

The Economy: Developments and Policies

Per capita GDP rose by 2.5 percent in 2004, after declining for three consecutive years. GDP growth, which was led by the business sector, resulted in a turnaround in the unemployment rate, which declined to 10 percent of the labor force in 2004:IV. Macroeconomic policy attained its targets this year: the budget deficit contracted to 3.9 percent of GDP, slightly below the target level set by the government, and the CPI (Consumer Price Index) rose by 1.2 percent during the year, a rate that is in line with the price-stability target. Alongside the return to GDP growth, the current account of the balance of payments was in surplus. Notwithstanding, unemployment was still high and above the rate prevailing in the developed countries.

The same factors which led to the protracted recession of the last few years acted in the opposite direction in 2004 and helped to boost growth. The main ones among these were the recovery of world trade and the high-tech industries, and the relative calm on the security front. All export industries expanded, particularly high-tech but also the services, contributing 3.2 percent to the rise in GDP. In addition, private consumption rallied markedly in the wake of the rise in real wages and the restoration of consumer confidence.

The two components of macroeconomic policy—fiscal and monetary—were coordinated this year, and this served to support business-sector growth. The contraction of the budget deficit sustained the reduction of domestic interest rates, making it possible for the Bank of Israel to reduce its key rate steadily and gradually to a historically low level. The decline in the share of government consumption in GDP in the last two years served to enhance the credibility of macroeconomic policy, supported the reduction of Israel's risk premium and the turnaround in the capital market, and enabled tax rates to be reduced. Although the fall in government consumption acted directly to reduce demand, the tax reductions backed by a simultaneous contraction of the government debt, as well as low real interest rates, served to increase private consumption and domestic investment.

The main challenge facing macroeconomic policy in the coming years is to support the persistence of the growth process led by the business sector while at the same time further reducing the unemployment rate. This should be done by continuing to reduce the government expenditure/GDP ratio, so as to allow a reduction in the share of the deficit and the government debt in GDP, as this will support the low level of real interest, which promotes investment.

While the return to growth is a necessary condition for alleviating poverty in the long run, it does not guarantee the ongoing reduction of the poverty rate, because of the unbalanced nature of Israel's economic growth in the last decade which was concentrated in high-skill-intensive industries. Hence, special policy measures are required in order to reduce poverty, primarily measures which should be anchored in quantitative targets for alleviating poverty in the long run (ten years) as an additional target of the government's economic policy. Priorities should be set for government spending with the emphasis on investment in education and the infrastructure. The policy of reducing the number of foreign workers should continue, the government should subsidize the costs of child-care for those with low earning power, a negative income tax system should be introduced, and compulsory pensions should be implemented on terms that are worthwhile for low earners.

Alongside these measures, the reform of the education system along the lines recommended by the Dovrat Committee should be implemented and structural changes should be made in various spheres in order to increase competitiveness. Competition should also be intensified in the financial sphere and the recommendations of the Bachar Committee, which are in line with this aim, should be implemented.

1. MAIN DEVELOPMENTS

In 2004 per capita GDP rose by 2.5 percent; GDP growth was led by the business sector.

After declining for three years, per capita GDP rose by an admirable 2.5 percent. This trend was led by the business sector, which expanded by 6.1 percent, alongside a turnaround in the unemployment rate, which began to fall after a protracted rise. Alongside the return to economic growth, the deficit targets were met and there was price stability and a surplus in the current account of the balance of payments. At the same time, the long recession has taken a heavy economic toll in terms of poverty, which has grown, and the unemployment, which is currently higher than in the developed countries (Table 1b).

The same factors which gave rise to the protracted recession of the last few years acted in the opposite direction in 2004 and helped to stabilize the economic growth evident already in 2003. The recovery of world trade in general, and the high-tech industry in particular, served to increase exports substantially, and their growth rate

surpassed that of world trade. The improvement in the security situation contributed to the rise in consumer confidence, expressed in the rally in private consumption and the expansion of tourism. These two exogenous developments were upheld by the macroeconomic policy mix—fiscal policy which operated to reduce the budget deficit alongside the reduction of tax rates, and expansionary monetary policy which was in line with attaining the price-stability target.

In 2003 there were already clear signs of a turnaround in economic growth. Economic expansion in the US was expressed towards the end of the year in the reinforcement of growth in the high-tech industry, pushing up demand for the product of these industries, which account for a large share of Israel's exports. Exports of Israel's high-tech industry, which had declined for three years in succession, rallied in 2004, as did exports of most of the other industries. Total exports expanded by 14.9 percent, outstripping the growth of world trade, which was up by 8.8 percent after rising by an annual average of 2.9 percent in 2001–2003. Exports of the traditional industries, which were affected positively by the real local-currency depreciation, as well as of the service industry, also expanded appreciably. The total contribution of nondiamond exports to GDP growth was 3.2 percent (Table 2a). Private consumption also rallied considerably, accounting for 1.8 percent of GDP growth.¹ Its expansion in 2004 is explained primarily by the rise in disposable wage income against the backdrop of the rise in consumer confidence.

The turnaround in macroeconomic policy began in March 2003, after two years in which the budget deficit rose and real interest rates were high (starting in mid-2002). In the framework of the Economic Recovery Program (ERP) it was decided that the deficit would be reduced from 7 percent of GDP to 4 percent, alongside a sharp cut in government spending. This led, for the first time since the economic stabilization

The growth rate of exports exceeded that of world trade. The improvement in the security situation served to increase consumer confidence and private consumption.

Exports contributed 3.2 percent, and private consumption 1.8 percent, to GDP growth.

Table 1a
Israel: Basic Economic Data,^a 1990–2004

	1990–1992	1993–1996	1997–1999	2000	2001	2002	2003	2004
Mean population ('000s)	4,911	5,473	5,975	6,289	6,439	6,570	6,690	6,806
Population growth rate (percent)	4.3	2.6	2.5	2.7	2.4	2.0	1.8	1.7
Israelis employed ('000s)	1,569	1,895	2,078	2,216	2,265	2,284	2,330	2,401
GDP (NIS billion, 2004 prices)	321	392	456	507	502	499	505	527
GDP growth rate (percent)	6.6	5.6	3.2	8.0	−0.9	−0.7	1.3	4.3
Per capita GDP (\$'000s, current prices)	12.2	15.1	17.4	18.4	17.6	15.9	16.5	17.3
Unemployment rate (percent)	10.5	7.8	8.4	8.8	9.3	10.3	10.7	10.4
Inflation rate (during year, percent)	15.0	11.1	5.7	0.0	1.4	6.5	−1.9	1.2
Current-account deficit (percent of GDP)	1.0	4.7	2.1	1.3	1.7	1.5	−0.5	−0.4
Foreign-exchange reserves (\$ billion)	6.0	8.3	21.9	23.3	23.4	24.1	26.3	27.1
Net external debt (percent of GDP)	26.3	24.2	11.2	3.2	0.5	−1.8	−5.1	−9.8

^a Annual averages.

SOURCE: Based on Central Bureau of Statistics data.

¹ Excluding consumer durables.

Table 1b
Basic Economic Data: International Comparison, 1994–2004

	(percent)											
	2003				2004				1994–2004 average			
	Israel	US	Euro area	OECD	Israel	US	Euro area	OECD	Israel	US	Euro area	OECD
Population growth rate ^a	1.8	1.0	0.4	0.7	1.7	1.0	0.4	0.7	2.4	1.2	0.4	0.8
GDP growth rate ^b	1.3	3.0	0.6	2.2	4.3	4.4	1.8	3.6	3.7	3.4	2.1	2.8
Per capita GDP growth ^a	-0.5	2.0	0.2	1.5	2.5	3.4	1.4	2.9	1.3	2.2	1.7	2.0
Per capita GDP (\$'000s, current prices) ^a	16.5	37.8	27.3	30.4	17.3	39.1	27.7	31.2	16.9	33.3	23.3	26.9
Unemployment rate ^b	10.7	6.0	8.9	6.9	10.4	5.5	8.8	6.6	8.7	5.2	9.5	6.7
Inflation rate (average) ^b	0.7	2.3	2.1	2.4	-0.4	2.6	2.1	2.3	5.6	2.5	2.2	3.7
Inflation rate (during year)	-1.9	1.9	1.9	2.0	1.2	3.3	2.2	2.6	5.2	2.5	2.2	3.6
Current-account deficit ^b (percent of GDP)	0.5	-4.8	0.4	-1.1	0.4	-5.7	0.7	-1.2	-2.3	-3.2	0.6	-0.6
Net public debt ^b (percent of GDP)	91.0	42.8	52.5	45.2	88.4	44.3	53.4	46.6	84.7	47.5	52.2	44.8

^a Population figures for the US, Euro area and OECD countries for 2004 are based on the 2003 figures.

^b Figures for the US, Euro area and OECD countries for 2004 are estimates.

SOURCE: OECD Economic Outlook, 2004; World Economic Outlook, 2004, and Bank of Israel annual reports.

program of 1985, to a real drop in government expenditure in 2003. This step, which was reflected by a reduction in long-term interest rates, made it possible for the Bank of Israel to gradually and continuously reduce its key interest rate, supported by the reduction of the risk premium of the emerging economies. The Bank of Israel's key interest rate reached its lowest level ever at the beginning of 2005, and interest rates in general were characterized by real rates which stimulated increased investment. Furthermore, the cumulative reduction of real government expenditure (excluding interest payments) in the last two years and the marked rise in tax revenues in the wake of the economic recovery made it possible to lower the statutory tax rate while attaining the government's deficit target and decreasing the government debt by 1.6 percent of GDP. The direct effect of the spending cuts was to lower domestic demand, mainly in 2003, but in 2004 the tax reductions and high real interest rates bolstered the expansion of both demand and supply. These effects were further strengthened by the reinforcement of the credibility of macroeconomic policy.

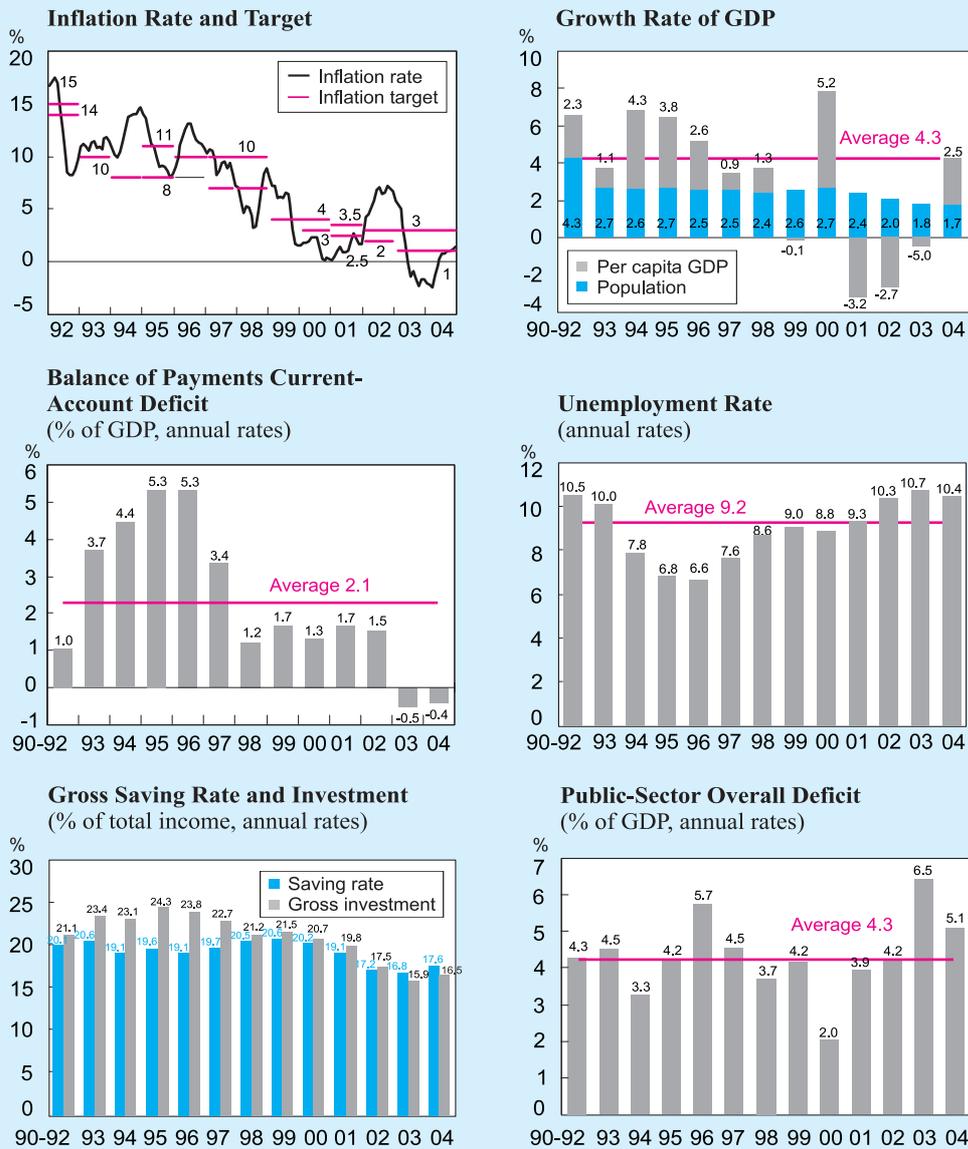
After a long period in which the unemployment rate rose, a turnaround was evident in this sphere, and it dipped to 10 percent in 2004:IV. Alongside the emergence from the recession, the employment rate went up in 2003, but since the improvement in economic conditions and the reduction of national insurance benefits caused the participation rate to rise as many people returned to the labor market, unemployment began to decline with a lag only in 2004. The latter, which persisted steadily throughout the year, stemmed from the increase in the business sector's demand for workers, whereas employment in the public services declined. A by-industry analysis of the employment rate shows that while the expansion of employment encompassed industries employing both skilled workers and unskilled workers, nonetheless the

In the last two years fiscal and monetary policy has been coordinated; the policy mix supported the expansion of the business sector.

The unemployment rate fell and reached ten percent in 2004:IV.

Employment rose, but part-time posts increased significantly.

Figure 1: Key Economic Indicators, 1990–2004



SOURCE: Based on Central Bureau of Statistics data.

extent of part-time posts rose considerably, primarily among low-wage workers. The rise in the demand for labor led to an increase in the real wage, which had been eroded during the recession. Note, too, that the policy of reducing the number of foreign workers persisted: some of them were replaced by Israelis in 2004, as may be inferred from the exceptional increase—6,000 reported posts—in Israelis employed in domestic work; some of the foreign workers were replaced by Israeli Arabs, mainly in construction.

The protracted recession of the previous years brought the economy to high rates of poverty and unemployment, and one of the major challenges facing policy is to

The policy of reducing the number of foreign workers continued.

The challenge facing economic policy is to support the sustainable growth of business-sector product and reduce unemployment and poverty.

The cuts in transfer payments brought some individuals back into the labor market, but in the short run also increased the number of families below the poverty line.

It is recommended that a quantitative long-term target be set involving steps for reducing poverty.

The reform of the education system must be implemented and changes introduced to increase competitiveness in the economy.

reduce them in the next few years. In order to do so it is advisable to persist with a macroeconomic policy that supports business-sector growth, based on the continued reduction of the share of the deficit and the debt in GDP. A low budget deficit contributes to lower long-term interest rates and makes it possible to keep the real interest rate down while maintaining price stability. The revival of growth is a necessary condition for contending with the problem of poverty, but it is not a sufficient one because Israel's economic growth in the last decade is biased towards technology, whereas demand for the product of low-skill-intensive industries is still moderate, and wages in them are very low, *inter alia* as a result of their large proportion of foreign workers in the past.

While the decision to cut transfer payments as a way of causing some individuals to return to the labor market works in that direction, these changes were not enough in the last two years to reduce poverty significantly, especially as long as the economic recovery does not ensure that low-wage individuals will find jobs at wage levels that will enable them to emerge from poverty. Furthermore, because there is no efficient mechanism for distinguishing between persons genuinely unable to work and those who can work, the cuts in transfer payments have in the short term increased the number of families below the poverty line.

Macroeconomic policy in the next few years must act to enable the achievement of sustainable growth which will alleviate unemployment, while simultaneously taking complementary steps to reduce poverty. It is recommended that a quantitative long-term target be set for easing poverty in tandem with a series of policy measures, namely, setting priorities for government expenditure, placing greater emphasis on education, implementing infrastructure investment, continuing the policy of reducing the number of foreign workers, subsidizing the cost of getting low-wage individuals back into the labor market, and introducing negative income tax and compulsory pensions on terms that are worthwhile for low earners. It is also recommended that transfer payments be linked to the median wage rather than to the CPI, and that a mechanism be developed for distinguishing between persons genuinely unable to work and those who are capable of working. In addition, the reform of the education system should be fostered and structural changes made in various spheres in order to increase competitiveness.

2. REAL ECONOMIC ACTIVITY

Business-sector product rose by 6.1 percent. The emergence from the recession was led by the impressive recovery of exports.

GDP rose by 4.3 percent in 2004, alongside a 2.5 percent increase in per capita GDP. The return to GDP growth was led by the business sector, whose product expanded by 6.1 percent. The emergence from the recession was led by the impressive recovery of exports, which expanded by 14.9 percent, and by a rally in private consumption. These two trends were evident already in 2003, and became entrenched in 2004 (Figure 2). By contrast, investment rallied only in the second half of 2004, mainly due to the increase in investment in machinery and equipment and a marked rise in inventory investment.

The main reasons for the recovery of growth were the upturn in world trade, especially in the high-tech industry, and the improvement in the security situation. These factors were supported by the combination of fiscal and monetary policy. The reduction of the deficit enabled long-term interest rates to decline, and made it possible

The main reasons for the resurgence of GDP growth were the recovery of world trade and the improvement in Israel's security situation. The central bank's key interest rate fell to its lowest level for many years.

for the Bank of Israel to lower its key interest rate to an historically low level.

World trade expanded by 8.8 percent in 2004, compared with an annual average of 2.9 percent in 2001–03, alongside an impressive rally in electronic goods worldwide (see the diagram in the section on manufacturing in Chapter 1, Output and the Principal Industries).² This led to a significant rise in high-tech exports, after they had fallen for the previous three years (annual average, Table 2a).

High-tech exports rallied, after declining for three years.

