 2002 to 26 percent in 2003 (the increase is smaller if shares are included in the portfolio). The main reasons for the increase were the impact of the income tax reform for individuals, including the extensive unification of the tax rates on tradable and nontradable assets, and the downturn in the interest rate. The growth in the tradable component of the portfolio is supported by the effects of the pension reform in 2003, principally the greatly reduced issues of earmarked government bonds for the pension funds, and the direction of most of the funds' investments into the capital market.

c. Main trends in government borrowing

The government again failed to adhere to its gross tradable domestic borrowing program in 2003, leading to an upward deviation of NIS 5 billion from the amount denoted in the budget plan. This resulted mainly from the higher than planned budget deficit, and from the government's inability to speed up the privatization process, which had begun at the end of the 1990s. However, government borrowing abroad, principally with the help of the loan guarantees provided by the US government, prevented a further growth in the domestic budget deficit.

The government's net tradable domestic borrowing in 2003 was NIS 4 billion less than in 2002, following an increase in the previous two years. The government thereby contributed to a fall in yields in the government bond market during 2003.

In 2003, the government reverted to the borrowing strategy that it adopted during previous years, after deviating from this strategy in 2002.¹⁵ The term to maturity of its debt instruments was extended again, and benchmark series alone were issued in the

¹³ The main reason for the non-inclusion of the share component when examining changes in the composition of the portfolio is the volatility typical of this component, and the difficulty of classifying it by type of indexation or investment term.

¹⁴ In 2002, in contrast to the overall trend, the proportion of unindexed assets fell due to a large rise in inflation expectations and actual inflation during that year.

¹⁵ Accordingly, the government extended the average term to maturity of its debt instruments, in the case of *Shahar* unindexed bonds by two years, to six years, and in the case of *Galil* CPI-indexed bonds by eight years to eleven years.

bond market. In addition, the proportion of unindexed bonds to total issues was increased.¹⁶ This strategy, from which no further deviation should be made, is essential due to its major contribution to the tradability of the government bond market (which is the basis for the entire capital market), and to the increased certainty in the government bond market and the entire capital market.

Although the proportion of *Shahar* unindexed bonds was increased from 37 percent in 2002 to 41 percent in 2003, the proportion of unindexed debt instruments in 2003 was still much lower than the peak levels recorded in 2000 and 2001, when issues of these instruments accounted for half of the government's bond issues.

The government reduced the proportion of *Gilon* floating-rate unindexed bonds in total tradable borrowing, and it is important that it maintain this trend until the issue of these bonds ceases, because of the low tradability resulting from the difficulty in pricing them. Such a measure will conform to the government's policy of recent years, whereby issues of floating-rate CPI-indexed and dollar-indexed bonds were halted.

The ratio of the government debt to GDP continued to grow in 2003, and reached 105 percent compared with 102 percent in 2002 and 89 percent in 2000. The consistent increase in the ratio during the last three years contrasts with the downturn that began in the mid-1980s, when the ratio reached 150 percent of GDP.¹⁷

The proportion of the CPI-indexed component of government debt fell again, by one percentage point, to 52 percent, while the unindexed proportion rose from 18 percent in 2002 to 22 percent in 2003.

¹⁶ With respect to unindexed debt instruments, the reference is to *Shahar* fixed-rate government bonds alone. This is because an indirect if not official indexation mechanism is implied in the interest on floating-rate *Gilon* bonds.

¹⁷ The Maastricht Treaty prescribes a debt/GDP ratio of no more than 60 percent as a precondition for joining the European Monetary Union.

APPENDIX: THE REFORMS IN THE CAPITAL AND MONEY MARKETS

1. The promotion of reforms in the capital and money markets

The aim of the reforms in the capital and money markets—a long-term process that began in the mid-1980s concurrent with the economic stabilization program—is to provide the infrastructure essential for a competitive and tradable capital market in Israel. The principal measure to be employed in this respect is the government's exit as a leading and determinant player from the capital and money markets, and the creation of a new *modus operandi*, with fair and uniform regulations applying to all the parties involved, whereby the government and the private sector compete for the sources in these markets. To date, the main measures in this process have been the rolling over of the government debt, the abolition of directed credit, the abolition of foreign-currency controls, a more flexible exchange-rate regime, a move from the management of monetary policy by means of administrative tools to management via market tools, the income tax reform for individuals that was first applied in 2003, and the pension reform which was implemented towards the end of 2003.

