

## Chapter 1

# The Economy and Economic Policy

- ◆ Growth in GDP was 5.2 percent this year and was led by the business sector which grew by 6.6 percent.
- ◆ The underlying economic conditions this year were favorable: continued growth worldwide, particularly in the high-tech industries, and the improved security situation.
- ◆ Economic policy provided support for sustainable growth and met its three targets: the rate of inflation was within the price stability target range and the deficit and growth in public expenditure were lower than their ceilings.
- ◆ The rate of unemployment fell to less than 9 percent by the end of the year while both employment and the participation rate grew.
- ◆ The surplus in the current account grew while the rate of growth in exports and imports decreased. Investment abroad by residents grew substantially.
- ◆ The booming capital market remained stable as it underwent structural changes initiated by the reforms implemented in recent years.
- ◆ The positive trends continued in the stability of the financial system.
- ◆ The ratio of public debt to GDP fell this year although its absolute level remained very high. It should be reduced considerably. The government should persevere in maintaining that the deficit and the increase in expenditure do not exceed their ceilings and should also endeavor to create a downward trend in the deficit.
- ◆ A number of steps are proposed in order to reduce poverty and encourage integration within the workforce among defined segments of the population. The number of families with a wage earner who are below the poverty line has increased in recent years and the institution of a “negative income tax” would reduce this population.
- ◆ In order to maintain financial stability, it is important to strengthen the financial infrastructure. The reforms instituted in recent years will indeed strengthen long-run stability but the regulation of institutional investors should be expanded.
- ◆ Appropriate infrastructure is essential to the growth and proper functioning of the economy. The efforts to develop the infrastructure should continue while the externalities of their use should be taken into consideration. Priority should be given to the development of public transportation and competition should be increased in the infrastructure sectors, including air travel, electricity and communications.

## 1. MAIN DEVELOPMENTS

The economic recovery continued and became more firmly established this year. The growth in GDP was led by the business sector.

The recovery of the economy, which began in 2003, continued and became more firmly established in 2005. The rapid growth in GDP, which totaled 5.2 percent, was led again this year by the business sector which grew by 6.6 percent. In contrast to the previous two years, the share of domestic uses in the growth of GDP was particularly noticeable this year, which was a reflection of the slowdown in the growth of exports, the consolidation of the recovery and the increase in public consumption. The high rate of growth in GDP was a result of the combination of the favorable economic environment and the economic strategy which included a macroeconomic policy mix that supported growth while maintaining price stability. This occurred against the background of excess capacity that enabled the quick adjustment of supply. The improvement in the macroeconomic environment and the situation of the economy were reflected in a number of developments, including a drop in unemployment, an increase in the current account surplus of the balance of payments and the positive developments in the capital market.

Underlying economic conditions were favorable: continuing world growth and an improvement in the security situation.

This year, as well as last, the economy benefited from favorable underlying conditions that supported the expansion of activity and the positive developments in the capital market. The continuation of solid growth worldwide, particularly in the high-tech sectors, led to a healthy increase in exports. This was led by high-tech exports which, despite a slowdown in their growth, constituted a major component of the economy's recovery. The continuing improvement in the security situation provided support for the expansion in activity, particularly in private consumption and tourism. This improvement, together with the growing interest of investors in emerging economies worldwide, has contributed to the boom in the domestic capital market and the reduction in the economy's risk premium. The combination of the reduction in the risk premium and the low level of global interest rates has provided support for the decline in real interest rates to particularly low levels accompanied by continued price stability. In contrast to the positive influences of most of the underlying economic conditions, there was a further and significant deterioration in the terms of trade due to the increase in the world price of oil which had a negative impact on the economy's income and was an important factor in the real depreciation recorded this year.

Economic policy met its three targets. The policy mix supported growth.