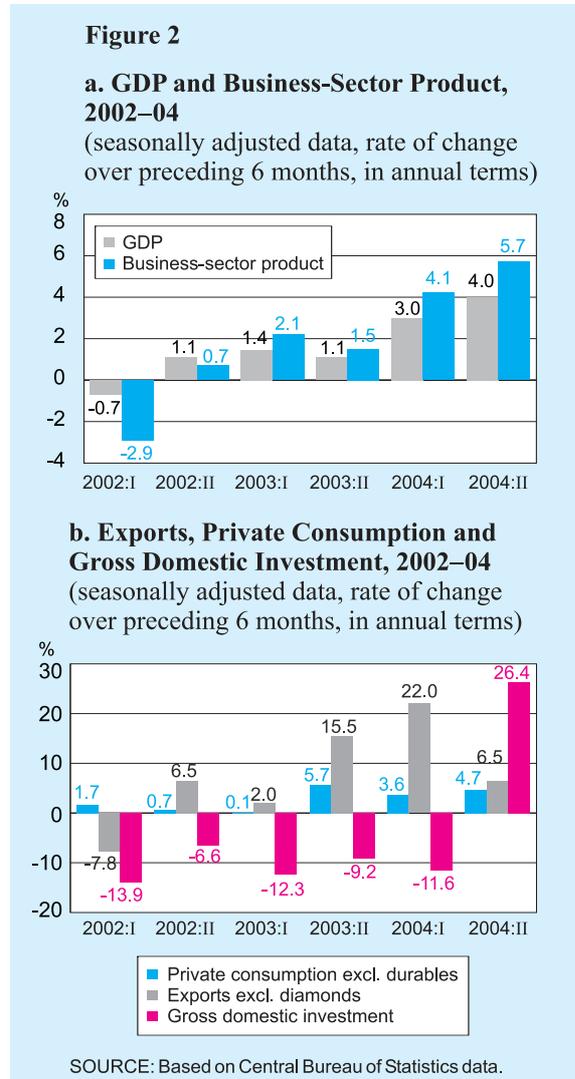
The improvement in the security situation, expressed in a marked decline in the number of incidents in 2003 and a further drop in 2004, led to the notable recovery of the commerce and services industry.³ The amelioration of the security situation is closely connected with the improvement in indices of consumer confidence during the year (Figure 3).

The amelioration of the security situation led to an improvement in the index of consumer confidence and to the recovery of the commerce and services industry.

Two significant factors led the recovery of private consumption in 2004. First, disposable wage income rose, after real wages

Real wages and disposable wage income rose this year; the tax rate was reduced credibly.

had declined for two years; there was some improvement in both the real wage and in disposable wage income, explaining a large part of the expansion of private



² Unless stated otherwise, all references to chapters given here are to the accompanying Research Department volume of this Report.

³ Much of the rise in the commerce and services industry, especially in food and hotel services (11.1 percent) is explained in 2004 by the increase in internal tourism, and especially by tourism from abroad due to the easing of the security situation. According to a calculation based on input/output coefficients, the recovery of tourism increased the product of the food and hotel services industry by 4.9 percent (see section on 'Commerce and Services' in the chapter on output and the principal industries).

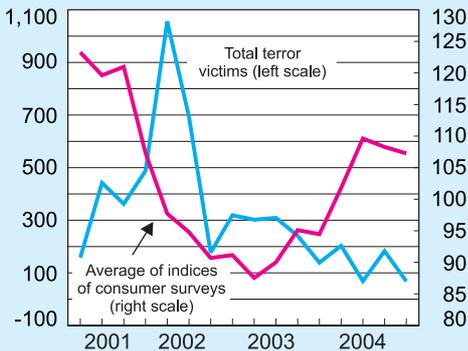
Table 2a
Sources and Uses, 2001–2004

	2001	2002	2003	2004	Contribution to growth 2004 ^a
Sources and uses					
GDP	-0.9	-0.7	1.3	4.3	
Business-sector product	-2.4	-2.6	1.7	6.1	
Derived GDP ^b					5.4
Private consumption	2.7	1.1	1.3	5.7	2.4
of which excl. durables	4.0	2.1	1.4	4.5	1.8
Public consumption	3.6	5.0	-2.0	-1.9	
of which domestic consumption	2.7	4.4	-0.7	-1.3	-0.3
Gross domestic investment	-5.1	-13.7	-10.7	6.4	0.1
of which fixed investment	-3.3	-7.0	-4.9	-1.7	
Exports	-11.2	-2.4	6.2	14.9	3.2
of which excl. diamonds	-10.4	-6.4	6.4	16.2	3.2
of which high-tech	-8.3	-12.0	-1.0	17.0	
of which service exports	-17.1	-5.8	9.7	15.9	1.0
Imports	-4.7	-2.1	-1.8	12.0	
of which excl. defense imports, ships, planes, and diamonds	-4.4	-6.4	-1.6	12.9	
Domestic uses	0.7	-0.7	-1.2	4.0	2.2

^a See Table 1.3 in the second part of the Research Department report.

^b Derived GDP is the sum of the contribution to GDP of domestic uses according to the input-output coefficients for 1995. The difference between GDP and derived GDP arises from the deviation of the actual added value from the coefficients.

SOURCE: Based on Central Bureau of Statistics data.

Figure 3
Average of Indices of Consumer Surveys, and Total Terror Victims, 2001–04

SOURCE: Based on data from the Rotem Institute for Market Research, TNS Teleseker, the Smith Institute, and the International Policy Institute for Counter-Terrorism of the Interdisciplinary Center, Herzliya.

consumption. Tax rates were reduced in a credible way as this was accompanied by the contraction of the share of expenditure and the government debt in GDP. Nonetheless, in the last three years transfer payments have fallen, and this has had a considerable influence on consumption by low-income individuals, who are characterized by a high level of marginal propensity to consume.⁴ Second, consumer confidence improved. This began in 2003 and was reinforced in 2004.⁵ This improvement, which was affected by the easing of the security situation, increases the readiness of consumers to make decisions about buying products, primarily durable goods, purchases of which rose considerably in the first half of 2004.

The effect of fiscal policy on economic activity was mixed. On the one hand, the cumulative real reduction of government expenditure (excluding interest payments) in the last two years acted directly to lower demand. On the other, the cumulative reduction of real expenditure in the last two years also had an expansionary influence on aggregate demand and supply, as it increased confidence in the achievement of the fiscal policy goal of reducing long-term public expenditure, which increases consumers' future disposable income. This reduction also had a

⁴ Disposable wage income rose by 5.2 percent, but the 4.1 percent decline in transfer payments moderated the increase in total disposable wage income and transfer payments, which went up by 3.1 percent. The quantitative contribution of wage changes to disposable income is emphasized in Y. Lavi (2003), "Do Changes in Current Income Help to Explain Changes in Consumption in Israel?" *Israel Economic Review*, Vol.1, no. 2, 113-135.

⁵ K. Braude and A. Friedman have shown that there is a significant correlation between consumer confidence and private consumption in Israel: "Survey of Consumers in Israel: the Leading Index of Private Consumption" (2003), Bank of Israel Research Department, *Discussion Paper* no. 11.03 (Hebrew).

Table 2b
Development of Sources and Uses, 2003 and 2004

(seasonally adjusted, change from previous quarter in annual terms)

	2003				2004				Change during 2004
	I	II	III	IV	I	II	III	IV	
Sources and uses									
GDP	3.0	-0.6	2.1	1.0	3.4	4.4	3.4	4.8	4.0
Business-sector product	4.3	-0.1	2.2	1.9	4.5	5.7	4.8	7.5	5.6
Private consumption	-7.2	12.9	8.6	1.1	6.1	3.3	3.2	14.0	6.5
Public consumption	-2.2	-11.6	3.1	-6.3	2.0	0.6	-2.7	-4.9	-1.3
Gross domestic investment	-8.9	-10.2	-2.2	-21.1	-16.6	11.4	52.3	-1.2	8.7
<i>Of which: Fixed investment</i>	-3.1	-2.8	-11.6	-5.2	6.8	-8.8	0.6	14.7	3.0
Exports, excluding diamonds	3.0	-8.9	37.4	3.7	35.0	17.0	3.9	1.9	13.7
Imports, excluding defense imports, ships, planes and diamonds	-9.3	8.9	19.3	-3.0	31.9	14.6	-0.6	14.0	14.4
Domestic uses	-4.3	1.5	5.9	-6.0	3.7	2.8	7.6	4.5	4.6
Labor market									
Unemployment rate	10.7	10.5	10.9	10.9	10.7	10.5	10.2	10.0	
Employment rate	48.7	48.4	48.4	48.9	49.2	49.4	49.3	49.1	
Participation rate	54.5	54.1	54.4	55.0	55.1	55.2	54.9	54.5	

SOURCE: Based on Central Bureau of Statistics data.

positive effect on the country's risk premium and on the real exchange rate in the short term (as explained in Box 2 of Chapter 1). Moreover, the reduction of expenditure even made it possible in 2004 to lower the tax rate, which served to increase demand in general and private consumption in particular, as well as to expand aggregate supply. The reduction of the budget deficit also had an expansionary effect, supporting the decline in interest rates and the fall in real interest, which had a positive influence on business-sector investment and on purchases of consumer durables in 2004. An examination of the timing of the changes indicates that while the external changes constituted the engine of the recovery, macroeconomic policy supported it: at the time of the emergence from the recession during 2003, and alongside the turnaround in world trade and the improvement in the security situation, the lowering of the deficit boosted the reduction of Israel's risk premium and augmented firms' confidence in the economy, as was expressed immediately in the impressive recovery of the capital market. The reduction of the deficit also bolstered the gradual lowering of interest rates, which later—in the course of 2004—contributed to the turnaround in investment in machinery, equipment, and inventory. The lowering of taxes during 2004 also contributed to the expansion of aggregate demand and supply during the year.⁶

The cumulative cuts in real expenditure also had an expansionary effect on supply and demand.

⁶ The most significant tax reduction was the 1 percent cut in V.A.T. as of March 2004. As far as the effect of the interest rate is concerned, whereas real interest went down already in the second half of 2003, research results for Israel show that the influence of interest on economic activity is expressed with a lag of several quarters (see: A. Barnea and J. Djivre (2004), "Changes in Monetary and Exchange Rate Policies and the Transmission Mechanisms in Israel, 1989:IV to 2002:I," Bank of Israel Research Department, *Discussion Paper* no. 2004:13.

Investment in housing continued to decline in 2004.

In spite of the decline in investment during the recession, capital stock continued to expand impressively (Table 3). It would appear that in some investment categories the stocks accumulated in previous years had created a surplus. Thus, investment in housing continued to contract in 2004, despite the emergence from the slump. Another area affected by this factor was nonresidential construction. The steep rise in inventory investment was affected by the sharp drop in real interest. There was also a recovery of investment in machinery, even though the share of equipment investment in business-sector product declined in 2004.

Table 3
Business-Sector Terms of Production, 1990–2004

	(percent, in annual terms)							
	1990–92	1993–96	1997–99	2000	2001	2002	2003	2004
Rates of change								
Business-sector product	8.1	6.9	3.4	10.2	-2.4	-2.6	1.7	6.1
Domestic labor inputs	5.5	8.1	2.9	4.6	-2.0	0.1	0.4	1.1
Labor supply ^a	5.2	4.1	4.0	3.3	1.8	1.2	1.8	1.5
Gross capital stock	2.8	7.6	9.5	7.8	7.1	5.6	3.9	2.9
Total factor productivity	3.5	-1.4	-1.5	4.4	-3.3	-4.4	0.2	4.3
Return on gross capital ^b (actual, not change)	13.7	14.7	12.7	13.8	11.0	9.5	11.1	15.5
Real wage in business sector	-1.6	0.5	3.4	6.6	3.3	-6.7	-2.5	1.9
Unit labor cost (business sector)	-3.7	1.1	0.4	-2.3	5.2	2.7	-4.4	-4.7
Real minimum wage	-1.7	1.2	4.6	4.9	7.9	-3.1	1.4	-1.8
	1961–70	1971–81	1982–92	1993–04				
Total factor productivity in manufacturing	5.8	1.6	0.9	0.6				

^a Civilian labor force plus foreign and Palestinian workers.

^b Before tax.

SOURCE: Based on Central Bureau of Statistics data.

Profitability improved and capital stock utilization rose.

A significant development that improves the chances that economic growth will become entrenched is the improvement in profitability. The rate of return has risen in the last two years, after dipping by over 4 percent in the recession years, in the context of the decline in unit labor costs. Total factor productivity (TFP) also rallied and rose notably, as a result of the marked increase in factor utilization, a feature that is characteristic of emergence from a recession.

A long-term analysis shows that the rise in productivity is still low.

A long-term analysis shows that the increase in TFP is still below its level before the 1970s (the bottom panel of Table 3), but TFP growth was more moderate after 1973 in other western economies, too. Note that this finding is influenced to a great extent by the slump of the last ten years: the low levels of demand of the last few years prevented full factor utilization, expressed in TFP. In fact, the protracted recession led to a steep and ongoing decline in per capita GDP relative to the OECD countries after 1996, i.e., once the direct economic effects of the influx of immigrants had run their course. Although the external factors which determine the business cycle make it

difficult to explain the development of productivity,⁷ the moderation of its rise for such a long period stresses the need for proceeding with the reforms which will improve it—first and foremost the education reform, intended to make investment in human capital more efficient. Second, it is necessary to increase infrastructure investment and continue undertaking reforms in the various spheres which increase competitiveness (see below).

A by-industry analysis of activity shows that growth in 2004 stemmed from the expansion of manufacturing, transport and communications, and commerce and services—which rose at rates of between 6.3 and 8.8 percent, while the construction industry contracted by 7.1 percent. The decline in construction appears to be approaching its conclusion, as is indicated by an analysis of investment cycles in this sphere.⁸

In 2004 GDP growth stemmed from the expansion of manufacturing, transport and communications, and commerce and services.

3. FISCAL POLICY

After three years in which the budget deficit target was not attained (Table 4),⁹ in 2004 the government met the target of 4 percent of GDP, and the deficit was even below the target—3.9 percent of GDP, a significant decline from the 5.6 percent of GDP level in 2003. The reduction of the deficit and the economic recovery made it possible to return to a declining debt/GDP path, which was down by 1.6 percent of GDP in 2004.

The government attained the deficit target this year.

The reduction of the deficit was achieved by means of the real cuts in cumulative government expenditure (excluding interest payments) as well as by the more rapid GDP growth than expected and surge in imports of consumer durables, which led to a sharp increase in tax revenues. All these factors made it possible to attain the deficit target in spite of the significant reduction of tax rates. The contraction of government spending led to a fall in the cyclically adjusted deficit, which went down by a cumulative 1.5 percent in the last two years (see ‘the fiscal impulse’ in Table 4).

The deficit was reduced by means of cuts in government expenditure, rapid GDP growth, and a steep increase in imports of consumer goods.

On the one hand, the contraction of the budget deficit provided the appropriate backdrop for the gradual and ongoing reduction of the Bank of Israel’s key interest rate in the last two years to its lowest real level in ten years, thereby contributing to the acceleration of economic growth and the reduction of unemployment. On the other, the government spending cuts impacted adversely on basic public services, such as those in the area of health.¹⁰ This affected mainly low-income individuals, who were

The reduction of the budget deficit enabled the Bank of Israel to bring its key interest rate down to its lowest level in ten years.

⁷ See K. Flug and M. Strawczynski (2003), “Sustainable Growth: Is It Around the Corner?” *Economic Quarterly*, 446-484 (Hebrew).

⁸ See the analysis in the box in the section on construction in the chapter on output and the principal industries.

⁹ Whereas the table shows that the deficit in 2002 was 3.8 percent of GDP, which is below the target (3.9 percent of GDP), this was not the original target, and this was amended in mid-year. The original budget was based on a deficit target of 3 percent of GDP.

¹⁰ There was considerable overcrowding in the hospitals in the winter of 2004/05. The Center for the Study of the Health Services and Health Policy reported that the assumption regarding average occupancy used as the basis for predicting the demand for hospital beds in Israel is erroneous, and in the winter this leads to occupancy of over 100 percent.

Table 4
Main Indicators of Fiscal Policy, 1995–2004

	(percent of GDP, in annual terms)									
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Overall public-sector deficit	4.2	5.7	4.5	3.7	4.2	2.0	3.9	4.2	6.5	5.1
Public-sector domestic deficit	5.3	6.8	5.7	5.0	5.3	3.4	5.1	5.3	7.3	5.3
Net overall public-sector debt	88.8	85.6	84.2	83.1	80.5	75.7	81.8	84.9	91.0	88.4
Gross overall public-sector debt	109.7	106.8	103.6	106.4	100.8	90.8	95.9	104.7	106.5	104.9
Total public-sector expenditure	54.8	54.5	53.2	52.6	51.8	50.4	53.0	54.3	53.2	51.6
Total taxes	40.0	38.6	39.2	38.2	38.5	39.8	39.7	39.0	38.1	37.9
Ceiling on domestic budget deficit ^a	3.9	3.7	3.0	2.8	3.1	3.6	1.8	3.9 ^b	3.0	4.0
Actual domestic budget deficit	4.4	4.2	3.3	3.2	3.3	0.7	4.4 ^c	3.8 ^c	5.6	3.9
Fiscal impulse ^d	1.8	1.9	-2.1	-0.3	-1.5	-0.3	0.5	0.1	-1.1	-0.4

^a From 2001, the deficit ceiling as prescribed by law.

^b The target set in mid-2002, when the budget was approved by the Knesset, was 3.0 percent of GDP.

^c The US economic aid was not received in 2001; if it had been, the total budget deficit would have been 4.0 percent of GDP. The aid was recorded in 2002, and reduced the deficit by 0.6 percent of GDP. However, aid of \$ 431 million, which was expected in 2002, was not received even though forecast income for 2002 included it. If it had been received in 2002, the deficit would have been 0.4 percent of GDP lower. Hence, on the basis of aid of \$ 600 million originally intended for 2002, the deficit that year would have been 4.2 percent of GDP.

^d The change in the general government's cyclically adjusted domestic deficit excluding the Bank of Israel, as in Table 3.8 (in Chapter 3 of the second part of the Research Department report).

SOURCE: Based on the National Budget and Central Bureau of Statistics data.

also those who suffered most from the cuts in transfer payments, and in many cases their incomes have fallen below the poverty line.