In 2003, the groundwork was prepared for a number of reforms that will be implemented from 2004 onwards. These include changes in the payments system, measures for supporting securities clearing operations, the formulation of regulations for the establishment of networks of private and governmental market makers in securities, and deposit insurance at the banks. The reforms are intended to enhance the sophistication of the local capital market and improve the efficiency of securities trading, while increasing the markets' tradability and liquidity and reinforcing the financial infrastructure necessary for their operation.

Despite the progress achieved in the course of almost two decades with these reform processes, much work still needs to be done. The measures that need to be completed include: the separation of the ownership of the banks from the ownership of the majority of institutional investors; regulating the framework required for the development of innovative tools such as tradable securities and leasing transactions; and formulating the legal framework necessary for Repo (Repurchase agreement) transactions and for collateral against all securities transactions. The Bank of Israel, the Ministry of Finance, the Securities Authority and the Tel Aviv Stock Exchange (TASE) are involved in the reform measures that still need to be expedited. It is important for each of these organizations to present its viewpoint on the implications of the action that has been taken in its area and in the entire market. In addition, all the organizations mentioned must coordinate in managing the reform processes in order to avoid discrimination (even if only temporary) in favor of different elements in the capital market, and to provide an overall and broad-ranging perception of developments. A striking example in this respect relates to a number of reform processes that the organizations concerned are currently implementing, such as the regulation of collateral—principally securities collateral used in financial transactions. The same applies to the establishment of a

final clearing system for large payments in real time, the strengthening of the TASE clearing house and the Maof (derivatives) clearing house, deposit insurance, and the development of Repo and lending transactions. A systematic solution needs to be applied when furthering these measures, in which collateral for financial transactions is a common denominator. This should be by means of an appropriate amendment to the Mortgage Law or the legislation of a Repo law.

a. The reforms in the capital and money markets prior to 2003

The reform of the capital and money markets began in the mid-1980s as stated, following the implementation of the economic stabilization program. During certain periods, the reform process progressed rapidly, while at other times progress was extremely slow. The main features of the reform process were as follows:

(1) Rolling over of the government debt

The government initiated a process of converting the earmarked bonds that it issues to institutional investors into tradable bonds. Accordingly, the issue of earmarked bonds for the provident funds ceased in the mid-1980s. At the beginning of the 1990s, new members were barred from joining guaranteed-yield life insurance plans, which purchase earmarked bonds from the government. Concurrently, profit-sharing plans were opened for new members. These plans are not entitled to purchase earmarked bonds from the government. In the mid-1990s, the pension funds were closed to new members and funds were opened that were permitted to purchase only smaller quantities of earmarked bonds than the amounts permitted to the established funds, although the quantities permitted to the new funds were still very large. In 2003, an additional pension reform was implemented, whereby the established and new funds' eligibility for purchased earmarked bonds from the government was reduced greatly (see Chapter 5 for details).

The rolling over of the government debt enabled another objective to be achieved—the direction of the majority of institutional investors' investments to the tradable capital market. This is leading to the more professional and efficient management of long-term institutional saving, and to increased liquidity and greater stability in the capital market due to the stabilizing effect on the market of investors with a relatively long-term investment horizon. In addition, the process enables the financial markets to exercise their own judgment as regards the nature of budgetary policy, by means of the premium that they require on the purchase of tradable government bonds.

(2) The abolition of directed credit

The government abolished special credit lines (directed credit) in the second half of the 1980s. These credit lines accounted for most of the banks' balance sheets, while their terms were stipulated by the government and the Bank of Israel on an administrative basis, regardless of the state of the market.