Macroeconomic policy met its three targets: the rate of inflation was within the target range of price stability and the deficit and rate of increase in public expenditure were lower than their ceilings. Policy was characterized this year by a mix that supported sustainable growth, by the exploitation of the favorable conditions that prevailed in the economy and by the positive reaction of the markets to that policy. The policy mix combined fiscal discipline, which was reflected in the restrained growth in expenditure and the significant reduction in the deficit, a reduction in taxes and an expansionary monetary policy that was reflected in a particularly low expected real rate of interest (which is derived from the Bank of Israel interest rate). Taking into account the present stage of the business cycle, fiscal policy was contractionary, as reflected in the

cyclically-adjusted deficit. Yet this provided support for the maintenance of a low rate of interest and improved fiscal credibility which is an important condition for long-term growth. Monetary policy exploited the low rates of interest worldwide and the reduction in the economy's risk premium in order to reduce the Bank of Israel interest rate to a particularly low rate while the spread against interest rates abroad reached a historic low. Only towards the end of the year did the Bank start to raise the rate of interest following the increase in world interest rates and the accelerated expansion of the economy. Fiscal policy exploited the substantial increase in tax revenues in order to reduce the deficit and to further reduce tax rates rather than to increase expenditure. In addition, the record revenues from privatization this year were dedicated in full to reducing the public debt. These steps, together with the growth in GDP itself, led to a significant reduction in the debt to GDP ratio this year although its absolute level remained very high in international terms.

The positive reaction of the capital markets to macroeconomic policy and the underlying conditions was reflected in the maintenance of stability in the markets, the decline in yields on government bonds and the reduction in the economy's risk premium, despite a number of political shocks and the reduction in interest rate spreads. The reduction in the budget deficit, which enabled a substantial reduction in the domestic financing needs of the government, also freed up sources of finance for the business sector and contributed to the structural changes taking place in the capital market as a result of the reforms implemented in recent years.

The improvement in the labor market reflected the consolidation of growth and its composition. During its initial stages, the recovery of the economy had little effect on the labor market but with the continuation of growth this year, there was a significant decline in the rate of unemployment to less than 9.0 percent at the end of the year and an increase in real wages in the business sector. This year, as opposed to previous

The capital markets reacted positively to economic policy and the favorable underlying conditions.

The improvement in the labor market reflected the consolidation of growth and its composition.

**Table 1a**  
**Israel: Basic Economic Data,<sup>a</sup> 1990–2005**

	1990–	1996–						
	1995	1999	2000	2001	2002	2003	2004	2005
Mean population ('000s)	5,156	5,902	6,289	6,439	6,570	6,690	6,806	6,926
Population growth rate (percent)	3.5	2.5	2.7	2.4	2.0	1.8	1.7	1.8
Israelis employed ('000s)	1,713	2,061	2,216	2,265	2,284	2,330	2,401	2,494
GDP (NIS billion, 2005 prices)	349	447	503	502	496	504	527	554
GDP growth rate (percent)	6.2	3.8	7.7	-0.3	-1.2	1.7	4.4	5.2
Per capita GDP (\$ '000s, current prices)	13.3	17.4	18.4	17.7	15.9	16.5	17.2	17.8
Unemployment rate (percent)	9.3	8.0	8.8	9.3	10.3	10.7	10.4	9.0
Inflation rate (during year, percent)	13.1	6.9	0.0	1.4	6.5	-1.9	1.2	2.4
Current-account (percent of GDP)	-2.8	-2.9	-1.1	-1.4	-1.2	0.7	1.6	1.9
Foreign-exchange reserves (\$ billion)	6.6	19.3	23.3	23.4	24.1	26.3	27.1	28.1
Net external debt (percent of GDP)	25.9	12.7	6.4	2.1	-0.6	-4.4	-8.8	-17.8

<sup>a</sup> Annual averages.

SOURCE: Based on Central Bureau of Statistics data.