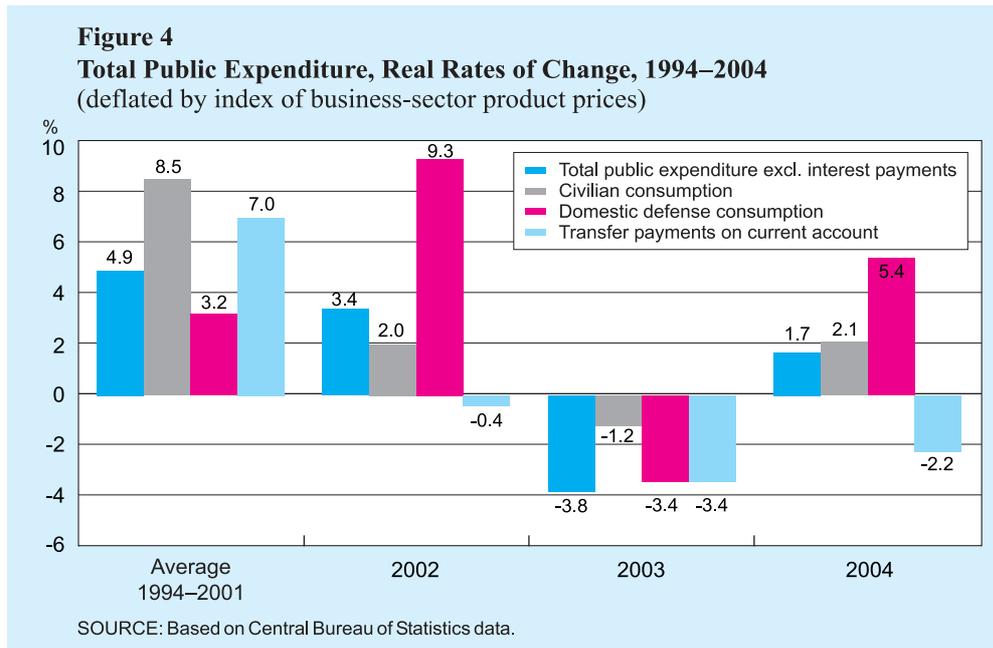
The public expenditure/GDP ratio has fallen by 2.7 percentage points in the last two years, with a steep drop in transfer payments.

The share of government expenditure in GDP has fallen by 2.7 percentage points in the last two years, and in 2004 it was down by 1.6 percent of GDP.¹¹ In contrast with 2003, when all government expenditure items were reduced (Figure 4), in 2004 only transfer payments were cut, while domestic security consumption rose sharply. The cuts in transfer payments were made in the framework of the government's program aimed at reducing the alternative income of individuals who are not in the labor market, thereby giving them an incentive to enter it.¹² Child allowances and unemployment benefits were slashed (by 40 percent relative to 2001), as were old-age and income-support pensions (by 20 percent relative to 2001). However, since an efficient system for distinguishing between persons genuinely unable to work and those who are capable of working has not yet been implemented, the cuts in transfer payments also affected the former.

The gap between the government's domestic income and the budget forecast was far smaller in 2004 than in previous years, and was concentrated mainly in non-tax revenues—royalties, dividends, and income from land sales. Tax receipts were slightly

¹¹ The decline in government expenditure was greater than is reflected by the budget data because part of the reduction in national insurance benefits was recorded in the budget as an increase in income under the rubric 'Loan from the National Insurance Institute' (see Box 3.1 in chapter 3, 'The Budget and the General Government').

¹² K. Flug and N. Kasir (2005) (not yet published) have shown that the increase in transfer payments granted to single mothers in the 1990s reduced their participation in the labor force.



above the budget forecast, even though tax rates were reduced during the year by some NIS 4 billion. These reductions were implemented in addition to planned legislative changes, whose impact on tax receipts was neutral. The increase in tax receipts (adjusting for the effect of the unplanned tax reductions) was made possible by the rapid economic expansion, which contributed NIS 3 billion to them, the exceptional rise in consumer durables purchases, which contributed NIS 2.5 billion, and the fact that payment of the vacation supplement and the Jubilee grant was brought forward to December, increasing tax receipts by some NIS 800 million. Adjusting for legislative changes, tax receipts rose by 8.5 percent.

The reduction of the share of government spending in GDP in the last two years made it possible to cut tax rates significantly, and thus to increase Israel’s competitiveness vis-à-vis markets abroad. Before the tax reform of the last few years direct tax rates in Israel were higher than in the OECD countries, while since the reform the average tax rate has been lower than in those countries for most income levels.¹³ The tax burden is lower than in the EU at all income levels, and higher than the average only at the high income levels, which include only a small proportion of taxpayers. The comparison also shows that the tax rates on unmarried employees in Israel are lower than those in most of the developed countries, while the tax rates on married employees and fathers are in the middle range of the taxation rates in those countries. This finding derives from the approach adopted by Israel’s tax authorities, which is based on the personal status of taxpayers, in contrast to that prevalent in most developed countries (see the section on policy recommendations below), which is based on the family.

Tax rates were reduced during the year.

Following the tax reform, the average tax rate at most income levels in Israel is lower than that in the OECD countries.

¹³ See section 2 in Chapter 3, ‘The Budget and the General Government.’

The policy measures of the last two years have affected the inequality of net income distribution in both directions.

Policy measures taken in the last two years have affected inequality in the distribution of net income in opposite directions: the taxation of capital and the reduction of V.A.T. have acted to reduce inequality in net income, whereas the cuts in transfer payments and public services served, at least in the short term, to increase inequality.¹⁴ Inequality in general, and poverty in particular, also have significant social and economic repercussions, emphasizing the need to cope with them in the framework of budgetary policy—especially in view of the danger that obstacles to the social mobility of the next generation will be created. The expansion of poverty can lead to the reduction of investment in education by low-income groups, having a severe and ongoing adverse affect on the chances of the children of these individuals to emerge from poverty, and hence impacting on future economic growth. Consequently, it is important to continue extending differential budgeting by socioeconomic status, as was proposed by the Dovrat Commission (see Chapter 4, ‘Welfare Policy’).¹⁵

4. THE LABOR MARKET AND THE DEVELOPMENT OF POVERTY

There was a trend shift in the unemployment rate in 2004.

After a continuous rise in the unemployment rate during the recession years, there was a reversal in 2004 and unemployment fell gradually in the course of the year, reaching an annual average of 10.4 percent of the labor force (Table 5), and 10 percent in 2004: IV.

The decline in unemployment reflects mainly the upturn in the business cycle, and to some extent the substitution between Israeli and foreign workers.

The decline in the unemployment rate reflects primarily the upturn in the business cycle and to some extent the substitution between Israeli and foreign workers. The emergence from the recession was expressed first, in 2003, by a rise in the employment and participation rates (which may also have been influenced by the cuts in transfer payments), but there was no concomitant decline in the unemployment rate. In the first two quarters of 2004 the employment and participation rates continued to rise, but this time alongside a dip in the unemployment rate during the year (the lower panel of Table 2b); in the third and fourth quarters, however, the participation rate fell.

The expansion of employment was led by the business sector.

The increase in employment was led by the business sector. Total employment of Israelis grew by 3 percent in 2004, with a 0.6 percent decline in employment in the public services. The rise in employment in the business sector was explained by the rise in the demand for labor due to the emergence from the recession, the contraction in the number of foreign workers (by over 10 percent in each of the last two years),

¹⁴ The cuts in transfer payments might increase the labor force participation rate, thereby moderating the negative effect on inequality in the short run. Nevertheless, this behavioral influence takes time, and insufficient data have accumulated to date to enable this to be examined empirically. Moreover, according to the findings of A. Brender and M. Strawczynski (2005), even large shifts in income (estimated in this study using wages) of extents similar to those implemented in the area of transfer payments, cause only a small change in the participation rate, up to 0.5 percent. This change is translated into an even smaller rise in the employment rate (see A. Brender and M. Strawczynski, “Characteristics of the Negative Income Tax System Desirable in Israel in View of the Labor Supply Characteristics of Persons with Low Earning Potential,” lecture given (in Hebrew) at the annual conference of the Research Department.

¹⁵ This is the first time that the Bank of Israel’s Annual Report contains a chapter on welfare policy.

Table 5
The Labor Force and Employment, 1990–2004

	(rates of change, percent)							
	1990–92	1993–96	1997–99	2000	2001	2002	2003	2004
Working-age population (15+)	5.1	3.0	2.7	2.9	2.6	2.2	1.8	1.8
Civilian labor force	5.0	3.6	2.9	3.8	2.8	1.9	2.5	2.6
Business-sector employment ^a	5.8 ^b	7.6	3.1	3.5	0.0	-0.7	1.2	2.5
Public-sector employment ^a	4.7 ^b	0.7	4.2	2.9	4.8	3.5	1.0	-0.6
Total Israelis employed	5.2 ^b	5.1	2.0	3.9	2.1	0.9	2.0	3.0
Unemployed	14.0 ^b	-10.1	13.5	3.4	10.0	12.1	6.7	-0.7
Foreign workers	172.2 ^b	70.1	10.4	8.6	14.0	2.6	-10.8	-11.6
Palestinian workers	3.9	-15.3	26.4	-15.2	-49.0	-37.0	29.2	-2.9
Working-age population/total population	69.2	70.3	71.0	71.3	71.5	71.6	71.6	71.6
Participation rate in civilian labor force ^c	51.9	53.5	53.5	54.2	54.3	54.1	54.5	54.9
Unemployment rate	10.5	7.8	8.4	8.8	9.3	10.3	10.7	10.4
Employment rate	46.2	49.2	49.1	49.4	49.2	48.5	48.6	49.2
Non-Israelis in business sector	9.0	9.1	14.4	14.9	13.8	13.2	12.3	10.8

^a Including foreign and Palestinian workers.

^b Excluding 1990.

^c Civilian labor force divided by working-age population.

SOURCE: Based on Central Bureau of Statistics data.

and the stable and lower number of Palestinian workers than in the past. This policy led to the expansion of employment of Israelis in domestic work and of Israeli Arabs in construction (see box in Chapter 2, ‘The Labor Market’).

In 2002–04 government policy regarding the labor market changed. Under the heading ‘from welfare to work’ transfer payments paid by the National Insurance Institute were slashed, and the number of foreign workers in Israel was cut drastically. The object of the changes was to reduce alternative income to wage income and to vacate posts for Israelis, thus giving them an incentive to enter the labor market. In addition, the rate at which public-services employment rose in the last two years was lower than in the past. The declared objective of the new policy was to enable economically disadvantaged groups to benefit from the return to sustainable growth, too.

One of the problems with which policy had to contend was the composition of growth in Israel in the long run. The revival of growth has been accompanied by the expansion of the high-tech industry, which requires primarily skilled workers and contributed 0.4 percent to the decline in unemployment (Table 2.6 in Chapter 2, ‘The Labor Market’). In 2004 the restoration of growth was also accompanied by a rise in employment in unskilled-labor-intensive industries, which contributed 0.2 percent to the fall in unemployment (see Table 2.6 op. cit, which is based on the assumption that the increase in labor-force participation is distributed uniformly among skilled and unskilled workers). However, because of the large supply of unskilled workers and limited demand for them, the unemployment rate among persons with less than

In 2002–04 the government’s labor-market policy changed.

High-tech industry contributed 0.4 percent to the reduction of unemployment, and unskilled-labor-intensive industries contributed 0.2 percent.

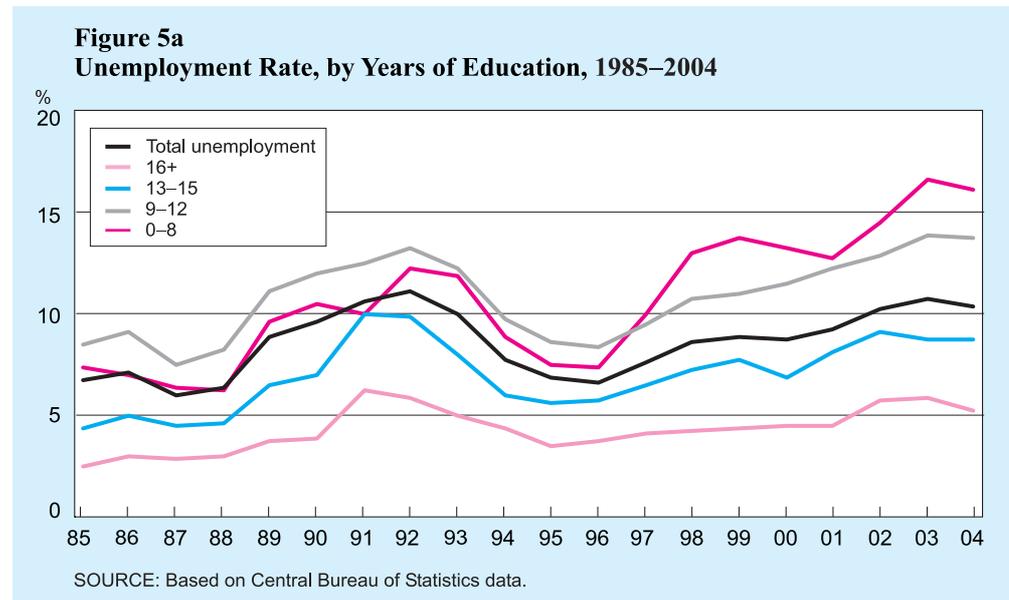
Many workers found employment in part-time posts.

12 years of education is above the average. At the initial stages of the growth process, moreover, its benefits do not reach the weaker segments of the labor force, such as the chronically unemployed. Despite the measures introduced in order to ease the entry into employment of unskilled workers, the share of the chronically unemployed in total unemployment has soared in the last two years. In addition, many of the workers who found employment did so in part-time positions, at low wages, and in industries where employment is generally temporary. It would appear, therefore, that at least at the initial stage of the return to growth, the ‘welfare to work’ reform alone is not capable of bringing these workers out of the cycle of poverty, and additional policy measures are required which will guarantee a rise in remuneration for work for individuals with low earning potential; these will be described in detail below.

Poverty

The proportion of families below the poverty line rose from 18.1 to 19.3 percent in 2003.

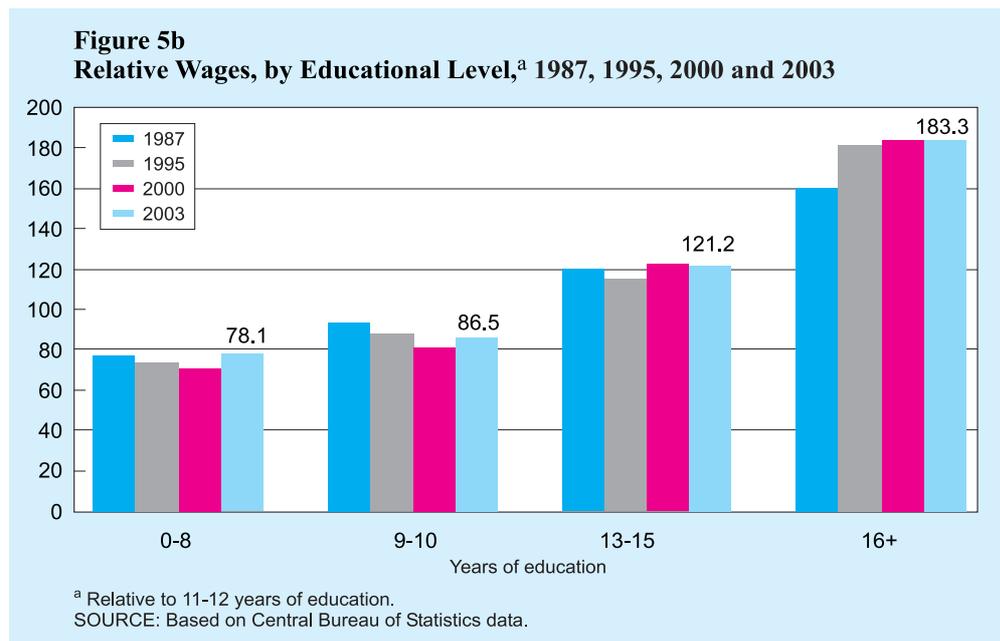
In 2003 the proportion of families below the poverty line rose from 18.1 percent to 19.3 percent, according to the relative poverty measure¹⁶ used by the National Insurance Institute, and there were 366,000 poor families. The average poverty gap, i.e., the difference between the average income of poor families and the income level defined as the poverty line, widened from 29.7 percent in 2002 to 30.5 percent in 2003. The incidence of poverty among children also rose, from 29.6 percent in 2002 to 30.8 percent in 2003.¹⁷



¹⁶ The poverty line is defined as half the median income per capita (i.e., family size is taken into account in determining individual income for this purpose).

¹⁷ See National Insurance Institute, *The Extent of Poverty and the Inequality of Income Distribution in Israel, 2003*, November 2004 (Hebrew).

The above analysis of developments in the labor market in 2004 indicates that the return to growth is a necessary but not a sufficient condition for reducing poverty. A long-term analysis also shows that the growth of poverty was evident during periods of economic expansion, at least initially, when economic growth was led by the high-tech industry (Figure 3 in Chapter 4, ‘Welfare Policy’). The weak demand for unskilled labor and the marked rise in the number of foreign workers in the second half of the 1990s led to high unemployment rates and relatively low wages among unskilled workers (Figures 5a and 5b). The sharp reduction in transfer payments in the last two years was added to these factors, leading (in 2003) to the rise in poverty, particularly among families outside the labor market.



5. THE BALANCE OF PAYMENTS

The year 2004 ended with a surplus of about \$ 0.5 billion on the current account, similar to the situation in 2003. The absence of change in the current account reflects a sharp increase in imports and exports, of both goods and services. There was real local-currency depreciation in 2004, and this contributed to the rise in exports, particularly of traditional goods, which are extremely price-sensitive. The maintenance of a surplus on the current account at a time when emergence from recession served to increase imports indicates that the main force contributing to developments in 2004 was the rise in foreign demand. As regards saving and investment, the maintenance of a surplus on the current account reflects an increase of 0.6 percent of GDP in investment, a rise of 1.5 percent of GDP in the public saving rate, and a decline of 0.7 percent of GDP in the private saving rate.¹⁸

2004 ended with a surplus of \$ 0.5 billion in the current account.

¹⁸ See discussion in Chapter 1, ‘Output and the Principal Industries.’

Table 6
Balance of Payments, 1990–2004

	(\$ billion, in annual terms)									
	1990–92	1993–96	1997	1998	1999	2000	2001	2002	2003	2004
Import surplus	6.2	9.8	9.5	7.3	8.1	8.0	8.6	8.3	5.8	5.7
Current account	-0.7	-4.0	-3.5	-1.3	-1.8	-1.5	-1.9	-1.5	0.6	0.5
Implied capital imports ^a	0.3	5.5	12.9	3.2	2.8	2.4	1.8	0.9	0.7	-0.2
Capital transfers	0.9	0.8	0.7	0.6	0.6	0.5	0.7	0.2	0.5	0.5
Investment in Israel										
by nonresidents ^b	0.3	1.7	3.3	2.2	4.6	9.5	4.2	2.2	4.3	5.1
Direct investment in Israel										
by nonresidents	0.4	0.9	1.6	1.7	3.1	5.1	3.6	1.8	3.9	1.6
Portfolio investment in										
Israel by nonresidents	-0.0	0.8	1.7	0.4	1.5	4.4	0.6	0.4	0.4	3.5
Rise (-) in foreign- exchange reserves ^c	0.4	-1.5	-9.4	-1.9	-1.0	-0.9	0.1	0.6	-1.3	-0.3
Foreign-exchange reserves ^d	6.0	8.3	20.3	22.7	22.6	23.3	23.4	24.1	26.3	27.1
Net external debt	15.2	19.2	14.7	11.2	7.2	3.7	0.5	-1.9	-5.9	-11.9

^a Including errors and omissions.^b Direct and portfolio investment.^c Excluding revaluation differentials.^d Held by Bank of Israel and central monetary institutions at end of period.