(3) The abolition of foreign exchange controls

The process of abolishing the foreign exchange controls began towards the end of the 1980s, resulting in free capital movements to and from the economy. In 2003, when the abolition of the controls was completed, the NIS had become a convertible currency.

(4) Increased flexibility of the exchange-rate regime

A process of gradual change from a fixed-exchange-rate regime to a regime in which the exchange rate is determined by the foreign-currency market began at the beginning of the 1990s. Since mid-1997, the Bank of Israel has no longer intervened in the foreign-currency market, and the exchange-rate regime effectively became a flexible one.

(5) The move from monetary policy management by administrative tools to market tools

During the 1990s, the Bank of Israel reduced the reserve requirements (liquidity ratios), which had been particularly high, and began to hold monetary tenders for the banking system. Concurrently, the Bank of Israel established an infrastructure for the development of tools that would make it possible to move to the management of monetary policy by means of market tools. For this purpose, the central bank took gradual action aimed at developing the Treasury bill market. Following the removal of the Treasury bill ceiling that had previously restricted the amount that could be listed for trading, it initiated a gradual process whereby Treasury bills came to replace monetary deposits from the banks at the Bank of Israel. In 2003, the Bank of Israel developed the Repo (repurchase agreement) instrument, which many central banks use as a key tool in the management of monetary policy. The Repo was prepared for use at the beginning of 2004, in relatively small amounts at this initial stage. The transition from administrative monetary policy management tools to market tools is creating a vital infrastructure for the development of the money market and non-banking financial intermediation, and enables the money market to exercise its own judgment regarding monetary policy, by means of market yields—principally in the Treasury bill market.

(6) The income tax reform for individuals

The first stage of the income tax reform for individuals was implemented in 2003. Under the reform, most tax distortions were abolished, principally those related to the taxation of income from labor and the taxation of income from capital. In the capital market, the majority of the elements of tax discrimination between the taxation of income from tradable assets, such as shares and bonds, and the taxation of income from nontradable assets, such as deposits at the banks and saving plans, were abolished. The discriminatory elements between the taxation of income from various tradable assets, such as CPI-indexed bonds and unindexed bonds, were also abolished (for more details, see the 2002 Annual Report of the Monetary Department).

b. The reforms in the capital and money markets in 2003

Major changes in the process of reforming the capital and money markets occurred in 2003. During the year, the authorities made a number of structural changes in the market, and established new frameworks for expediting the reforms in the capital market in 2004 and the coming years. The main changes were as follows:

(1) A final clearing system for large payments in real time—RTGS (Real Time Gross Settlement)

The Bank of Israel took action during the year in order to promote the establishment of a final clearing system for large payments in real time. Such an RTGS system, which is commonly used in developed economies and in most developing economies, will constitute an upgrade of the existing payments system, and will provide a vital and relatively safe infrastructure for payments and transactions. The system will thereby help to enhance the financial stability of the economy.

(2) Enhancement of the Tel Aviv Stock Exchange's clearing houses

The Tel Aviv Stock Exchange took numerous measures in 2003 in order to enhance the functioning of the stock exchange clearing house and the Maof (derivatives) clearing house:

- (a) *Consideration of securities clearing on the day following the transaction (T+1) secured by monetary proceeds (DVP—Delivery Versus Payment):* In 2003, the stock exchange began to examine ways of adapting its clearing systems to international standards. The study focused on the move to DVP in securities clearing. The possibility of clearing securities on the day following the transaction (T+1) is being examined in this respect.
- (b) *Standardization of collateral:* With respect to the collateral that members provide to the clearing house, the stock exchange stipulated that from April 2004 members will deposit bonds from their account as collateral in the clearing house.
- (c) *Calculation of intraday collateral at the Maof clearing house:* In 2003, the stock exchange completed the preparation of a system for calculating interday collateral at the Maof clearing house. The system will be operated in April 2004.