**Table 1b**  
**Basic Economic Data: International Comparison, 1995–2005**

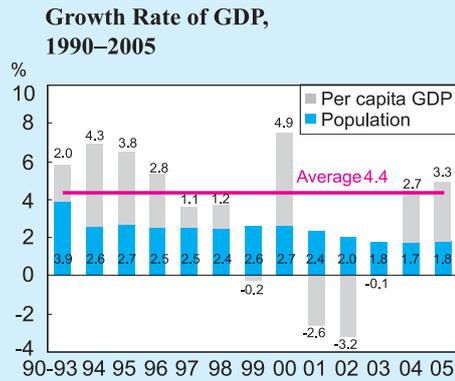
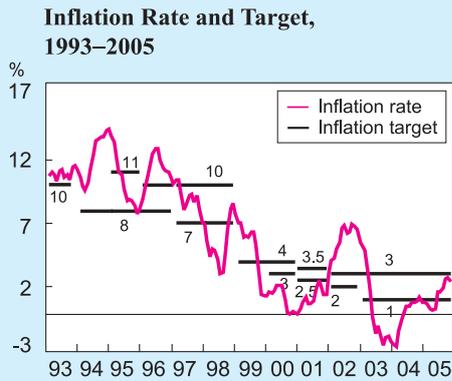
	(percent)															
	2004					2005					1995–2005 average					
	Israel	US	Euro area	OECD	Israel	US	Euro area	OECD	Israel	US	Euro area	OECD	Israel	US	Euro area	OECD
Population growth rate <sup>a</sup>	1.7	1.0	0.4	0.7	1.8	1.0	0.4	0.7	2.3	1.2	0.4	0.7	2.3	1.2	0.4	0.8
GDP growth rate <sup>b</sup>	4.4	4.2	1.8	3.3	5.2	3.6	1.4	2.7	3.6	3.3	2.1	2.7	3.6	3.3	2.1	2.7
Per capita GDP growth <sup>a</sup>	2.7	2.6	1.0	2.0	3.3	2.6	1.0	2.0	1.2	2.1	1.7	2.0	1.2	2.1	1.7	2.0
Per capita GDP (\$'000s, current prices) <sup>a</sup>	17.2	40.0	25.2	33.5	17.8	41.0	25.5	34.1	17.2	34.6	19.8	28.1	17.2	34.6	19.8	28.1
Unemployment rate <sup>b</sup>	10.4	5.5	8.8	6.7	9.0	5.0	8.6	6.4	8.8	5.1	9.2	6.6	8.8	5.1	9.2	6.6
Inflation rate (average) <sup>b</sup>	-0.4	2.7	1.7	2.3	1.3	3.4	1.7	2.5	4.6	2.5	1.7	3.5	4.6	2.5	1.7	3.5
Inflation rate (during year)	1.2	3.3	1.8	2.6	2.4	4.7	1.6	2.8	4.1	2.6	1.7	3.4	4.1	2.6	1.7	3.4
Current-account (percent of GDP) <sup>b</sup>	1.6	-5.7	0.5	-1.3	1.9	-6.5	-0.2	-1.8	-1.5	-3.6	0.4	-0.8	-1.5	-3.6	0.4	-0.8
Gross public debt (percent of GDP) <sup>b</sup>	105.7	64.0	78.1	76.3	101.9	63.8	79.3	76.9	103.0	65.3	78.0	73.9	103.0	65.3	78.0	73.9

<sup>a</sup> Population data for the US, Euro area and OECD countries for 2005 are based on the 2004 figures.

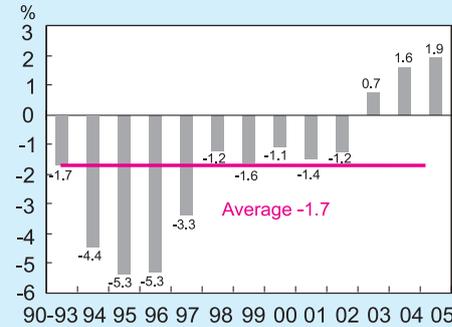
<sup>b</sup> Figures for the US, Euro area and OECD countries for 2005 are estimates.

Source: OECD Economic Outlook, 2005; World Economic Outlook, 2005, and Bank of Israel annual reports.