SOURCE: Based on Central Bureau of Statistics data.

Table 7
Saving, Investment, and the Current Account, 1990–2004

	(percent of total revenue, in annual terms)									
	1990–92	1993–96	1997	1998	1999	2000	2001	2002	2003	2004
Gross saving rate	20.1	19.6	19.7	20.5	20.6	20.2	19.1	17.2	16.8	17.6
Public	-0.5	0.1	-0.9	-1.1	-1.5	-0.0	-1.6	-1.8	-4.2	-2.7
Private	20.6	19.5	20.6	21.6	22.1	20.2	20.7	18.9	21.0	20.3
Gross investment	21.1	23.7	22.7	21.2	21.5	20.7	19.8	17.5	15.9	16.5
<i>Of which:</i> Business sector	12.7	15.6	14.7	14.1	14.5	14.1	13.3	12.6	12.0	11.7
Current account of balance of payments	-1.0	-4.1	-3.0	-0.6	-0.9	-0.5	-0.8	-0.3	0.9	1.1

SOURCE: Based on Central Bureau of Statistics data.

There was real local-currency depreciation in 2004.

The real exchange rate in terms of export prices declined by 1.8 percent in 2004, and in terms of import prices it was down by 4.3 percent. In purchasing power parity terms there was real local-currency depreciation of 5.5 percent in 2004, expressing a combination of several factors which operated this year to raise the relative price of tradables and imported goods, namely: 1. The persistence of the output gap, which exerts downward pressure on prices (GDP deflator); 2. The deterioration in the terms of trade, a steeper rise in import prices than in those of exports, causing a decline at the margin in national income and hence the relative decline in prices (GDP deflator); 3. The decline in government domestic consumption and therefore the asymmetrical development of domestic demand, most of the expansion of which is directed to tradables. The nominal weakening of the dollar relative to the euro and other major

international currencies made it easier in 2004 for the real factors operating for real local-currency depreciation to be expressed. This was because of the moderating influence of the local-currency appreciation vis-à-vis the dollar on prices in Israel, including those of nontradables, chief among them housing.

Goods exports (excluding diamonds) rose in volume terms by 16.3 percent in 2004, after increasing by 4.7 percent in 2003 and declining in 2001 and 2002. The expansion of exports expresses a 17 percent rise in exports of the high-tech and mixed high-tech industries, and increases of 8 and 20 percent in exports of the traditional and mixed-traditional industries respectively. The expansion of exports was led mainly by the rise in world demand, expressed in the 8.8 percent volume increase in world trade, compared with moderate growth of only 0.2 and 3.3 percent in 2001 and 2002. The increase in exports was also supported by real depreciation, which led to an improvement in Israel's competitiveness in international markets. In particular the exports of the traditional industries benefited from this, as they are relatively price-sensitive and biased towards the countries of the EU, against whom the local-currency depreciation was particularly steep.

Goods exports rose by 16.3 percent in volume terms in 2004.

Services exports (in current dollars) were up by 15.9 percent in 2004. This was the outcome of the rise in world demand, which supported high-tech-intensive services exports, and the improvement in the security situation, which enabled tourism to expand sharply. Exports of 'other services,' consisting mainly of high-tech services such as software services and R&D services, rose by 15 percent. The dramatic decline in the number of security incidents within the green line made a significant improvement in tourism service exports possible, and this went up by about 40 percent due to a similar rise in the number of incoming tourists. Despite this steep increase, however, the number of tourists was far lower than in 2000.

Services exports expanded by 15.9 percent in 2004.

Goods imports (excluding ships, aircraft, and diamonds) rose by 14 percent in volume terms in 2004, due to the steep increase in imports of raw materials, consumer goods, and capital goods. The fact that imports of raw materials, some of which are used to manufacture export goods, rose by slightly more than imports of consumer and capital goods also attests to the force that led growth in 2004—world demand—while domestic demand, especially on the consumption side, supported growth but was not the leading factor. The expansion of imports of capital goods expressed the rise in investment in machinery and equipment, the result of expectations of continued economic recovery and relatively low real interest rates.

Goods imports were up by 14 percent in volume terms in 2004.

Israel's terms of trade, defined as the ratio between export and import prices (excluding diamonds, ships, and aircraft), deteriorated by 4 percent in 2004, further to a similar deterioration in 2003. This expressed the rise in oil prices, which contributed over 2 percentage points to the deterioration, as well as the continued weakening of the dollar against the euro, which contributed 1.5 points. The cross rates affect Israel's terms of trade because Israel has a trade deficit vis-à-vis the EU, but a trade surplus vis-à-vis the US.¹⁹

Israel's terms of trade deteriorated.

¹⁹ In 2004 the trade deficit vis-à-vis the EU was over \$ 4 billion, and the trade surplus vis-à-vis the US was \$ 1.5 billion.

Portfolio investment amounted to \$ 5.4 billion in 2004, compared with \$ 2 billion in 2003.

Since the Bank of Israel has not intervened in foreign trade in the last few years, the balance of payments of the private sector should be balanced; this means that the current account of this sector together with its capital flows should amount to zero.²⁰ This situation creates a close link between the extent of foreign investment in Israel (i.e., the supply of foreign currency) and investment abroad by residents (for which foreign currency is required). In 2004 financial investment by nonresidents apparently led the development of the exchange rate. IPOs abroad by Israeli firms accounted for \$ 2.8 billion, as compared with annual averages of \$ 0.6 billion in 2001–2003, expressing the emergence from the recession in the developed countries, and especially the recovery of the high-tech industry and the rise in share prices on foreign stock markets. The increase in deposits of the commercial banks abroad was also prominent. Investment in the tradable portfolio amounted to \$ 5.4 billion, compared with \$ 2 billion in 2003. In contrast with the positive developments in financial investment, direct investment in Israel by nonresidents amounted to only \$ 1.6 billion in 2004. It is difficult to explain the decline in direct investment via changes in the economic environment, especially because of the positive developments in the economy this year, but since direct investment is concentrated in a small number of transactions the cause of the decline may lie in a few specific incidents, which do not reflect a general trend. Thus, several direct investment transactions which were agreed upon in recent months will be implemented only in the middle of 2005. Direct investment abroad by residents amounted to \$ 3 billion in 2004, the highest level since 2000. Portfolio investment by residents, on the other hand, was particularly low this year.

At the beginning of 2005 the tax discrimination against residents' holdings of foreign securities was cancelled. This change is expected to increase the share of foreign-currency assets held abroad by residents, but to date there has been no significant shift in residents' capital flows, which should be expressed in the exchange rate. Current assessments are that the adjustment of residents' portfolios as a result of the harmonization of taxation on investment in Israel and abroad will be gradual, and will be spread over a long period of time.

6. MONETARY POLICY, PRICES, AND THE CAPITAL MARKET

a. Main developments

Monetary policy became expansionary in 2004, and supported the attainment of the price-stability target.

Monetary policy in 2004 was the direct continuation of the policy of relaxation of monetary restraint introduced by the Bank of Israel in 2003, and in 2004 monetary policy became expansionary. This policy helped attain the target of price stability this year, and prices rose by 1.2 percent—slightly above the lower limit of the target (Table 8). There was a significant decline in both nominal and real long-term and

²⁰ Except for transactions between the public sector and the private sector, e.g., bond issues abroad. Transactions of this kind are recorded as investment in Israel by nonresidents and do not increase the supply of foreign currency in the market.

Table 8
Indicators of Price Developments, 1992–2004

	(percent, in annual terms)									
	1992–95	1996	1997	1998	1999	2000	2001	2002	2003	2004
Year-end										
CPI	10.8	10.6	7.0	8.6	1.3	0.0	1.4	6.5	-1.9	1.2
CPI excl. housing	9.2	9.8	6.8	8.6	2.0	0.6	0.4	6.1	-0.5	2.3
CPI excl. housing, fruit & vegetables, clothing & footwear	9.5	10.5	7.8	8.5	2.2	0.9	0.4	6.8	-0.5	2.3
Wholesale price index	9.0	7.0	5.9	8.2	3.5	2.0	-1.9	6.9	3.3	7.6
NIS/ currency-basket ^a										
exchange rate	8.5	3.0	3.7	20.6	-2.5	-6.3	3.7	14.2	-0.5	1.8
NIS/dollar exchange rate	8.0	5.0	7.9	18.2	0.4	-2.7	4.8	9.8	-6.4	-1.2
Average										
CPI	11.3	11.3	9.0	5.4	5.2	1.1	1.1	5.7	0.7	-0.4
CPI excl. housing	9.7	9.8	8.4	5.3	6.0	2.0	0.4	4.1	2.4	0.2
CPI excl. housing, fruit & vegetables, clothing & footwear	9.9	10.5	8.9	6.0	6.4	2.2	0.4	4.6	2.6	0.7
Wholesale price index	9.2	8.6	6.3	4.2	7.1	3.6	-0.1	3.9	4.3	5.4
NIS/currency-basket										
exchange rate	8.7	3.5	4.3	9.6	8.3	-4.7	1.4	14.2	1.2	2.2
NIS/dollar exchange rate	7.3	5.9	8.2	10.2	8.9	-1.5	3.1	12.7	-4.0	-1.5
Real exchange rate in export terms ^b	-3.0	-5.7	-2.8	0.5	1.0	-3.1	-1.1	6.6	-2.4	1.8
Real exchange rate in import terms ^c	-2.3	-8.8	-6.6	-2.4	0.3	-0.8	-1.8	7.5	0.5	4.3
Terms of trade ^d	-0.8	3.3	4.1	3.0	0.6	-2.4	0.7	-0.9	-2.9	-2.4
Volume increase in world trade	6.5	7.1	10.5	4.4	5.9	12.5	0.2	3.3	5.1	8.8

^a Average of last month of period vis-à-vis average of last month of preceding period.

^b Ratio of export prices excluding diamonds to index of business-sector product prices including residential services.

^c Ratio of import prices excluding diamonds to index of business-sector product prices including residential services.

^d Import-export price ratio, excluding diamonds.

SOURCE: Based on Central Bureau of Statistics data.

short-term interest rates, to levels that have not been seen in Israel since 1995 (Table 9), and with a significant reduction of the interest-rate gap between Israel and abroad, alongside maintenance of the stability of the financial markets.

The policy of monetary expansion while maintaining the stability of the financial markets was made possible in 2004 by the significant support received from fiscal policy. Government expenditure was cut in 2003, alongside the reduction of the deficit in 2004 to a level that was significantly below that of 2003 (averages of 3.9 percent of GDP compared with 5.6 percent respectively), and even lower than the target set for 2004.²¹ The mix of fiscal restraint and monetary expansion increased public

The cut in the interest rate was supported by the reduction of the deficit and the decline in the risk premium for emerging economies, which remained low throughout 2004.

²¹ The fiscal restraint was also expressed in the reduction of the cyclically adjusted deficit.

Table 9
Monetary Indicators, 1990–2004

	(percent, in annual terms)										
	1990–1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
M1 ^a	24.0	3.9	15.9	13.3	12.0	9.5	11.0	14.2	15.6	0.5	18.0
Total bank credit ^a	31.7	47.2	24.5	18.9	16.1	16.7	13.1	10.8	10.5	1.7	1.1
Nominal Bank of Israel interest rate	14.0	15.8	16.5	14.8	12.6	13.0	9.8	7.1	7.3	7.9	4.4
Expected inflation ^b	13.9	10.1	11.2	9.2	6.2	5.3	2.6	1.9	3.3	2.2	1.7
Nominal interest on SRO deposits (CDs)	11.5	13.3	13.8	12.2	10.3	10.7	8.0	5.6	5.8	6.2	3.2
Nominal interest on non-directed credit in NIS	21.3	20.2	20.6	18.7	16.2	16.4	12.9	10.0	9.9	10.6	7.4
Average currency-basket interest rate ^c	6.3	5.3	4.6	4.9	4.9	4.5	5.5	3.6	2.1	1.5	1.8
Real yield on 5-year bonds	2.4	4.3	4.6	4.1	5.1	5.6	6.0	4.9	4.8	4.9	3.8
Real Bank of Israel interest rate ^d	1.1	5.2	4.7	5.1	6.1	7.3	7.0	5.1	3.5	5.1	2.4
Real weighted interest ^e		9.3	8.3	8.1	8.3	9.2	9.2	7.2	5.8	6.8	5.4
General Share-Price Index ^f	33.1	14.8	-1.6	36.1	2.9	65.7	0.5	-6.9	-20.2	55.6	16.5

^a Rise in annual average. M1 = cash in the hands of the public plus demand deposits. From 1996, this includes mortgage banks.

^b 12-month inflation expectations estimated from the capital market, assuming full tax exemption.

^c Based on 3-month Libid rate.

^d Until 1997, daily average of effective marginal interest on monetary loan at quota; from 1998, average of effective interest at daily auction of banks' deposits in Bank of Israel less expected inflation for 12 months, as derived from capital market.

^e This interest weights the indexed, unindexed and foreign-currency interest, and adjusts for expected inflation.

^f Index of all shares and convertible securities, rate of change during the year.

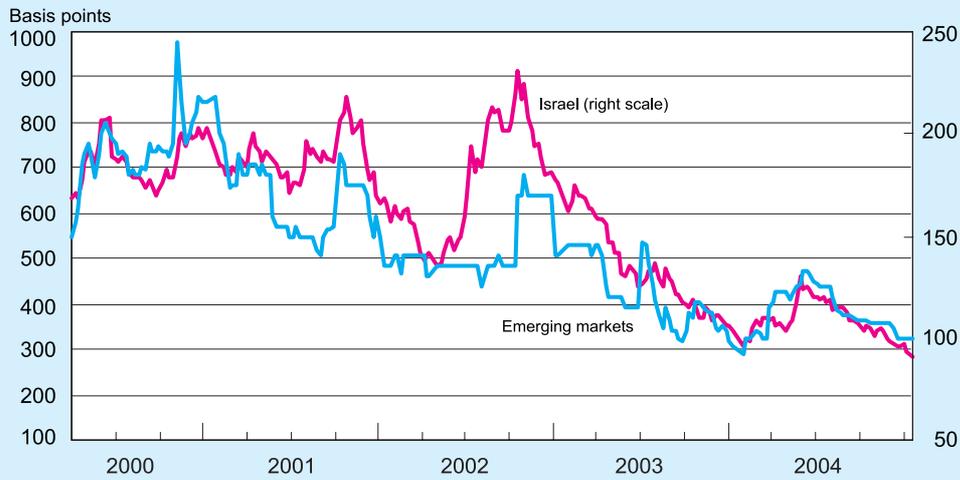
SOURCE: Based on Central Bureau of Statistics data.

confidence in the central bank's ability to attain the inflation target.²² Additional background factors which facilitated the continued implementation of the policy of lowering interest rates were the improvement in the security situation in 2004, with a decline in the number of security incidents, and the expansion of the global economy, which caused Israel's economic growth to accelerate from the end of 2003. In addition, the risk premium of the emerging economies declined significantly during 2003, and remained low in 2004, and Israel benefited from this development. At the end of the year under review Israel's risk premium (the difference between the yield on 10-year government bonds in Israel and the US)²³ was similar to its level at the end of 2003 and significantly lower than at the end of 2002 (Figure 6). The decline in the risk premium in 2003, which was also influenced by the guarantees received from the US government, and the low level of the premium in 2004 also facilitated the reduction of the Bank of Israel's key interest rate.

²² The importance of the coordination between monetary and fiscal policy has been discussed in the economics literature in recent years, e.g., M. Buti, 2003, *Monetary Policy in the EMU, Interactions and Coordination*. This literature seeks to assess the effect of coordinated policy on the economy, the central thesis being that fiscal discipline can affect the credibility of monetary policymakers.

²³ The yield on Israel government bonds does not include bonds issued under US government guarantees.

Figure 6
Israel's Risk Premium (relative to the US): Israel Government 10-Year Bonds and the Index of Emerging Markets, 2000–04

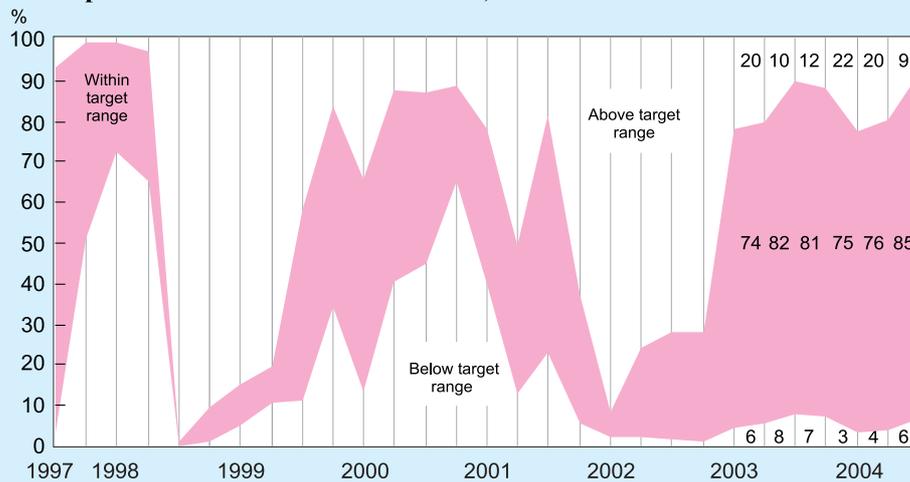


SOURCE: Index of emerging markets calculated by J.P. Morgan (excluding Argentina), and Israel's risk premium by Salomon Smith Barney.

The rise in public confidence in the determination and ability of monetary policymakers to attain the target of price stability was expressed during the year by several indicators, foremost among them the relative stability of the foreign-currency and bond markets. Further evidence of confidence in the policy arises from the Bank of Israel's survey of companies and firms; over 75 percent of the 600 firms surveyed

Increased public confidence in monetary policy was expressed in relative stability in the foreign currency and bond markets.

Figure 7
Probability of being within the Inflation Target Range, According to Expected Inflation in next 12 Months, 1997:IV to 2004^a



^aPercent of participants in the survey.