(3) A system of market makers in private securities

The stock exchange adapted its trading systems in order to accommodate market-making activity in private securities (shares, bonds and derivative assets). Regulations and frameworks for the market makers' activity have been defined, including a list of rights and obligations and methods of supervising activity. This followed the recommendations of the Hauzer Committee at the end of 2002. (See the Monetary Department's Annual Review in the Bank of Israel for 2002). In March 2004, market makers will begin to operate in derivatives on the euro exchange rate. A system of market makers could help to increase the tradability in less tradable asset markets, encourage the entry of sophisticated financial investors and promote the development of new financial instruments.

(4) *A system of market makers in government securities*

In 2003 the Ministry of Finance acted to promote the establishment of a system of market makers in the government bond market. With this system, the Ministry of Finance proposes to provide the market makers with rights, such as exclusive access to government bond tenders, to a closed trading system that will be established, and to a government bond leasing bank. In return, the market makers will undertake to quote bid and offer prices of the bonds for most of the trading day, to participate in government bond tenders and to acquire certain amounts of bonds in these tenders.

Notwithstanding the great importance of market makers in government bonds—and in other assets—the process must be carried out in the proper manner, while examining the implications of the market’s functioning and adapting it to the structure of the Israeli capital market. We have two comments to make with respect to the framework that is being formulated for this purpose:

(a) *Granting market makers with exclusive access to government bond tenders:*

This measure, like any other measure that would limit the range of organizations that are currently permitted to bid in government bond tenders, could detract from the level of competition prevailing in the primary market for these bonds, a market that is functioning well and at an adequate level of competitiveness. Impairing the functioning of the primary market could also harm the functioning of the secondary market and the capital market as a whole. During recent years the Bank of Israel and the Ministry of Finance endeavored to increase the number of participants in government bond tenders, in order to enhance competition in the primary market. The Ministry of Finance’s proposal to reduce the number of participants in these tenders to a single (or principal) market maker is in direct contrast to this trend, which has contributed greatly to the development of the primary market.

It should be noted that there is no worldwide consensus regarding the advantage inherent in granting exclusivity to market makers in the purchase of government bonds. Some 300 representatives from 122 countries attended five international conferences that the World Bank and the IMF held in the UK, South Africa, Hong Kong, Abu Dhabi and Chile where guidelines for government debt management were formulated. The delegates of many countries expressed doubts as to the advantage of granting market makers with exclusive access to the purchase of government bonds. The doubts mainly arose from considerations similar to those mentioned previously, and mainly concerned the need to maintain and increase competition in the primary market for government bonds. The reservations expressed are recorded in a World Bank publication of March 2001: *Guidelines for Public Debt Management*. Among the numerous developed and developing countries that have not provided market makers with exclusive access to the purchase of government bonds are the US, the UK, Canada and most of the EU countries, including France, Spain and Italy. A similar number of countries do provide market makers with exclusive access to the purchase of government bonds.

These countries include Austria, Ireland, Holland, Denmark, Finland and Sweden. Evidently therefore, such access is not essential for the success of a network of market makers. The issue needs to be examined in light of the conditions prevailing in the local capital market of each country. In Israel's capital market, with its relatively high concentration, there is no place for granting this broad ranging benefit to a group of market makers, especially if these include the large banks whose involvement in the capital market is extensive in any case. The practice of obliging market makers to participate in and acquire certain amounts of bonds in government bond tenders is not to be encouraged either. This is because market makers should be left to exercise their own discretion regarding the manner in which they wish to purchase government bonds and the stock of bonds that they wish to hold.

- (b) *Government bond-leasing facility*: Under the Ministry of Finance proposal, it will manage a bond-leasing facility, even though it supplies the government bonds. Such a measure could harm the functioning of the secondary market for these bonds, as well as the management of the government debt. This is because the government's leasing bonds as well as issuing them has the effect of increasing its debt. A leasing facility as suggested thereby implies issuing in excess of deficit financing requirements. Moreover, the public are unable to know in advance the amount at which bonds will be supplied. (At present, the government announces in advance the quantity of bonds that it intends to issue in the near future and in the current year). Since the supply will change in accordance with market makers' requirements, which will be impossible to forecast, it will be very difficult to price the bonds in the market. It is therefore essential that the leasing facility be owned by a non-governmental entity with the appropriate experience and know-how.