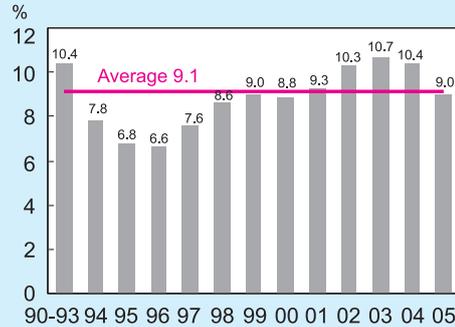
**Figure 1.1**  
**Key Economic Indicators, 1990–2005**



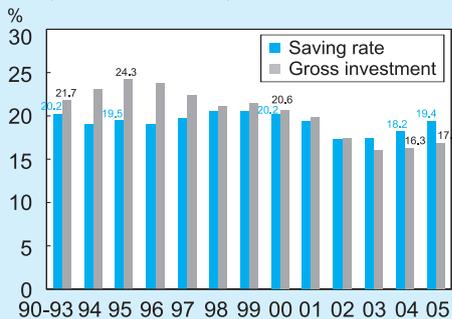
**Balance of Payments Current-Account, 1990–2005**  
(% of GDP)



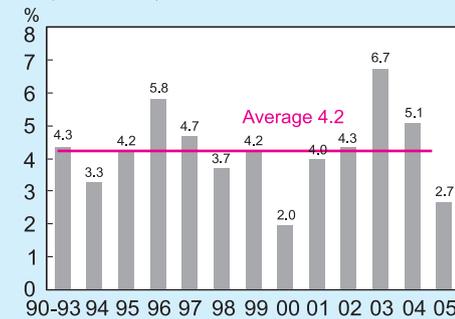
**Unemployment Rate, 1990–2005**  
(annual average)



**Gross National Saving Rate and Investment, 1990–2005**  
(% of total income)



**Public-Sector Overall Deficit, 1990–2005**  
(% of GDP)



SOURCE: Based on Central Bureau of Statistics data.

ones, the number of employed in the public sector also grew. The composition of growth, which was biased towards domestic demand and services, was reflected in the accelerated growth of employment in the service industries which are intensive in unskilled labor though wages increased primarily in the industries which are intensive

in skilled labor. Although unemployment among less educated workers fell this year, it still remained at a high level.

The number of foreign workers was not reduced this year despite the declared policy of the government.

The number of foreign workers did not decline this year despite the declared policy of the government. The number of illegal workers who were expelled from the country fell significantly and there are indications of a weakening of efforts in enforcement. The presence of foreign workers harms the opportunities of uneducated Israelis, both workers and jobseekers. This is especially true in view of the high unemployment rates among less educated workers. Furthermore, the presence of foreign workers is not consistent with the sharp cutbacks in welfare benefits in recent years and the Mehalev program which was initiated this year. These measures were meant to encourage the shift of individuals with little education from “welfare to employment”.

The extent of poverty has increased in recent years.

The extent of poverty in Israel has grown in recent years measured both relatively and absolutely. According to the relative index used in Israel, the rate of poverty is also high in international terms. Both economic processes and government policy are contributing to this situation. The former includes a shift away from less educated workers which is part of the structural change taking place in the economy. This trend, which was particularly evident in the 90s, is due to, among other things, the growing competition faced by the traditional manufacturing industry from countries with low labor costs (both through competing imports and competition in export markets). The factors related to government policy include the significant growth in the number of foreign workers up until 2002 and the poor enforcement of labor laws among foreign workers. To this was added the wide-ranging cutbacks in transfer payments in recent years although some of these were meant to encourage certain groups to integrate within the workforce and thus have some chance of reducing poverty in the long term. The overall contribution of taxation and welfare benefits to reducing poverty diminished during each of the last three years. The renewal of growth in mid-2003 and the reduction in the number of foreign workers until this year did in fact improve the situation of less educated workers and halted the increase in income inequality before taxes and transfer payments although poverty and inequality in relation to net income have continued to grow. Growth increases the income of the economy but this in itself is not a sufficient condition for reducing poverty. Government intervention is needed in a number of areas in order to deal with both those who are able to work and those who are not.<sup>1</sup>

The surplus in the current account grew. Investment abroad by residents and investment in Israel by nonresidents increased.