SOURCE: Bank of Israel Companies Survey.

answered the question “What are your expectations of the change in the CPI in the next 12 months?” by assessing inflation in the coming year as being within the target range (Figure 7). This high rate has been in evidence since 2003:II and has persisted for six quarters in succession (until the end of 2004)—the longest period since the end of 1997, when this question was first included in the survey. Concurrent evidence of public confidence in monetary policy was obtained from inflation expectations, which were found to be within the inflation target, with slight fluctuations, for most of the months of the year.

The market’s assessment that future inflation will remain at a level that is consistent with the target range cannot be taken for granted because of the deviations from the inflation target in the past and the sharp fluctuations in inflation that still prevail in Israel. In 2002, it will be recalled, prices rose by 6.5 percent, while in 2003 they fell by 1.9 percent. This volatility, alongside a deviation from the price-stability target, could undermine public confidence in the Bank of Israel’s ability to attain the inflation target. During the 1990s and until the end of 2002, the public’s inflation expectations for the year ahead were affected to a great extent by past developments, as is indicated by the high correlation between expectations for the coming year and actual inflation in the previous year. The development of expectations in the second half of 2003 and in 2004, which remained stable despite the wide fluctuations in actual inflation, represents a turning-point that stems from the rehabilitation of the credibility of policy.

Inflation expectations remained stable in the second half of 2003 and in 2004.

The monetary policy implemented in 2004 can be divided into three periods: from the beginning of the year until the end of April, when the interest rate continued to be reduced; from April to November, when the key interest rate remained unchanged; and in the last month of the year, when the Bank of Israel again lowered the interest rate on its sources.

In the first four months of 2004 the Bank of Israel reduced its key interest rate by a cumulative 1.1 percentage points.

At the end of 2003, after the Bank of Israel’s key interest rate had been reduced from 9.1 percent in December 2002 to 5.2 percent in December 2003, various indicators showed that the price environment was very moderate, and that it was possible to continue the process of lowering interest. The Bank of Israel therefore reduced the interest rate in the first four months of the year by a total of 1.1 percentage points. During this period the price environment rose gradually, and this was expressed *inter alia* in a rise in inflation expectations derived from the capital market, to 2 percent, and in inflation forecasts by private forecasters. The slope of the Treasury bill yield curve became positive,²⁴ reflecting public assessments that the Bank of Israel would

²⁴ The situation in which the central bank’s key interest rate is lower than 12-month Treasury-bill yields (a curve with a positive slope) is common abroad and is expected in accordance with economic theory. A positive yield curve slope can reflect the public’s demand for a risk premium for holding onto an asset for 12 months rather than for a shorter period, as well as expectations of the public that the central bank will raise its key interest rate during the year. Nevertheless, a positive slope to the Treasury-bill yield curve has not been prevalent in Israel in the last ten years, and has occurred only twice, at times when there was instability in the financial markets. The last such episode occurred at the beginning of 2002, after the Bank of Israel reduced the interest rate on its sources by two percentage points in one fell swoop.

raise the interest rate during the year. Because of the development of these indicators, and in the context of expectations in financial markets in the US that the Fed would soon start raising its interest rate, and the repercussions this might have on inflation in Israel, the Bank of Israel stopped the process of reducing its key interest rate at the end of April.

At the end of April the Bank of Israel stopped reducing its key interest rate.

After reducing the interest rate each month for 13 months, amounting to a 5 percentage-point reduction, the Bank of Israel decided that the interest rate for May would remain 4.1 percent, and this remained unchanged for eight months. The first part of this period—from May to November—was characterized by assessments and analyses that the inflation environment was rising, and so the central bank was unable to continue reducing the interest rate, and might even have to raise it later in the year. This occurred *inter alia* against the backdrop of the local-currency depreciation at that time, high CPI indices in April and May, and a continuous rise in medium- and long-term inflation expectations. Later in the period some of the external conditions changed: amongst other things, from September there was consistent local-currency appreciation against the dollar (influenced mainly by the weakening of the dollar against the euro, in view of the large US trade deficit), medium- and short-term yields in the money market declined, low and negative CPI indices were published in and after June, and medium- and long-term inflation expectations dipped to a level close to the upper limit of the price-stability target.

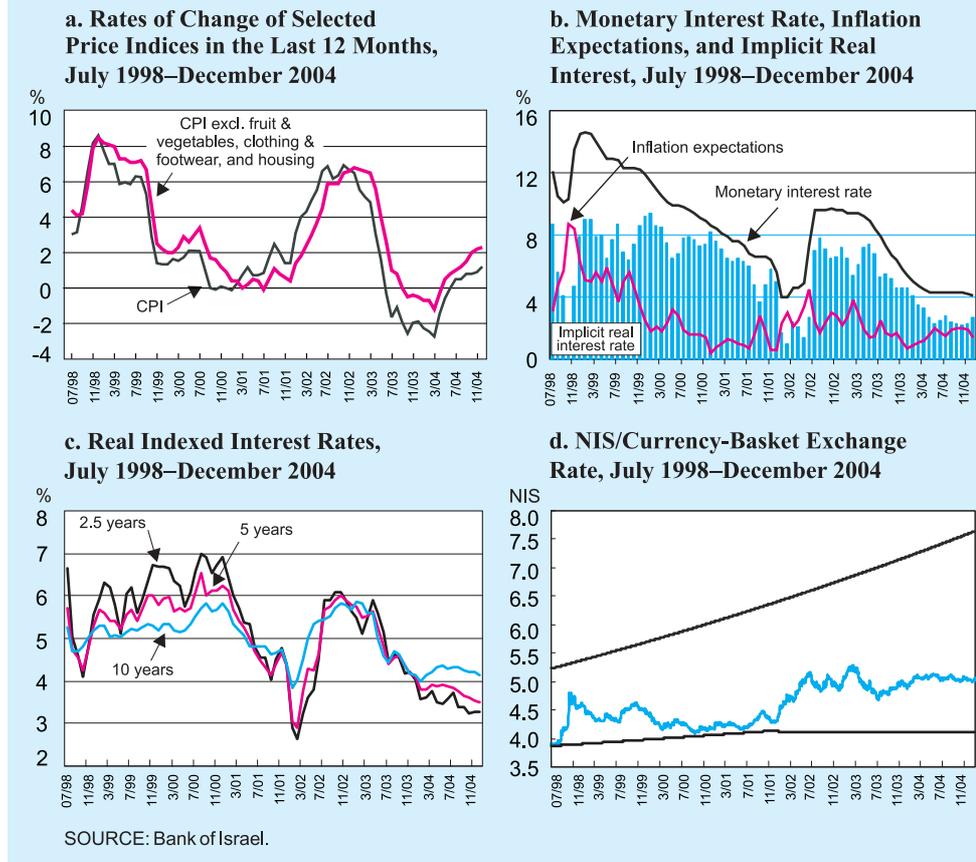
The above indicators led to new assessments, according to which the inflation environment was low, and it was in this context that the Bank of Israel reduced the interest rate on its sources to 3.9 percent in December. When it became clear that the foreign-currency and bond markets had remained stable even after this interest-rate reduction, the January 2005 interest rate was lowered to 3.7 percent and the February rate to 3.5 percent. These reductions were implemented despite market assessments prevailing at that time (derived from the Treasury-bill curve), and those obtained from the Bank of Israel's models, that in the future it would be necessary to raise the interest rate again because of the economic expansion and contraction of the output gap. This would be required because according to the Bank of Israel's assessments it would be possible to attain the price-stability target at an interest rate that was lower than 4.1 percent—the rate prevailing prior to the reduction in December. Moreover, the assessment of the inflation environment on the basis of models is biased upward to some extent because it is based on the 1990s, when for most of the time the inflation environment was higher than it is today.²⁵ Be that as it may, it will be possible to assess the monetary policy implemented at the end of the year only during 2005.

In December the Bank of Israel reduced the key interest rate, bringing it to 3.9 percent.

It was also necessary to use caution in reducing the interest rate in view of its low nominal and real level relative to that of the last few years. The implicit real interest

²⁵ The inflation rate predicted by the models for 2004 was higher than the actual inflation in that year, even taking into account the actual development of the factors affecting inflation, such as exchange-rate shifts and economic activity.

Figure 8



The level of real interest in 2004 was the lowest in the last ten years.

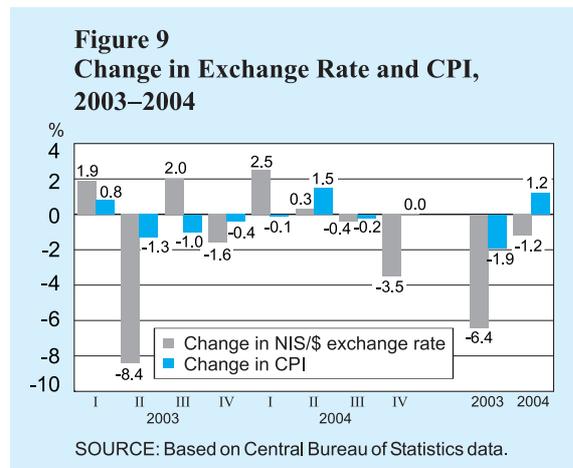
rate on the Bank of Israel’s sources fell from 4.6 percent in December 2003 to 2.6 percent in December 2004 (Figure 8b), and the annual averages dropped from 5.1 percent in 2003 to 2.4 percent in 2004,²⁶ and even to less than 2 percent in January and February 2005. This is the lowest interest rate in the last ten years, and is supported by the reduction of medium- and short-term interest rates to their lowest level in a decade (Table 9). The interest-rate spread vis-à-vis the US also contracted markedly during the year, to its lowest level ever, and therefore it was necessary to exercise caution in reducing the interest rate (see discussion below). The Bank of Israel’s assessment was, therefore, that reducing the interest rate more rapidly than was actually the case in 2004 could have imperiled the stability of the financial markets.

Against the backdrop of the monetary policy implemented in 2004 the CPI rose by 1.2 percent. An ex post analysis of the factors that affected the development of prices

²⁶ The real ex post interest rate, adjusted for the actual (not expected) inflation rate, also declined significantly in 2004. The weighted ex post interest rate by all credit categories fell from an average of 11.9 percent in 2003 to 6.2 percent in 2004 (till October). Nonetheless, its level was higher than that of expected interest because actual inflation was lower than expected inflation in 2004.

this year, using the Research Department’s econometric models, indicates that the rise in prices during the year as a whole stemmed from two main factors: first, despite the acceleration in economic activity in 2004, its level is still low, and there is a gap between actual and potential GDP; the output gap exerted downward pressure on prices, although this lessened slightly during the year, as the gap narrowed. Alongside the output gap, mention should also be made of the development of wages and labor costs. The real wage rose in 2004, after declining significantly in the recession years, but did not cause prices to increase because of the steeper rise in labor productivity (output per unit of labor), so that unit labor costs declined in 2004. Another factor contributing to the low rise in prices was the NIS/dollar exchange rate. This variable has had a marked influence on prices for many years (Figure 9), especially because

The CPI rose by 1.2 percent.



of the large share of the housing item, which is still in the main part linked to the dollar in the CPI. Consequently, the NIS/dollar exchange rate is the main rate affecting prices, more so than that of the NIS against the currency basket (which is not the case in other open economies). In the first half of 2004 there was local-currency depreciation of 3 percent against the dollar, leading to price rises (in April and May), but in the second half of the year the trend reversed,

and there was local-currency appreciation of 4 percent against the dollar, contributing to the decline of the CPI.

Evidence of the effect of the NIS/dollar exchange rate on price developments, arising from Israel’s indexation mechanisms, may be found in the CPI excluding the housing item.²⁷ The 2.3 percent increase in this index during the year outstripped the rise in the CPI. While the above factors moderated the rate at which prices rose in 2004, the rise in input prices worldwide served to increase them; this was particularly the case with oil, which soared from about \$ 30 a barrel to a record high of over \$ 50 in 2004:III. Nevertheless, the assessments derived from the Research Department’s price model is that this factor contributed about half a percentage point to the rise in prices in 2004, less than during previous energy crises (see Box 3 in the Inflation Report for the second half of 2004).²⁸

²⁷ Even though the housing price index was also affected during the year by the continued slump in the construction industry, and it fell at a faster rate than the appreciation of the NIS against the dollar.

²⁸ Oil prices had a greater effect on the wholesale price index, which rose by 7.6 percent in 2004.

Box 1**Central Issues in Monetary Policy in 2004**

A retroactive analysis of price developments raises the question as to **whether monetary policy in 2004 was expansionary and if so, to what extent**. The economic models that the Bank of Israel uses show that the fact that the expected real interest rate in the economy—the Bank of Israel’s interest rate less inflation expectations—reached a level of 2 percent at the end of the year, supported an increase in prices and their reversion to within the range of the target. The interest rate in 2004 was not only lower than the interest rates prevailing in Israel during the past decade, but also lower than the interest rate that is perceived as a long-term rate¹—the interest rate matching a situation of full employment (a level that is not measured directly, but that is usually estimated on the basis of the potential GDP growth rate). In this sense, monetary policy in 2004 was expansionary. This is in contrast to 2003 when despite the Bank of Israel’s interest rate cuts, the real interest rate (an annual average of 5.1 percent) was higher than the equilibrium level of the long term, meaning that although policy at the time alleviated the monetary restraint, it was not expansionary. When referring to the price increase in 2004, the 1.9 percent price decrease in 2003 should be taken into account. The difference between the two years indicates that the economic forces acting in 2004, including monetary policy, speeded up the pace of change in prices. The attainment of the inflation target in 2004 after inflation had fallen below the target in 2003 also supports the assessment that monetary policy in 2004 was expansionary (although the development of prices was affected by numerous other factors apart from monetary policy).

Despite all of the above-mentioned, since the rate of price increase only slightly exceeded the lower limit of the target, the question can be asked as to **whether monetary policy was expansionary enough**. The Bank of Israel refrained from adopting a more expansionary policy for several reasons: (1) certain factors prevalent in the Israeli economy prevent policy managers from aiming precisely at a specific rate of inflation—at the middle of the range of the target of price stability, for example. Accordingly, a price stability target is set as a range and not as a point rate. The most important of these factors is the small size of the economy and its openness to capital movements, which are reflected in the high volatility of the price indices from month to month that results from exchange rate adjustments. (2) Since part of the index items are indexed to the dollar, the dollar

¹ That is usually called “the natural interest rate.”

exchange rate has a dominant impact on prices, and especially on housing prices, for whose dollar indexation there is currently no economic reason. (3) An examination of the consumer price indices exclusive of volatile and seasonal items shows that the inflation environment in 2004 was higher than that obtained from the (general) consumer price index, and higher than the middle of the target range: The CPI excluding housing, fruit and vegetables, and clothing and shoes rose by 2.3 percent. (4) The monetary policy objective of attaining the inflation target while maintaining stability in the financial markets sometimes requires a gradual response. This is due to the fear—inherent in the management of policy *ex ante*—that a rapid response will undermine the stability of the foreign currency market and the other financial markets, which would also endanger the attainment of price stability. It should be noted in this respect that while asymmetry sometimes arose in recent years between the Bank of Israel's response to upward changes in the price environment and its response to downward changes—as a result *inter alia* of the disinflation process—in 2004 this asymmetry decreased significantly.

Another question is **whether the rapid growth in the money supply could endanger price stability**. During 2004 the money supply (M1) expanded rapidly from month to month. The average rate of growth in the means of payment amounted to 18 percent (Table 9, Figure 10). Against the background of the rapid growth in the money supply, which reflected the liquidation (move to liquid assets) of the asset portfolio, the question arose as to whether this growth was endangering price stability. When answering this question, it is important to note first and foremost that the monetary policy regime that the Bank of Israel has managed for the last decade is not a regime of money supply determination, but a regime of interest rate specification aimed at attaining the inflation target. Accordingly, the monetary policy regime was changed in the first half of the 1990s, and every month the Bank of Israel began to announce the interest rate that it charges on its sources.² The significance of this announcement is that the Bank is prepared to supply any amount of liquidity that will be required at that interest rate (a totally flexible supply at the declared interest rate). In this situation, the money supply that the public hold and the monthly change in this supply are determined by the demand for money (and not

² At the beginning of the 1990s, the exchange rate served as a nominal anchor for monetary policy. From August 1994, the Bank of Israel began to announce the interest rate on its sources, and not on the amounts that it supplied within the framework of the monetary loan and at tenders, as it had until then. See also Y. Djivre and D. Tziddon, 2001, "Monetary Maze: Monetary Policy Tools and Management in Israel 1987–1998," in Ben Bassat (ed.), *From Government Involvement to a Market Economy: The Israeli Economy 1985–1998*.

by the supply). This leads to the question: **What is the function and importance of the money supply in a regime in which the interest rate is set by the central bank?**

This question has been discussed extensively among economists worldwide during recent years.³ For a decade now, all have agreed that the effective instrument for controlling inflation in the short term is the interest rate: the interest rate should be raised when inflation exceeds the target, and should be reduced when inflation is lower than the target—a strategy called ‘the Taylor rule.’ A (retroactive) analysis of the monetary policy that the Bank of Israel has adopted shows that this rule is characteristic of it as well (with certain changes that match a small and open economy).⁴ Under this approach, the function of the money supply is very limited, and is not very useful in forecasting inflation in the short term. In view of the fact that this approach has been widely adopted by central banks in developed countries, the weighting attributed to developments in the money supply has decreased greatly (in the USA and the EU for example). This is justified for several reasons: in the short term, the relationship between the size of the money supply and inflation is relatively minor and changes over time; there are direct indicators of inflationary pressures such as inflation expectations; the provision of a high weighting, apart from the interest rate, to the monetary aggregates as well can confuse the public, and make monetary policy less transparent; policy aimed directly at attaining the inflation target has proved successful in many countries, and has been adopted in other developed countries.

In recent years it has also been claimed that the management of monetary policy by the Taylor rule is suitable if the money supply is within a certain range (which until now has not been defined operatively), but when its size exceeds this range over time, price stability could be undermined.

Since with the monetary regime applied in Israel the money supply is determined by the demand for money as stated, the Research Department has examined the question of whether the rapid growth in the money supply in 2004 can be fully attributed to the decline in the nominal interest rate and the rise in economic activity, with a focus on long-term relationships.⁵ The answer is negative: The public’s demand for money is greater than that

³ For example: Christiano and Rostagno, 2001, “Money growth monitoring and the Taylor rule,” NBER Working paper series; Gali, 2001, “Monetary policy in the early years of the EMU.”

⁴ See Melnick, 2005, “A peek into the Governor’s chamber: The Israeli case,” *Israel Economic Review* Vol. 3 No. 1 (forthcoming).