(5) *Repo transactions*

The Bank of Israel began to engage in Repo transactions at the beginning of 2004. The infrastructure for this activity was prepared during 2003. At the first stage of these transactions, the Bank of Israel will sell Treasury bills, and the buyers will undertake to sell them back to the Bank of Israel two weeks later, at a different price. The buying and selling prices will be determined at the first stage of the transaction. Such transactions serve as an important monetary tool for many of the world's central banks. An extensive infrastructure for Repo and securities lending transactions is essential for the activity of market makers in securities.

(6) *Bank deposit insurance*

In 2003, the Bank of Israel promoted the issue of insurance for bank deposits. Deposit insurance is practiced in many countries, and is another element that helps to support the stability of the banking system. Under the proposal that was formulated, insurance will be provided for all types of deposits of the public, i.e., deposits of residents and nonresidents, in NIS and in foreign currency (exclusive of loans). The deposits of local

and foreign institutional investors—local authorities, government companies, interested parties, related parties and directors at banks, as well as inter-bank deposits—will not be insured. The insurance will be obligatory for all the banks, and its amount will be limited for each depositor at each bank. Deposit holders will pay a premium for the insurance, and will be compensated in the event that a bank collapses.

(7) The reform of the pension system

The reform of the pension funds was implemented towards the end of 2003. The reform centers on the decision to issue earmarked bonds to a pension fund only when such bonds account for no more than 30 percent of its assets. Previously, the established pension funds held over 95 percent of their assets in the form of earmarked bonds, and the new funds held 70 percent. Permission for the new and established pension funds to purchase earmarked bonds again is only likely to be granted in 2008 and 2013 respectively.

Concurrently, most of the funds' investments have been directed to the tradable market, in line with the investment regulations that were defined for this purpose. It is estimated that the pension funds will direct NIS 12-14 billion a year into the tradable capital market.

c. The reforms required in the capital and money markets

Despite the progress achieved to date in implementing reforms in the capital market, attention still needs to be given to a number of important issues. The main issues in this respect are:

(1) Separation of ownership of the banks from the ownership of institutional investors

The banks' ownership of the provident funds, advanced study funds and mutual funds should cease, and the affiliation between the banks and the insurance companies needs to be subjected to regulatory procedures. This will help reduce the banks' involvement in the capital market, which is currently very extensive.

(2) Development of the money market

The changes necessary for the development of the money market must be completed. In particular, the development of a commercial paper market should be facilitated. Commercial paper is issued by companies for a relatively short term, and serves as a substitute for bank deposits and bank credit.

(3) Repo law

Repo transactions constitute an essential financial infrastructure for enhancing the sophistication of the bond market, which is the basis for the entire capital market, and the proper activity of market makers in it. Repo transactions are similar to securities lending transactions and enable an investor to sell a particular security that he does not actually hold for any specified period of time, by purchasing it from another investor and re-selling it to its owner at a predetermined date and price. These transactions

enable financial bodies, such as market makers, to hold relatively limited stocks of securities for the purposes of their activity, and to effectively increase them by means of Repo (or lending) transactions when necessary.

Repo transactions also serve as a means for extending credit against which a particular security serves as collateral, thereby increasing the competition with the banking system in borrowing and lending activity.

Repo transactions are most highly developed in the international capital markets, where a special law usually defines the features of a Repo transaction, the inter-relationships between the parties to the transactions and the status of the security on which the transaction is based. Israel does not yet have a law such as this, meaning that the issues involved are shrouded in considerable uncertainty. In the present situation, a Repo transaction can be interpreted as the current purchase (or sale) of a security, and its future sale (or purchase), or as a loan (or deposit) for which a security serves as collateral.

The Bank of Israel has therefore taken steps to initiate a special law that will define all the issues relating to Repo transactions, as practiced worldwide. The legislation will result in the creation of a sound legal infrastructure for this market, and thereby facilitate its development in Israel.