The surplus in the current account and the net export of capital grew this year. Imports grew very slowly relative to GDP. However, the deficit in the balance of goods and services did not improve this year due to the slowdown in the real growth of exports and a deterioration in the terms of trade. Thus, the improvement in the current account was solely due to the increase in net income from capital. A significant increase was recorded both in investment by residents abroad and investment in Israel by nonresidents. Also contributing to the increase in the export of capital were the

<sup>1</sup> For further discussion of poverty and its measurement, see Chapter 8. In addition, see the recommendations for reducing poverty in the section on policy targets in this chapter.

changes in the investment rules for institutional investors, the equalization of tax rates on investment in Israel and abroad and the reduction in the domestic financing needs of the government. The growth in nonresident investment in Israel was focused on shares and the purchase of companies that were privatized and was a reflection of, among other things, the improvement in the environment of the economy.

Aside from the boom and stability that characterized the capital market this year, there were also important changes in its composition. These changes were a result of the continuing adjustment to the reforms implemented in recent years, such as the reform in the pension funds, the reduction in the issue of designated bonds and the liberalization of rules applying to institutional investors, the reforms that went into effect this year (foremost among them the recommendations of the Bachar Committee), and the reduction in the local financing needs of the government. The changes in the composition of the public's portfolio included the continuing reduction in the share of the banks and the increasing share of tradable assets, particularly local private bonds and foreign debt instruments. The changes in the composition of the financing of the business sector included the reduction in the share of bank credit together with an expansion in the use of non-banking financing channels, particularly private bonds.

The positive trends in the stability of the financial system continued this year following the significant improvement in the previous two years. The resilience of the financial markets and institutions increased this year, particularly among the banks. The reforms are expected to increase the resilience of the financial system in the long run, yet improvement is still needed in regulation and supervision due to the systemic risk, particularly in the form of credit risk, among institutional investors during the transition period.

The main goal of economic policy is to support sustainable growth. To this end, it must maintain fiscal discipline, price stability and financial stability, as well as confront poverty. In order to maintain fiscal credibility, the government must remain committed to expenditure and deficit targets while significantly reducing the ratio of the public debt to GDP. In order to maintain financial stability, measures need to be taken in the areas of regulation and availability of information to the public, the regulatory mechanism for institutional investors needs to be strengthened; and cooperation between regulatory authorities needs to be increased. The effort to reduce poverty requires a variety of measures as part of a long-term program which will include a negative income tax and additional steps to improve the integration of various segments of the population in the labor market. A more detailed discussion of the policy required in coming years appears at the end of the chapter.

## 2. GDP

The expansion in economic activity, which began in the second half of 2003, continued this year. GDP grew by 5.2 percent and per capita GDP by 3.3 percent. The business sector, which grew at a rapid rate of 6.6 percent, continued to lead the expansion

The booming capital market remained stable and underwent changes in its composition.

The positive trends in the stability of the financial system continued.

Economic policy should continue to maintain fiscal discipline, price stability and financial stability while reducing the scope of poverty.

Exports continued to lead the recovery although the role of domestic uses in the expansion of activity grew.

this year as it has since the end of the recession. Although exports, particularly from the high-tech industries, continued to lead the economic recovery, the share of domestic demand in the expansion grew substantially. Thus, the contribution of private consumption to the rate of growth was similar to that of exports which was an expression of the slowing in the rate of growth of exports on the one hand and the consolidation of the recovery on the other. Public consumption and investment also contributed to the growth in GDP following two years in which their influence was either negative or negligible.<sup>2</sup>

The main factors in the expansion of activity were on the demand side; the output gap enabled the quick response of supply.

Underlying factors that supported the expansion in activity this year were similar to those in the previous year: continuing world growth, particular in the high-tech industries, and the continuing improvement in the security situation. The macroeconomic policy mix also played a role. Although public expenditure was lower than planned, fiscal discipline and the reduction in the deficit enabled an expansionary monetary policy to be implemented. The reduction in taxes also contributed to the expansion in activity. This year, the factors driving growth were primarily on the demand side although it was the output gap that enabled a quick adjustment of supply to meet increased demand with only a moderate increase in prices and even a real depreciation. In contrast to the rest of the underlying factors, the increase in the price of oil had a negative effect on the economy.