⁵ The examination was conducted on the basis of the approach proposed by N. Klein, 2003, “The demand for money in Israel in the years 1994 to 2001: A line-integration approach under the error correction model,” working paper 08.03, Bank of Israel Research Department.

forecast by the model,⁶ that is, greater than the demand derived from the fall in the interest rate and the rise in GDP. A possible explanation for this is that changes occurred in the economic environment that were not registered in the model, leading to a growth in the money supply that the public wish to hold. These changes were the large decrease in the price of holding money (the interest rate), the decline in the inflation environment, and the public's growing confidence that the low price environment would be maintained. Supporting this explanation is the moderate expansion of only 5.5 percent in the broader monetary aggregate (M2), which includes interest-bearing deposits, implying that the public chose to hold liquid assets at the expense of less liquid assets, even though the latter bear interest. The decline in inflation expectations for the long term (two years and more) to within the limits of price stability in 2004 provides further support for the assessment that the public are not afraid that price stability will be disturbed in the medium term.

Everything stated above indicates that the answer to the question of whether the growth in the money supply could endanger price stability, is that for as long as the growth is not sustained over a long period it does not present any danger. But a continued growth could endanger price stability. Such a growth will be reflected by a rise in inflation expectations and will compel the Bank of Israel to raise the interest rate, especially when the GDP gap in the economy is contracting, and pressures for a price increase will arise from this direction.

Another issue that concerned the Bank of Israel when managing policy during the year is **whether the contraction of the interest rate between Israel and abroad makes it difficult to attain the target of price stability, and whether it could endanger financial stability.** In 2004 the differential between short-term interest rates in Israel and the rates prevailing in the developed countries and the emerging markets contracted significantly (as can be seen from the table below). In the case of several countries, the interest rate differential actually became negative; the interest rate in Israel reached a level lower than in those countries, even when the inflation rate in each country is deducted. Since a large part of the capital movements to and from the Israeli economy are in dollars, the most notable development was the contraction of the interest rate differential with the USA, which reached historical low levels. The differential between the interest rates of the central banks amounted to 1.65 percent in December, fell to one percent

⁶ In another estimate, presented in Box 2 of the Inflation Report for the second half of 2004, it was found that the difference between the actual money supply and the amount forecast on the basis of a demand for money equation arose from the third quarter of 2000. It was also found in this estimate that the whole difference derives from the public's demand for cash (while the demand for deposits matches the actual development), and that it increased until 2002, after which its growth ceased.

in February 2005 (a level lower than that even at the end of 2001, after the Bank of Israel cut the monetary interest rate by 2 percentage points), and the differentials between short-term interest rates contracted even more. The main reason for the contraction in the interest rate differential during the last two years was the reduction in the Bank of Israel's interest rate. In 2004, the contraction resulted from the American central bank's interest rate hikes. A contraction in the interest rate differential in a small and open economy such as Israel increases the tendency to export capital (for the short term). The question therefore arose in the course of the year as to whether the contraction was endangering financial stability, and whether there is a minimum differential that should not be reduced. These questions became more pressing as a result of the implementation of the government's decision to lower the taxation on foreign assets with effect from January 2005, which reduced the tax discrimination against these assets and therefore increased the feasibility of investment abroad.

The differentials between the nominal interest rates on assets in two currencies should reflect the expectations of exchange rate adjustments in both currencies, the risk inherent in volatility in the currencies' exchange rates and the risk premium of the country in question.⁷ (The latter two components should develop in opposing directions.) Since changes have occurred in some of these factors during recent years, reference to the interest rate differential between Israel and the rest of the world should be examined over time, due to developments in the economic environment in

Interest-Rate Differentials between Israel and Advanced Economies and Emerging Markets

	Central bank interest rates				Short-term interest rates in money market			
	Nominal differential		Differential adjusted for inflation		Nominal differential		Differential adjusted for inflation	
	2003	2004	2003	2004	2003	2004	2003	2004
Advanced economies, average	3.4	1.5	7.0	2.4	2.6	1.2	6.1	1.7
of which US	4.6	1.7	8.5	4.2	3.8	1.2	7.7	3.4
ECB	3.6	1.9	8.0	3.2	–	–	–	–
Emerging markets, average	-2.3	-3.2	4.7	0.5	-2.8	-3.7	3.9	-0.2

The advanced economies included in the calculation are: Australia, Canada, Denmark, the ECB, Japan, Sweden, Switzerland, the UK, and the US.

The emerging markets included are: Brazil, Chile, the Czech Republic, Hungary, Mexico, Poland, South Africa, South Korea, Taiwan, Thailand, and Turkey.

The differential adjusted for inflation is calculated using inflation during the year in each country.

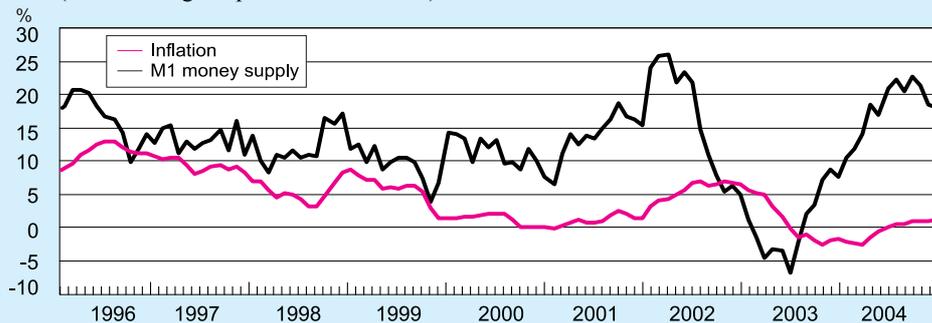
SOURCE: Central bank interest rates—Reuters; market interest rates and data on inflation—*The Economist*.

⁷ Under certain assumptions, the real interest rates in the different economies are expected to be equal, except for the risk differentials between the economies.

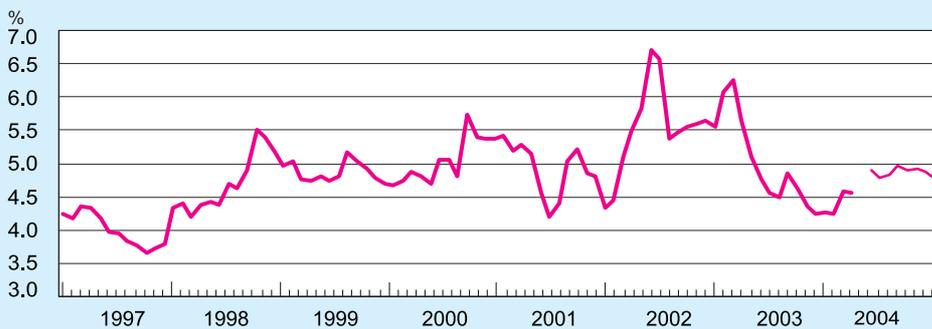
Israel. During the 1990s inflation in the Israeli economy was higher than in the developed economies, the economy was subject to uncertainty over inflation, and the Bank of Israel managed a monetary policy of disinflation that was reflected by high nominal and real interest rates. From 1999 inflation in Israel fell and was lower than in the developed countries (except for 2002), and indicators of a decline in inflationary uncertainty accumulated. The low inflation enabled the Bank of Israel to relax its monetary restraint and to reduce the interest rates on its sources. Concurrent with these developments, fiscal policy improved and Israel's risk premium fell (at the same time as the premium fell in all the emerging markets as mentioned previously). Against the background of these changes in the economic environment, the contraction of the interest rate differential between Israel and the developed countries and the emerging markets appears to have derived from the basic economic forces in the economy, and therefore did not reflect and did not create instability in capital movements. To conclude, the minimum differential that should be permitted between interest rates in Israel and worldwide is not fixed, and is dependent on the macroeconomic environment.

Figure 10

a. The M1 Money Supply and Prices, 1996–2004
(rate of change in previous 12 months)



b. Future 5-9-Year Yields, 1997–2004
(derived from yields on CPI-indexed bonds)



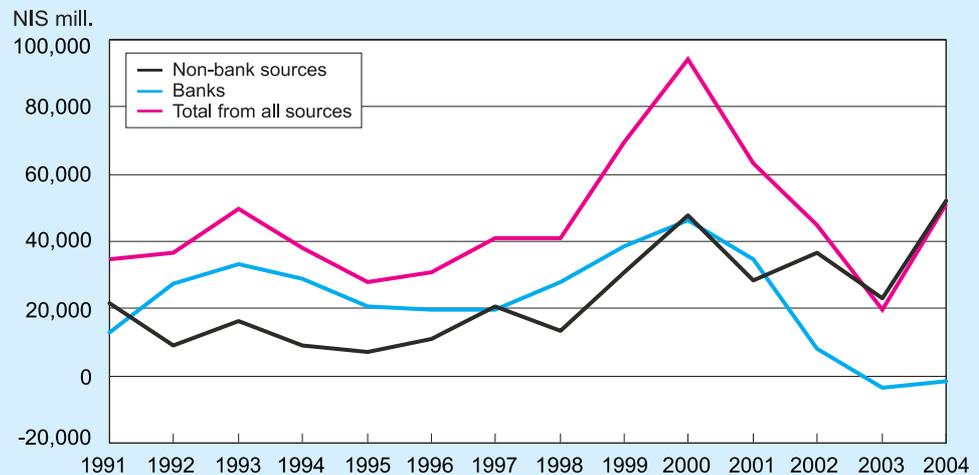
SOURCE: Based on Central Bureau of Statistics data.

b. The capital and money markets in 2004

The Israeli capital market enjoyed an exceptional boom period in 2004.

The Israeli capital market enjoyed an exceptional boom period in 2004 due to the resumption of growth in the economy. Business sector capital raising increased, mainly in the form of issues to the public, the share indices rose considerably concurrent with a large growth in turnover, and the public's financial asset portfolio expanded by 6.4 percent in real terms. The year 2004 was the last year before the implementation of the taxation changes that abolished the tax preference between investments in Israel and abroad. Under the taxation changes, the rates of tax on capital gains and dividend income from abroad were reduced and equalized to those imposed on investments in Israel—15 percent and 25 percent respectively. Sixteen new exchange traded funds

Figure 11
Total Capital Raised by Private Sector from all Sources: Banks in Israel,^a Banks Abroad,^b Stock Markets in Israel and Abroad, and Venture Capital Funds, 1991–2004 (end-2002 prices)



^a Credit from banks in Israel: change in outstanding credit, excluding mortgage credit.

^b Credit from banks abroad: \$ change in outstanding credit in NIS terms.

SOURCE: Bank of Israel and Association of Venture Capital Funds in Israel.

(ETFs or tracker funds) were issued on the Tel Aviv Stock Exchange in 2004. The international indices ETFs benefited from the taxation advantage in 2004 that resulted from the reduction in the tax on them to 15 percent compared with the tax of 35 percent on direct investments abroad. The equalization of the tax rates from January 2005 is expected to lead to increased investment abroad, although Israelis will to some extent prefer to continue investing in Israel ('the home bias').

The recommendations of the inter-ministerial team on the reform of the capital market (the Bachar Committee) were published in September. The main elements of the recommendations call for a separation of the provident funds from the banks and for further restrictions to be placed on the activity of the banks and other entities in the capital market, with the aim of increasing competition. The government announced that it will take action to implement the recommendations by means of legislation,

and appointed a committee to examine their implementation. This committee, which is also headed by the Finance Ministry's Director-General Yossi Bachar, submitted its recommendations at the beginning of January 2005.

(1) Sources of finance for private sector activity

The growth in the economy and the buoyant trading in the Israel stock market were reflected by a large increase in private sector capital raising. The total amount of capital raised in 2004 was almost three times more than in 2003, when the amount raised reached its lowest ebb for a decade following three years of continued decline (Figure 11).

The total amount of capital raised in 2004 was almost three times more than in 2003.

The growth in capital raising encompassed most channels, with the non-banking channels particularly prominent. Issues via the stock markets in Israel and abroad increased considerably and for the first time since the record year of 2000, the private sector raised capital in European markets. (Although the amounts raised were small, this was a significant development in view of the opening up of new financing opportunities that were not exploited in the past.) Capital raising via venture capital funds and other non-banking intermediaries also increased substantially. Recorded against this background was a notable decrease in bank credit, which although it expanded in the first quarter subsequently contracted appreciably, by NIS 1.5 billion during the year as a whole. A similar development was recorded in the raising of capital by means of credit from abroad—an increase in the first half of the year and a decrease in the second half, with the result that credit from abroad grew by NIS 1 billion in 2004. These data present a clear picture of the redirection of sources from the banking channel to the non-banking channel. During the last three years, this was reflected by a large decrease in the proportion of bank credit in total finance after many years when it had accounted for the bulk of the sources in the economy. On the supply side, the decrease in the proportion of bank credit could reflect a cutback in credit by the banks due to the restrictions imposed on the extension of credit to large borrowers and to single borrowers. On the demand side, the decrease reflected a drop in demand for credit in the area of housing and the existence of better alternatives for raising capital as a result of the boom in the stock market and the reduction in the risk premium. The average cost of raising capital by means of bank credit was lower than in 2003 (Table 9), although it rose in the course of the year.

Capital raising via non-banking channels increased greatly.

The large growth in capital raising in 2003 was accompanied by a substantial reduction in the financing constraint on activity as reported by the companies participating in the Companies Survey.²⁹ However, the redirection of sources to non-banking channels raises a question regarding the financing difficulties that small businesses were likely to experience in less advanced industries, which have less access to non-banking channels of finance and that are heavily dependent on banking finance. As expected, Companies Survey data show that while small and medium-sized companies continue to report more serious financing difficulties than large

²⁹ This decrease in reports on the financing constraint on activity encompassed all principal industries except for the construction industry. Construction companies continued to report serious financing difficulties in line with the other difficulties that the industry is experiencing.

companies, they too have benefited from the alleviation of such difficulties. It can be assumed that as large or advanced (high-tech) companies' financing efforts have been redirected to non-banking channels, the mix of bank credit to smaller companies has changed as well. An examination of the sector-specific composition of the companies that raised capital in the stock market during the year shows that as distinct from the bubble period in 2000, the majority of capital was raised by companies from the traditional industries.

Capital raising in stock markets in Israel and abroad increased considerably in 2004.

Capital raising in stock markets in Israel and abroad increased considerably in 2004, continuing a trend that became apparent in the second half of 2003 and after declining in the previous years. The increase in the amount of capital raised via this channel resulted to a considerable extent from the large rise in the share indices in Israel and abroad, the improvement in activity and optimistic growth forecasts. These factors outweighed the uncertainty regarding the security and geopolitical situation, which declined in the course of the year. The growth in capital raising by means of tradable bonds also resulted from the reduction in government bond issues following the decrease in government borrowing for financing the budget deficit, and especially from the change in the investment regulations for institutional investors (provident funds and pension funds) that were intended to reduce the proportion of earmarked bonds in their asset portfolio.

The largest growth in issues was in the first quarter of the year, when the amount of capital raised was similar to that in the whole of 2003 (in Israel) and even double (in the USA). Although large-scale issues continued during the subsequent quarters, these were not on a scale of those in the first quarter. Most issues in the stock market were of tradable bonds, in a record year for these instruments after many years in which they fulfilled a secondary function only in capital raising (NIS 17 billion).³⁰ Another large part of the total was raised by means of share issues in the USA (NIS 13 billion) and issues of shares and convertible securities in Israel (NIS 6 billion). The relatively small amount of NIS 350 million was raised in European stock markets.

(2) The public's asset portfolio

The value of the public's asset portfolio increased by 9.4 percent in real terms during 2004.

The value of the public's asset portfolio increased by 9.4 percent in real terms during 2004, mainly due to the large rise in share prices in Israel and abroad. An examination of the composition of the asset portfolio shows that as expected, the proportion of Israeli shares grew to a considerable extent in 2004 as a result of the buoyant trading in the stock market. This growth followed a large increase in 2003, with the result that the proportion of shares in the asset portfolio at the end of 2004 reached 22.7 percent, similar to the record level of August 2000. An examination of the portfolio composition excluding shares reveals a decrease in the proportion of CPI-indexed assets, mainly of saving plans, in favor of an increase in the proportion of unindexed assets, principally Treasury bills and long-term deposits. These changes in the

³⁰ This amount does not include NIS 4.5 billion raised in ETFs and issues of structured bonds, because these amounts are not used for the direct finance of activity in the non-financial private sector.

composition of the public's asset portfolio reflect the portfolio's gradual adjustment to the changes in the taxation of financial assets and the removal of the restrictions on investments abroad. The proportion of financial assets that Israelis hold abroad rose slightly during the year, but was notable for a considerable decrease in the second half of the year, with the result that their proportion at the end of 2004 was lower than at the end of 2003. However, the proportion of these assets is still relatively high, and this has been the case since the removal of the restrictions on capital movements in 1999. The proportion of saving plans dropped appreciably during the last two years, concurrent with an increase in the proportion of investment in tradable bonds.

(3) *The stock market in Israel in 2004*

The Israeli share indices rose sharply in 2004 amidst an unprecedented growth in trading turnover. Concurrent with the large growth in turnover, a considerable decline in the concentration of trading in the stock market was observed, a development typical of a boom period. This was apparent from the decrease in the proportion of trading in the most heavily traded shares in overall trading, and from the increase in the proportion of trading in the shares of small and medium-sized companies.

The General Share Price Index rose by 18 percent in 2004, the Tel Aviv 100 Index by 19 percent, the index of other shares and convertibles by 31.6 percent and the Tel-Tech Index by 16 percent. A growth in activity was also recorded in the fixed-income market, and was apparent from a large increase in trading and allocations (their number and size) and by a 5.3 percent rise in the bond index. Part of the growth in activity in the fixed-income market resulted from the decrease in government bond issues in the local market and the redirection of institutional investors' money to the tradable market as the volume of earmarked bonds declined.

The boom in the equities market was also reflected by a large growth in corporate stock issues. Unlike in the 'bubble' period of 2000, most of the capital was raised by companies from the traditional industries, rather than by high-tech companies. The companies issuing in 2004 included 20 newly listed companies that raised capital in the market for the first time (compared with only 2 newly listed companies in each of the previous three years). Interested parties (principal shareholders) exploited the upturn in prices to realize part of their investments. As a result, the float amount (holdings by the general public that are not interested parties) increased and accounted for 51 percent of the market value of all shares at the end of the year.