2. Strategy for the management of the government debt

As an integral adjunct to the reforms in the capital market, during the last decade the government has adopted a debt-management policy based on the development of the government bond market. This is in recognition of the fact that over time, a developed and tradable bond market helps to reduce the cost of government borrowing. A well developed bond market is also an essential basis for a well developed capital market. Under its debt-management policy, the government has issued relatively few but large series of bonds, which have served as a benchmark for the medium and long terms for the bond market, since this contributes to increased liquidity in the market. Concurrently, the government extended the average term to maturity of its bond issues, a measure that enhances the stability of the government debt, and increased the proportion of unindexed bonds to its total bond issues in view of the disinflation process in the economy.

The number of government bond issue series fell to only three in 2003 (compared with 26 series in 1992), thereby reducing the number of series traded to 81 (compared with 265 in 1992). The average size of each series issued rose to NIS 13 billion (compared with NIS 0.5 billion in 1992). At the same time, the proportion to tradable domestic borrowing of fixed-rate unindexed bonds was increased to 41 percent. (This was a major change compared with the early 1990s, when all of the bonds that the government issued were indexed to the CPI or to the dollar).

Government debt-management policy needs to be enhanced from the aspects of transparency, types of bonds issued, their size, term to maturity, indexation composition of the debt, and the issue of benchmark series.

(a) Transparency

Towards the end of every month, the government announces the size and composition of the bond issues planned for the following month and usually, at the end of every quarter, the estimated size of the issues planned for the following quarter. This is in addition to the annual report on total planned borrowing in the budget plan. However, the government still leaves the bond market with an element of uncertainty regarding the size and composition of future borrowing.

It is therefore important for the government to publish its borrowing program on a current basis, with details of the size and composition of issues, for a period longer than a month (for three or six months) as practiced in other countries, and to update this program according to the circumstances prevailing. In this way, the government will be able to increase the climate of certainty in the capital market, which is extremely important, especially in periods of general uncertainty. Although this will reduce the government's flexibility in compiling its borrowing program, it will compel it to adhere to certain principles, which will be detailed below.

(b) Types of bond

The government currently issues bonds of three types—*Shahar* fixed-rate unindexed bonds, *Galil* CPI-indexed bonds and *Gilon* floating-rate bonds. During recent years, the government has adopted a policy of issuing relatively simple bonds, as practiced worldwide, and ceased the issue of complex bonds that are difficult to price and notable for low tradability. The government also stopped issuing *Rimon* fixed-rate dollar-indexed bonds, *Geva* bonds that were indexed to the CPI from the second year of their lifetime, *Kfir* floating-rate CPI-indexed bonds, and *Gilboa* floating-rate dollar-indexed bonds. This policy conforms to the strategy of developing the bond market, since bonds that are easy to price are notable for high tradability.

It is important that the government take a further step in this direction by ceasing the issue of *Gilon* bonds as well. These bonds are difficult to price and their tradability is low.

(c) The term to maturity of bonds

At present, the government issues *Galil* bonds for terms of 10 and 20 years, and *Shahar* bonds for terms of 5 and 10 years to maturity.

The government must examine the possibility of extending the term to maturity of unindexed bonds, in view of the convergence of inflation at relatively low levels since the end of the 1990s, and of CPI-indexed bonds following the pension funds' entry to the tradable capital market—primarily the government bond market.

(d) The indexation composition of government borrowing

In 2003, 41 percent of government bond issues consisted of *Shahar* unindexed bonds. Considering the low and relatively stable level of inflation, the government should consider a further increase in the proportion of these bonds to total issues, in line with worldwide practice. In the currently prevailing circumstances, it would appear that

CPI-indexed bonds should only be issued for particularly long terms, against long-term institutional saving (such as the pension funds).

(e) *Benchmark bond series*

In line with worldwide practice, the government currently issues bond series as a benchmark for the entire market. This is not only important for the tradability of the government bond market, but also has implications for the corporate bond market and the medium and long-term interest rates in the economy. But in 2002, the government deviated from this policy by suspending issues of benchmark series and issuing other series of bonds that were shorter in their term to maturity.