Daily bond turnover rose by more than 30 percent compared with 2003. The increase resulted mainly from the particularly vibrant trading in *Shahar* unindexed government bonds. (For more details of this instrument, see the Monetary Department's Report in the Bank of Israel Report for 2003.) The amount of capital raised by means of non-government bonds doubled in 2004, with the increase largely consisting of issues and allocations of CPI-indexed corporate bonds. A smaller amount of capital was raised via the issue of structured bonds (mostly indexed to foreign currency) and of foreign currency certificates of deposit. These two instruments are a substitute for (*Gilboa*) dollar-indexed government bonds, of which only one series remained. Turnover in

The General Share Price Index rose by 18 percent in 2004 amidst an unprecedented growth in turnover.

Figure 12
The Share Price Index in the US and in Israel, 2004



SOURCE: Bank of Israel.

Figure 13
Share of Financial Assets Abroad in the Public's Total Asset Portfolio, 1990–2004



SOURCE: Bank of Israel.

Treasury bills was 30 percent higher than in 2003, with a 5.2 percent increase due to a rise in their price. The abolition of the Treasury bill ceilings for institutional investors facilitated another large increase in the balance of Treasury bills held by the public, and this totaled NIS 72 billion at the end of 2004 compared with NIS 55 billion at the end of 2003 and NIS 43 billion at the end of 2002.

(4) The structural change in the capital market and the Bachar Committee's conclusions regarding competition in the area of financial products

The recommendations of the committee formed to propose reforms in the areas of the provident funds, mutual funds and insurance (the Bachar Committee) were published

in 2004. The recommendations are aimed principally at increasing competition in the capital market as a means of coping with the potential for conflicts of interest inherent in the existing structure.³¹ The committee emphasized that its recommendations are an essential (but in themselves not totally adequate) prerequisite for a growth in competition and for solving a range of problems in the capital market, including the potential for conflicts of interest. It should be realized that the proposed reform is only part of the policy measures concerning the regulatory coverage of the capital market's activity that are currently on the agenda (the reform of the pension funds, the reduced issue of earmarked bonds, restrictions on the extension of credit in the banking system, the equalization of the tax rates on the holding of securities in Israel and abroad, and the market-makers reform). In addition, the committee decided to examine and compile, by June 2005, a series of recommendations on supplementary measures that are aimed at achieving a further increase in competition in the capital market.³²

The Bachar Committee's main recommendation is to gradually reduce the banks' holdings in the provident funds and the mutual funds, in a manner whereby within four years they will not be permitted to hold the means of control or be interested parties in the provident funds or the mutual funds. Neither will the banks be permitted to manage investment portfolios for institutional investors (insurance, including pension funds, provident funds or mutual funds), except for their nostro accounts. The committee also imposed restrictions on underwriting, with the result that the banks will be unable to act as lead (pricing) underwriters in the share issues by entities borrowing from them. In addition, the committee determined rules for regulatory coverage and supervision, and called for a restriction on concentration in the area of long-term saving and in the mutual funds. These recommendations derive from the committee's main conclusion that conflicts of interest and lack of competition are a result of the high degree of concentration in the capital market. This concentration is reflected by the small number of entities operating in the market and by the banks' very dominant role in all areas of financial activity. These factors, together with substantial information gaps and the lack of a well-developed credit rating system create highly effective barriers to entry, thereby maintaining the concentration in the industry while increasing the potential for structured conflicts of interest. Previous attempts to solve the problem, such as the segregation of activities imposed by the Bank of Israel and the Finance Ministry, were unsuccessful due to the great difficulty in enforcing it: as long as the banks have a strong economic interest in marketing their products, they will find ways to do so. The banks' dominance in the area of financial products not

³¹ The committee's recommendations are also discussed in part of the report issued by the Monetary Department.

³² The committee will examine and recommend regulations regarding the following subjects: money market funds, including the withdrawal by checks from shekel funds, the sale and re-purchase of securities ('repo'), the distribution of mutual funds by non-stock exchange members, facilitating the move between banks, deposit insurance, nostro investment and market-making by the banks and the operation of securitization programs by the banks. The implementation committee also referred to the need to take action regarding increased competition in the area of deposits and the area of short-term credit, and in facilitating the entry of new financial entities to the market.

The recommendations of the committee concerned with reforms in the areas of the provident funds, mutual funds and insurance (the Bachar Committee) were published in 2004. The recommendations are aimed principally at increasing competition in the capital market.

only impairs competition in this area, but also exacerbates the lack of competition in the area of credit. This is because their dominance provides the banks with marketing power in the area of non-bank credit as well, credit that is supposed to serve as a substitute for bank credit.

An analysis of the effects expected in the wake of the Bachar Committee's recommendations shows that their implementation is likely to lead to increased competition in the money and capital markets in Israel. In addition, their implementation will reduce the conflicts of interest that are currently embodied in the banks' activity—although such conflicts of interest will not disappear completely—and which are a problem mainly due to the banks' dominance in the money market. However, in the future it will be necessary to ensure that households as well as companies are able to benefit from the growth in competition. This will be done by devising supplementary measures to the reform, such as those that the Bachar Committee proposed concerning the facilitation of the move from bank to bank. As the Committee's recommendations state, it will also be necessary to increase the extent of supervision and enforcement over non-banking entities, whose proportion will rise following the separation of the provident funds and the mutual funds from the banks. This is in order to ensure that the conflicts of interest do not merely pass over to these entities.

7. OBJECTIVES AND POLICY FOR THE COMING YEARS

The main objective of macroeconomic policy is to support sustained growth.

It will be desirable to adhere to a policy mix in which fiscal discipline will be retained, while maintaining price stability and financial stability.

The main objective of macroeconomic policy is to support sustained growth, which will make possible a further increase in employment while coping with the problem of poverty. The resumption of growth will support a decrease in unemployment and a reduction in poverty.

The macroeconomic framework for supporting sustained economic growth requires a policy mix in which fiscal discipline will be retained, while maintaining price stability and financial stability. Fiscal discipline will support a low level of long-term interest rates, and will make it possible to keep the Bank of Israel's interest rate at a level consistent with a real interest rate that supports sustained growth. When determining the Bank of Israel's interest rate, it is important to take into account the interest rate differentials between Israel and abroad less the risk premium, in order to maintain financial stability. The retention of fiscal discipline increases the credibility of the macroeconomic policy mix, and makes it possible to formulate monetary policy that is based on symmetrical responses to upward and downward deviations from the inflation target.

a. Fiscal policy

The decline in the proportion of public spending to GDP contributed to a decrease in the ratio of the budget deficit to GDP in 2003. This supported a reduction in interest rates in the economy and the consistent downturn in the Bank of Israel's interest rate to a historically low level. These reductions positioned the real interest rate at a

level that supports sustained growth. The main challenge of macroeconomic policy today therefore is to ensure that a low real interest rate is maintained while preserving economic stability as a whole and price stability in particular.

It should be remembered in this respect that the globalization process makes it necessary to ensure that fiscal policy in Israel conforms to the objective of a reduction in the debt/GDP ratio over time. The government has set a budget deficit target of 3 percent of GDP for 2005, and from 2005 a new target has been set whereby government spending will increase by one percent and the total deficit ceiling in the budget will be 3 percent of GDP. These decisions create the right background for a continued reduction in the debt/GDP ratio, although this is on the condition that the government does not over exploit the moderate nature of the growth in its spending in order to reduce taxes instead of cutting the deficit and the debt. During the government's discussions on the budget, it was decided to add the expenses on the disengagement from the Gaza Strip. As a result, the deficit in 2005 is likely to be higher than the deficit ceiling that was actually set.

(1) Fiscal policy in the coming years

One of the most important issues with which fiscal policy will have to cope in the coming years is whether it is appropriate to carry on reducing tax rates in a continuation of the policy that was adopted in 2004. The tax reductions were intended to stimulate the demand side and the supply side of GDP, and thereby support further growth. In 2004, the policy of tax cuts was in line with the objective of adhering to the deficit target.

It should be realized that the success achieved in 2004 was attributed to the drastic cut in government spending that began in 2003 due to the sharp drop in tax revenue during a period of economic recession. The special circumstances prevailing in the economy necessitated a series of decisions to implement cuts in various areas of public spending, which led to a real decrease in accrued public expenditure (excluding interest) during the last two years. In view of the growth in poverty, it is obvious that that there is no place for a further drastic cut in areas of expenditure that are directly connected to the weak populations.

Since 2003 considerable progress has been made in restoring the credibility of fiscal policy by means of the economic recovery program. Against the background of the recurrent deviations from the deficit targets in the previous years, adherence to deficits that are consistent with a continual reduction of the debt, which rose again to the level of the mid-1990s due to the continued recession, is of special importance. Moreover, given the zigzags in taxation decisions in the past, only a reduction that conforms to a decrease in the debt will be regarded as a credible reduction that will not have to be canceled in the future. Although a cut in taxation is partly financed by a growth in GDP, in the first year of its implementation it increases the deficit.³³ The need to

³³ A tax reduction of 1 percent of GDP increases the deficit in the first year of its implementation by 0.7 percent of GDP. Source: Y. Lavi and M. Strawczynski, 2001, "The effect of policy variables and immigration on business sector product and its components (factor inputs and total factor productivity); Israel, 1960–95," *Bank of Israel Review* 73, 97.

It will be desirable to persist with a fiscal policy that leads to a decrease in the debt-GDP ratio over time.

The deficit target for 2005 is 3 percent (excluding disengagement expenditures).

From 2005 a new target has been set whereby government spending will increase by one percent.

The reduction in taxes in 2004 concurrent with adherence to the deficit target was attributed to the drastic cut in government spending that began in 2003.

adhere to the deficit target while avoiding further harm to public services reduces the latitude for a reduction in taxation. Such a reduction will only be appropriate if a further decrease in the public debt is assured at the same time.

The latitude for reducing taxation can be demonstrated by means of the calculation of the multi-year budget framework.

The latitude for reducing taxation can be demonstrated by calculating the multi-year budget framework on the basis of the present development of expenditures and the decisions taken to date, as presented in Section 6 of the chapter “The State Budget and the General Government.” The calculation, in accordance with a scenario based on the specific government decisions taken to date (not including the adoption of additional measures for the purpose of adhering to the restriction on a one-percent growth in real spending) shows that it will be possible to adhere to the spending and deficit targets that have been set until 2006. It should be emphasized that these decisions include components that, on the basis of past experience, will not be sustainable over time, such as the decision that wages in the public sector will be significantly and continually lower than in the business sector. Accordingly, additional decisions are necessary in order to adhere to the spending and deficit targets from 2007, and especially from 2009. The calculation shows that without a further reduction in taxes, the debt can be expected to fall from a level of 105 percent of GDP in 2004 to 90 percent of GDP in 2010. However, if taxes are cut by 1.5 percent of GDP, the debt/GDP ratio will reach 96 percent of GDP. We would emphasize that this is on the assumption that growth will be maintained at a pace of 4 percent a year. In the event of a recession, the debt/GDP ratio could stay above 100 percent of GDP—a level that is regarded as problematical, and considerably higher than that usual in the OECD countries.

Another scenario is based on the government’s adherence to the decision to reduce the annual rate of growth in expenditures to one percent a year in real terms until 2010. This implies an additional reduction of 2 percent of GDP compared to that set until now under the specific decisions that have already been made. The reduction in question is substantial and will lead to an almost total contraction of the gap in the ratio of spending to GDP between Israel and the developed countries. If the government adheres to the new spending target from 2005, without implementing tax cuts in excess of those already decided, the deficit is expected to become a surplus in 2009 and reduce the gross debt/GDP ratio to 85 percent in 2010.

In selecting the relevant scenario, the government must take into account all the components of fiscal policy – public spending and its composition, taxation and the deficit.

In selecting the relevant scenario, the government must take into account all the components of fiscal policy—public spending and its composition, taxation and the deficit. Developments in the past two years show that cutting taxes while adhering to the deficit target involves a decrease in public spending accompanied by difficulties in the supply of essential public services, in the area of health for example, and a drastic reduction in transfer payments. In 2003, the latter led to a growth in the number of families living below the poverty line. Moreover, the moderate real increase in spending in 2004 was based on expenditure underperformance relative to the budget, indicating that the government failed to implement its decisions as expressed in the budget that was approved by the Knesset. When selecting a fiscal policy scenario from among those described above, it is important to analyze the cost-benefit ratio while attributing an appropriate weight to all the policy components.

Within the framework of long-term planning, the government aspires to ensure that the public sector will be small and efficient. This principle requires advance planning with respect to those areas in which new employees will be absorbed, and the areas in which early retirement will be exploited in order to reduce the number of employees. A multi-year planning process could contribute to increased efficiency in the public sector, to the minimal detriment of the public services.

(2) Public spending and priorities

The government has determined that from 2005 public spending will increase every year by one percent in real terms. Since the population is expected to grow by 1.7 percent in the coming years, an increase in this growth rate implies a decrease in government spending per capita. However, the course of development expected in the different areas of spending—defense and civilian expenditure—is not uniform, and varies according to the requirements in the different areas. The negative experience of the past two years in specific areas, primarily the difficulties that arose with respect to health and transfer payments to the needy, demonstrates that public services should not be eroded over time in the absence of a parallel decrease in requirements. While it should be remembered that since the budget cuts of the last two years were made without prior preparation and constituted a rapid response to the recession in the economy, in most cases they were implemented in line with decisions relating to a transverse cut encompassing all areas of spending (principally in 2003—see Figure 4).

Looking ahead, it will only be possible to limit the rate of growth in expenditure without an erosion in certain areas if suitable preparations are made in the area of public spending, and the government determines in advance the means for increasing efficiency in the different types of spending and the order of priorities between the different areas. It should be realized that part of the changes in spending derive from a direct response to requirements in these areas, due to a growth in the population for example. The effect of demography on transfer payments and on social issues is expected to be relatively moderate during the coming years, while an increase is expected after 2010.³⁴ In the area of defense, the Iraqi threat is over, making it possible to reduce defense spending. While this spending has risen since 2000 to a greater extent than the increase in the population, economies of scale exist in such spending as is known. Moreover, the proportion of defense spending to GDP remained at the level of 2000, although from the requirements aspect it could be reduced. In the future, the resumption of growth and fiscal discipline will make it possible to reduce the proportion of interest payments to GDP. It should be emphasized that efficiency could be increased in various areas of public spending. On the other hand, the planned education reform and worsening poverty during the last two years, which in the short term was affected by the cut in transfer payments, make it necessary to increase the resources devoted to education and reducing poverty. An increase in resources for the purpose of reducing poverty should be part of the government's declared strategy, by

³⁴ See the study of K. Braude, 2003, "Effect of demography on public expenditure in Israel in the long term," *Economic Quarterly* 3, 748-770.

A cost benefit analysis of different scenarios regarding the composition of government spending must be prepared prior to the discussions on the State budget for 2006.

providing incentives for participating in the labor force while at the same time cutting back on the number of foreign workers. A return to the labor force will ensure an escape from poverty in the future.

In order to cope with these issues, a cost benefit analysis of different scenarios regarding the composition of government spending must be prepared prior to the discussions on the State budget for 2006, and these should detail the implications expected in the different areas of expenditure. The analysis must be deeper than that in the budget discussions during recent years, which in most cases led, as stated, to transverse cuts spread in equal percentages over all areas.

(3) The tax system in the coming years

Recent legislative changes are expected to lead to further substantial cuts in tax rates. The income tax reform is expected to reduce the income tax burden by another NIS 1.5 billion (net) in 2006, and the cut in corporation tax to 30 percent in 2007 is expected to reduce revenue by NIS 2 billion a year. Other changes will be a NIS 0.7 billion cut in stamp duty, and a gradual 1.5 percentage point reduction in the national insurance payments made by employers and the self-employed (NIS 2 billion). Since these cuts will be partly offset by an increase in the tax on diesel (NIS 1 billion), total tax revenue is expected to fall by NIS 5 billion. As this approximates to the forecast increase in taxes in excess of the growth rate, the tax burden in terms of GDP is expected to remain the same.

The taxes on single people in Israel are very low by international standards, while the taxes on low-income-earning fathers are similar to those in the developed countries.

A reform that should be considered in the future is a move to taxation on the basis of the family unit. Since family expenditures are a function of the size and composition of the family, in different countries it is usual to take into account the number of persons in the family when setting tax rates.³⁵ Due to the failure to take family size into account,³⁶ the taxes on single people in Israel are very low by international standards, while the taxes on low-income-earning fathers are similar to those in the developed countries. Since part of the working families with children are below the poverty line, this phenomenon can be reduced if the tax system in Israel takes family size into account.³⁷

(4) Budget transparency and medium-term budget planning

The previously mentioned rules that the government determined with respect to the deficit and spending have two advantages; (1) From 2005 the credibility of fiscal

³⁵ In accordance with the recommendation of the Ben-Shahar Committee, it was decided in Israel to make a separation between child allowances and the tax system. This separation created a break in the connection between the tax system and the family unit, and could also create an incentive for childbearing. According to a recently published study, the evidence regarding the childbearing incentive is mixed. (See the study of R. Frish, 2004, "Child allowances and their effect on childbearing in Israel," Discussion Paper 04.09, Bank of Israel, Research Department.)

³⁶ Except for the credit points for working mothers, which are relevant for a low number of taxpayers.

³⁷ This is within the framework of a negative tax system. See A. Brender and M. Strawczynski, 2005, "Features of the negative tax system desirable in Israel in view of the labor supply characteristics of those with low income-earning potential" (forthcoming).

policy will be examined according to adherence to the budgetary spending target, an area over which the government has considerable control; (2) The parameters set and the decisions made during recent years make it possible for the downturn in the debt/GDP ratio to resume.

However, the new method has a number of disadvantages: (1) Apart from a budget ceiling of 3 percent of GDP, a downturn in the budget deficit has not been prescribed for the purpose of ensuring the reduction in the debt/GDP ratio. Uncertainty over the government's future performance could reduce the effectiveness of part of its fiscal measures, such as the cut in taxation. This is because the public's lack of information on the government's intentions in cutting the debt in the future prevents them from knowing whether the measure in question will be maintained or not. We recommend that within the framework of the new rules, the government add a quantitative multi-year target for reducing the ratio of the public debt to GDP; (2) The method whereby a target for the increase in public spending is determined (as one percent a year in real terms) involves a lack of transparency. Due to the reference to an increase in spending between two successive budgets, regardless of performance, the Finance Ministry's decision to increase public spending is dependent on the assumption of an increase in prices. Forecasting errors are corrected by means of internal calculations, without detailed reporting to the public. It was also stipulated that the flow of credit is part of the expenditure ceiling, with the result that a growth in other spending is possible in 2005 in view of the decrease in credit expected in that year; (3) The expenditure ceiling could provide an incentive to grant benefits by means of a tax exemption—for example a move in the Law for the Encouragement of Capital Investment to the 'green track,' which is based on a tax exemption; (4) A reserve that will suffice to cope with errors in the growth forecast and the price forecast has yet to be determined. Although a reserve for dealing with unexpected factors has been prescribed, the size of the reserve is inadequate for coping with these factors. It would also be desirable to establish an orderly (quarterly or at least half-yearly) mechanism for monitoring the development of the budget aggregates in the course of the year.

In the future the government should relate to the general government budget and not only to the central government budget as it does today. Adopting such a perspective requires preparation, principally a change in the reports of the authorities and different entities that comprise the public sector.

b. Increasing infrastructure investment and competitiveness in the economy

Methods of mass transportation are used much less in Israel than in the industrialized countries. Progress has been made in recent years in part of the projects for mass transportation, such as the light railways in Jerusalem and the Tel Aviv area, and Israel Railways. However, not all of the projects are progressing at the desired pace, and this could prove to be an obstacle to the resumption of sustained growth. Accordingly, the appointment of a special entity for this matter is recommended—a ministerial infrastructure committee for example—which will take on responsibility for carrying out the projects and constantly monitoring their performance. When the budget is

The new rules with respect to the deficit and spending have advantages and disadvantages. The rules make it possible to reduce the debt-GDP ratio.

A downturn in the budget deficit has not been prescribed.

The expenditure ceiling could provide an incentive to grant benefits by means of a tax exemption.

A reserve that will suffice to cope with errors in the growth forecast and the price forecast has yet to be determined.

In the future the government should relate to the general government budget.

Methods of mass transit are used much less in Israel than in the industrialized countries.

prepared, it is recommended that a special government meeting be convened in which the executive entities—in the areas of roads, railways, water, electricity, gas and other areas of infrastructure—will be required to report on the progress achieved in the projects. It is also recommended that they submit quarterly progress reports.

In many areas in the economy, including electricity, cargo services at Ben Gurion Airport, bus services and oil refining, the level of competition is low. In these areas it is important that the price of the service reflect its cost, and it is important to prevent monopolistic profit that could be reflected in firms' balance-sheet items, principally salaries. This should be done by opening up to competition sections of the market where this is possible, or by means of supervision on the part of independent authorities. The ports are an area characterized by limited competition in which changes will occur in the future. An agreement was recently signed with the port employees whereby port services will be opened up to competition in the future. (See the chapter discussing the principal industries for more details on these subjects.)

c. Monetary policy and the reforms in the money and capital markets.

The guiding principle of monetary policy is to consolidate price stability by observing inflation expectations for the coming months. In 2004 and at the beginning of 2005, the Bank of Israel was able to implement a consistent and gradual reduction in the interest rate, which led to a decline in the real interest rate while maintaining financial stability. The recent success in bringing down the interest rate to usual worldwide levels (plus a risk premium) is notable in comparison with the previous attempt at the end of 2001 and the beginning of 2002, which was unsuccessful. It is particularly important to prevent a return to the mismatch between monetary policy and fiscal policy such as occurred in 2002, that harmed the credibility of economic policy and in the final account, compelled policy makers to operate a range of restrictive measures that deepened the recession in activity. A continued decline in the public debt will make it possible to avoid a procyclical policy, as occurred in the last crisis.

As price stability in the economy becomes consolidated, it is important for monetary policy to act symmetrically, meaning that the interest rate should be cut as inflation expectations deviate downwards and be raised in the event of an upward deviation. A continued decrease in the proportion of the public debt to GDP is a precondition for implementing this policy.

The two most important rules in implementing monetary policy are independence and transparency. The Bank of Israel Law should therefore be amended in the spirit of the recommendations of the Levine Committee, whereby a decision on the short-term interest rate will be taken by a monetary council headed by the Governor and whose members are specialists not affected by a conflict of interests, who will be appointed and approved by the government. The Law should stipulate that the main objective of monetary policy is price stability and subject to this, the Bank of Israel will support other objectives in accordance with the government's economic policy. This will be done while according the bank full independence in the selection and operation of monetary tools.

The level of competition in many areas in the economy is low.

The success in bringing down the interest rate to usual worldwide levels (plus a risk premium) was supported by the decrease in the ratio of the government debt to GDP.

As price stability in the economy becomes consolidated, it is important for monetary policy to act symmetrically.

The Bank of Israel Law should be amended in the spirit of the recommendations of the Levine Committee.

Despite the liberalization measures in the economy, government intervention in the financial markets is still considerable. The large growth in the public debt to a level of 105 percent of GDP (the average for recent years based on the same form of measurement as specified in the Maastricht Treaty) effectively increases the government's function as a main player in the financial markets. An area that the government began to leave in recent years is pensions, after it was decided to reduce the proportion of earmarked bonds in the new pension funds. Once the reform was implemented, the proportion of the pension funds' investment in earmarked bonds, which are not tradable, began to gradually decline concurrent with an increase in the proportion of tradable assets—government bonds and shares.

The proportion of the pension funds' investment in earmarked bonds declined gradually during recent years.

d. Reducing poverty and encouraging employment

The main justification for government involvement in social issues is the desire to lead to a change in the distribution of net income, in order to reflect society's preference in this area. Growing poverty must be dealt with, particularly when it is considered that it could cause continual harm to social mobility, which is a keystone of socio-economic stability. According to modern growth theory, a continued increase in the rate of poverty could sabotage the process of sustained growth.

Transfer payments have been cut during recent years, including the income guarantee payment, and the number of foreign workers has been reduced with the aim of encouraging workers with a low income-earning ability to enter the labor market. But in contrast to many developed countries where the move from 'welfare to work' was accompanied by the allocation of substantial resources and the formulation of a special program for encouraging employment, in Israel broad-ranging measures that provide direct and comprehensive support for entry to the labor market have yet to be adopted.

Extensive measures have yet to be adopted in Israel that support entry to the labor market directly and in a comprehensive manner.

It is recommended that in the coming years the government implement a series of policy measures in order to encourage a more large-scale entry into the labor market and to reduce poverty. The following are the main recommendations.³⁸

The implementation of a series of policy measures is recommended in order to encourage a more large-scale entry into the labor market.

(1) Setting a long-term objective for reducing poverty

It is proposed to adopt in a government resolution a quantitative long-term target for reducing poverty during the next ten years. Positioning the issue of poverty as one of the government's principal economic objectives makes it necessary to place the issue at the head of the order of priorities, and to allocate budgetary resources to it. The setting of objectives for reducing poverty is practiced in other countries as well. The European Union has determined clear objectives for its member states in the area of poverty, as have 117 countries that formulated their objectives with respect to poverty for the next millennium under the auspices of the UN and the IMF.

³⁸ See the study of D. Gottlieb and N. Kasir (Kaliner), "Poverty in Israel and the desired strategy for reducing it," available on the Bank of Israel website, www.boi.gov.il.

The development of an additional method for measuring poverty based on a consumption basket is recommended. But as long as this index is not developed, objectives should be determined on the basis of relative measurement. The objective that we propose is to reduce the extent of poverty by 4 percentage points by 2015. We propose that in the future, an index based on a consumption basket be added to the measurement of poverty.

It is proposed to adopt in a government resolution a quantitative long-term target for reducing poverty during the next ten years.

We also propose reducing the income gap by 4 percentage points in order to ensure that together with a reduction in poverty, the poverty gap will decline by 1.5 percentage points within ten years. Concurrent with the achievement of the said objective, it is important to improve the situation of the poorest people in society.

The government resolution should include a periodic reporting requirement on progress in achieving objectives.

Measuring poverty—relative target and basic requirements target

Two basic approaches are employed for measuring poverty: (1) the relative approach, which is usual in Israel, whereby a household is regarded as poor if its disposable monetary income is less than half the median income; (2) the basic requirements approach, whereby poverty is a situation of lack of essential living requirements. The extent of essentiality varies according to the standard of living of the society and its preferences. Under this approach, the target needs to include a reference to the value of a basket of essential commodities and services. The minimalist approach usually includes in the index the food, dwelling and clothing components. A broader approach, which adds the areas of health and transportation components, was recently adopted by an American committee of specialists for changing the official definition of poverty in the USA and Canada. We propose the broader approach, including in the basket the areas of health and basic education. Since the term poverty relates to the relative aspect and the ability to satisfy essential requirements, two objectives should be referred to—a relative target and a requirements target.

The development of an additional method for measuring poverty based on a consumption basket is recommended.

None of the existing indices of poverty refer to the length of time that a household is subject to poverty, because the statistical information that is currently gathered is inadequate for this purpose. But as regards the need to implement anti-poverty policy, it is very important to distinguish between temporary poverty and continued poverty. Policy should focus on preventing a transformation into permanent poverty. In order to establish an information infrastructure that will make it possible to cope with this problem, the compilation of monitoring surveys in the areas of household income and expenses at the Central Bureau of Statistics should be expedited. Such surveys will make it possible to monitor households' poverty over time.

A household's sources of income that are taken into account when comparing its standard of living relative to the poverty line do not currently include major non-monetary income items, such as housing subsidy, discount on city taxes and apartment rental subsidy. It is therefore important to expand the calculation of sources of income with respect to all the poverty indices, in order for them to include these non-monetary income items.

(2) Foreign workers

The large number of non-Israeli workers and the low cost of employing them has pushed many uneducated Israelis out of the labor force and increased the poverty among them. Although the government acted to reduce the number of foreign workers during the last two years, their number is still high and it is important to continue the policy of reducing their number. We propose that the number of foreign workers in the long term be set at a level similar to that in the OECD countries, at 4 percent of the Israeli labor force.

We propose that the number of foreign workers in the long term be set at a level similar to that in the OECD countries.

The experience of the past two years proves that if the government persists with its policy and continues to reduce the number of foreign workers, this will contribute to an increase in the employment of Israeli workers as has happened in the area of domestic help and according to evidence related to Israeli Arabs, in the area of construction as well. It is important for the government to persist with this policy and to take into account that the process of substitution of foreign workers by Israelis will be a lengthy one. Difficulties may arise in this process in the short term, such as a shortage of workers in certain areas since gradual and protracted wage adjustment is necessary. At the start of the process private employers, as far as possible, tend to employ foreigners, whose wages are low and who are willing to work longer hours than Israeli workers. But if the government closes this avenue to them, the excess demand that would arise would lead to a wage increase that would attract Israelis into working in the industries in question, even if they have not worked in them previously.

We propose increasing the cost of employing legal foreign workers by means of taxation and creating an incentive for shortening their stay in Israel, by transferring part of the foreign worker's wages to a deposit in his name, to which he will have access only when he leaves Israel. Towards the end of 2004 an agreement was signed for implementing a new arrangement, whereby the mechanism for employing foreign workers is based on corporations (manpower companies) that supply the workers to the employers. The new arrangement will have the effect of providing greater flexibility and competition in the area. However, the limited number of these companies could adversely affect competition and apart from that, the arrangement does not relieve the state of servitude of the workers (this time to the manpower companies). In December 2004 the Ministry of Industry and Trade authorized the mobility of foreign workers from manufacturing industry to the construction industry, in accordance with the quotas that were set for the two industries.

The decrease in the number of permits should be continued, and the enforcement of the restriction on the number of foreign workers should be improved, while ensuring that their human rights are respected. It is important to increase enforcement with respect to households that employ foreign workers without a permit, since this will help to make room for work places for uneducated Israelis.

In view of the low rate of compliance with the labor laws among those employing foreign workers, the enforcement of the Minimum Wage Law and the other labor laws should be increased. We recommend increasing the transparency of the enforcement efforts by means of a periodic report detailing such activities.

(3) Public spending on health and education

The necessary resources should be devoted for the reform in education (the Dovrat Reform) and for alleviating the crowding in hospitals.

During the last two years public spending has been cut in areas that have a direct impact on low-income-earning individuals. These cuts include health expenditure, education, and transfer payments. Resources have to be directed at spending items that directly affect the weak populations in order to reduce poverty in the long term. In particular, the supply of the resources necessary for coping with the reform in education (the Dovrat Reform) and alleviating crowding in hospitals should be planned in advance. It is especially important to extend the application of differential budgeting that takes into consideration schoolchildren's socioeconomic status as emphasized in the Dovrat Committee's recommendations. As with other areas of public expenditure, it is important for spending to become more efficient in this area as well, in order to achieve the desired output while minimizing expenses.

(4) Transfer payments

Individuals who are unable to participate in the labor market (especially the elderly and the disabled) are dependent for their livelihood on national insurance transfer payments. But for individuals who are capable of working, the provision of transfer payments is an incentive to remain outside the labor force. As long as effective tools are not developed for distinguishing between individuals who are unable to work and those who are capable of doing so and do not wish to, it is important to avoid setting transfer payments—principally the income guarantee payment—at a level that propels individuals into poverty. The considerable erosion of the last two years, part of it in the transfer payments base, should be emphasized in this respect.

We propose changing the principle that was recently adopted regarding the indexation of transfer payments, and to index them to the median wage.

Looking to the future, a decision has been taken whereby transfer payments will be indexed to the consumer price index instead of to the average wage as practiced in the past. Indexation to the CPI implies a substantial erosion in payments (see Box 1 in Chapter 4—'Welfare Policy'). We propose changing the principle that was recently adopted and indexing transfer payments to the median wage, which is used as a base for measuring poverty. Indexation of this type internalizes the previously mentioned considerations by preventing payments from eroding while taking due account of the problem of lack of incentives for entering the labor market.

(5) Negative income tax

We propose introducing a negative income tax.

We propose introducing a negative income tax that will take into account the number of children in families that do not reach the tax threshold. Negative tax for low-wage families is practiced successfully in a number of countries, including the USA, the UK and Ireland.

It is proposed to set a negative rate of tax that takes the level of income into account. The subsidy would be determined at the income levels between NIS 1,000 and NIS 3,500, and at a declining rate until this zeroes at an income level of NIS 5,000. In addition, the benefit should be directed at families with children and take account of income from work within the framework of the family unit.³⁹

³⁹ Based on the previously mentioned study of Brender and Strawczynski, 2005.

(6) Employment centers and the subsidization of day-care centers

The function of employment centers is to help remove the obstacles that delay entering the labor force among those receiving existence allowances and to assist the unemployed in finding work, while defining an individual plan for each job seeker according to his abilities and needs. This plan includes vocational training, child-care services, transportation solutions and placement services.

The main body that engages in placement and employment in Israel is the Employment Service, whose principal aim is to find work for the unemployed. It is important to reinforce the facilities of the Employment Service, which is the only such service in Israel that is located in all parts of the country.

Under the Wisconsin Plan, the government recently signed contracts with four private companies that will operate from July 2005. The plan will be activated in four centers (Ashkelon and Sderot; the Jerusalem area; Nazareth and Upper Nazareth; Hadera and other localities in the north). The plan is intended to create incentives and to ease the move into the labor market of individuals who are dependent on the income guarantee allowance. The operation of the employment centers is a first stage. Based on its results, the expansion of this service will be considered.

One of the most effective ways of facilitating entry into the labor market is to reduce the cost of day-care centers, a measure that could be particularly practical for populations with a low labor force participation rate.⁴⁰

It is important to reinforce the facilities of the Employment Service.

Subsidization of child day-care centers will increase the participation in the labor force.

(7) Abolition of the Law for the Encouragement of Capital Investment and its replacement with a law for the encouragement of employment in peripheral regions

We propose the abolition of the subsidization provisions of the Law for the Encouragement of Capital Investment, and using the resources freed in this manner to subsidize employment in peripheral regions. The criterion for the receipt of a subsidy should be the extent to which employment is increased in the preference areas of the periphery (for more details on the subject, see Box 1.1 in the second part of the Research Department report).

We propose the abolition of the subsidization provisions of the Law for the Encouragement of Capital Investment and subsidizing employment in peripheral regions.

(8) Implementation of a compulsory pension

Israel does not currently have a compulsory pension law. The Compulsory State Pension Law recently passed its first reading in the Knesset. The draft law stipulates that there will be a pension arrangement for every worker in the economy, up to a ceiling that the Minister of Industry and Trade and the Finance Minister will determine. But the draft law that was approved in the Knesset states that the pension will be financed entirely by the worker, and therefore does not increase the attractiveness of the labor market for workers with low income-earning ability. In order to ensure that the law has the desired effect in this direction, we propose changing it in accordance with the following principles:

We propose changing the Compulsory Pension Law in order for it to encourage entry to the labor market.

The compulsory pension will be limited by a wage ceiling. The ceiling should be determined in a manner whereby the future pension to be derived from it, together

⁴⁰ See the study of Analya Schlosser, 2005, which analyzes the effect of a day-care subsidization program in Arab localities (forthcoming).

with the National Insurance Institute's old age allowance, will assure a respectable livelihood. A ceiling of NIS 3,000 is proposed.⁴¹

We propose charging a reduced premium from those earning very low wages, with the government supplementing the difference to the insurance company. This is in order to provide a financial benefit to wage earners who are below the tax threshold. This benefit is parallel to the tax credit in respect of financial saving that is granted to higher income-earners. The benefit should only be granted following an effective income test.

In order to ensure the stability of pension income, the pension must be on a defined contribution base and actuarially balanced. It is also important for the pension to be supplied at market conditions.

e. Education

One of the most important areas for assuring social mobility is education. For many years now, it has been acknowledged that despite the major resources that are devoted to education in Israel, the level of performance is relatively low. The Dovrat Report proposes a reform in the area of education. The full implementation of the Dovrat Report is likely to lead to increased efficiency in the education system and to an improvement in the quality of children's education in Israel while reducing inequality in education. The principles of the reform should be adopted, and especially the following:⁴²

- Conferring schools with managerial independence;
- Improving teachers' relative wages;
- Differential budgeting based on the schoolchildren's socioeconomic background;
- Adoption of compulsory free education from the age of 3.

It can be assumed that implementation of the report as it stands will require the addition of considerable resources to the education system, although the reform is planned to be carried out within the framework of the existing budget (except for the budget for the move to the first stage of implementation). When the reform is implemented, its effects must be monitored in order to remedy potential deficiencies. For example, there is a fear that the reform will adversely affect the labor supply of certain parents due the abolition of classes on Friday, and a fear of harming the process of integration because of the incentive to create alternative frameworks for strong students. Teachers' move to a full-time post could deter good teachers who wish to work in a part-time position.

⁴¹ This amount ensures that after 15 years of accrual, the pension will reach NIS 1,000. As a result, together with the national insurance old age allowance, the insured party's income will reach an amount slightly above the poverty line. In the long term, when the accrual will be complete (70 percent), it will be possible to lower the wage ceiling (in fixed prices) without adversely affecting the standard of living of the elderly.

⁴² For a detailed analysis of the education system and the advantages and disadvantages of the proposed reform, see section two in Chapter 4, Welfare Policy, in the second part of the Research Department report.

The full implementation of the Dovrat Report is likely to lead to increased efficiency in the education system and to an improvement in the quality of education while reducing inequality in education.