It is important for the government to adhere to the policy of issuing benchmark series and endeavor to reach a situation within two years where benchmark series will be issued at the long end of the yield curves. (Currently, *Shahar* bonds are issued for a maximum of 10 years and *Galil* bonds for 20 years.)

Table 1.1
Principal Indicators of Inflation, Monetary Policy and the Money and Capital Markets, 1998–2003

	(percent)					
	1998	1999	2000	2001	2002	2003
Inflation						
Inflation target	7–10	4.0	3–4	2.5–3.5	3–2	3–1
Actual inflation ^a	8.6	1.3	0.0	1.4	6.5	–1.9
Inflation expectations for a year	6.3	5.1	2.4	1.9	3.3	2.0
Yields						
Nominal interest rate on Bank of Israel tenders ^b	12.6	13.0	9.8	7.1	7.3	7.8
Nominal yield for 5 years ^c	11.6	11.2	8.6	7.1	9.1	8.4
Nominal yield for 10 years ^c				7.4	10.9	8.8
Real yield to maturity on 5-year bonds ^c	5.1	5.5	5.8	5.0	4.8	5.1
Real yield to maturity on 10-year bonds ^c	4.9	5.1	5.4	5.0	5.0	4.7
Real yield to maturity on 20-year bonds ^c				4.6	5.4	4.9
Depreciation						
Against the currency basket ^d	20.6	–2.5	–6.3	3.7	14.2	–0.5
Against the dollar ^d	18.2	0.4	–2.7	4.8	9.8	–6.4
Against the D mark/euro ^e	25.9	–13.3	–13.7	4.2	25.5	12.7
Asset prices						
Overall rate of return on shares (nominal)	3.6	59.4	6.9	–15.4	–8.6	44.4
Apartment prices ^f	7.6	0.7	–8.2	–2.2	4.4	–5.7
Monetary aggregates (nominal rates of change)^d						
Narrow monetary base (M1)	11.7	14.3	7.5	15.4	4.9	7.7
Total credit (C3)	19.1	12.7	9.7	8.9	9.7	–2.7
The public's financial asset portfolio						
Nominal growth ^g	13.6	25.4	7.5	7.3	1.8	12.5
Weighting of unindexed assets ^h	24.9	24.6	28.3	30.9	31.2	30.9
Weighting of CPI-indexed assets ^h	46.1	38.4	35.9	35.1	37.5	34.2
Weighting of foreign-currency-indexed assets ^h	11.0	11.0	11.3	12.8	15.9	13.7
Weighting of shares ^h	18.1	26.0	24.5	21.2	15.4	21.1
Actual budget deficit (percentage of GDP)						
Domestic deficit, excluding credit	2.8	2.8	0.5	3.6	3.5	5.4
Total deficit, excluding credit	3.2	3.1	0.7	4.5	3.8	5.6
Additional data						
Bal. of payments, current account deficit (\$b) ⁱ	1.3	1.5	0.7	1.8	1.4	0.2
Unemployment rate	8.6	9.0	8.8	9.3	10.3	10.7
GDP growth rate ^j	3.3	2.6	7.4	–0.9	–0.8	1.3

^a Consumer price index during the year.

^b Effective rate.

^c Gross (relative) annual average yield for the terms in question. Up to 2002 (inc.), relative gross yield. From 2003, gross yields. See note 4 in Chapter 2.

^d December average compared with the same for previous year.

^e December average compared with the same for the previous year (from 2000, compared with euro).

^f According to Apartment Prices Survey.

^g Year-end compared with end of previous year.

^h Year-end data.

ⁱ New definition. The difference between the new and the old definition of the balance of payments is that under the old definition, capital transfers (principally immigrants' transfers) were deducted from the remainder of the deficit, while under the new definition these transfers are classified in the capital account and are not deducted from the current deficit.

^j Year-on-year annual average.

SOURCE: Monetary Department, Bank of Israel.