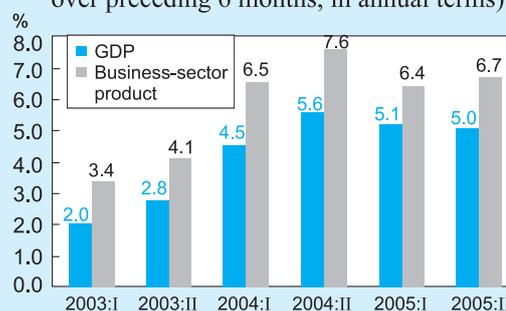
The rate of increase in exports slowed considerably during the second half of the year.

Exports grew this year at a rate similar to that of the expansion in world trade although their rate of growth slowed substantially during the second half of the year and the fall in their growth rate relative to 2004 was far greater than the slowdown in the expansion of world trade. The rate

**Figure 1.2**

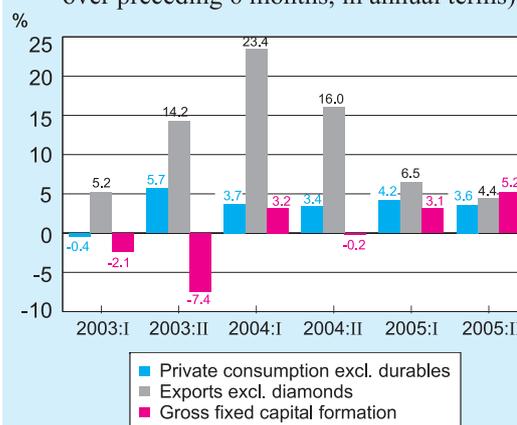
**a. GDP and Business-Sector Product, 2003–05**

(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)



**b. Exports, Private Consumption and Gross Fixed Capital Formation, 2003–05**

(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)



SOURCE: Based on Central Bureau of Statistics data.

<sup>2</sup> The contribution of the various uses to the growth in GDP is presented in Table 2.3 in Chapter 2.

of growth in the export of services was greater than that of goods and reflected both the growth in high-tech services (computers and R&D) and the continuing recovery in tourism.

A number of interrelated factors were behind the increase in private consumption this year: a) The increase in disposable income. b) The increase in the value of the public's portfolio of assets as a result of the boom in the capital market. c) The improvement in consumers' expectations of the future (according to consumer surveys) which are influenced by the improvement in underlying conditions, particularly the security situation (Figure 1.3). d) The reduction in the government deficit which supported the increase in consumption as a result of the increased public confidence in the government's commitment to reducing taxes.

A number of factors were behind the growth in private consumption.

The rate of growth in private consumption this year was lower than that of GDP and that of consumption last year, despite the increase in the economy's rate of expansion. A number of factors can explain this: the sharp increase in the price of electricity and gasoline which acted to reduce the quantitative growth in overall consumption; the slower increase in private disposable income relative to 2004; and the slowdown in the purchase of durable goods which is consistent with the increase in relative prices (that resulted from the increase in import prices) and with the sharp increase in the purchase of durables in 2004 (which is an indication that individuals had already adjusted their inventory of durable goods the previous year).

The growth in private consumption was relatively slow.

Fixed capital formation increased this year by only a small amount following an uninterrupted decline during the previous four years. Despite the accelerated expansion in the economy and favorable underlying conditions, there was no real recovery in investment of this type and its share in GDP is lower than it has been in the past. However, the investment in intangible assets (primarily software) increased substantially and figures show that the scope of investment in machinery and equipment was in accordance with the underlying factors (for further discussion see Box 2.1 in Chapter 2). The investment in startup companies (which is recorded as an increase in inventory) grew significantly which reflected the continuing recovery in the high-tech industries. The investment in residential construction continued to decline although at a slower rate than in the previous two years. This decline stemmed from weak demand, which was difficult to explain in light of the continued economic recovery.

Fixed capital formation grew by a small amount.

The basis for the recovery during the last two years has been the substantial improvement in the underlying conditions of the economy. However, the question is whether the particularly rapid rate of growth this year and its increase relative to last year reflected temporary or permanent factors (beyond the improvement in underlying conditions). The following analysis of both the supply side and the demand side brings up a number of points in this context.

Is the rapid rate of growth sustainable?

The contribution of the supply side to the rapid growth in GDP this year was based primarily on the current stage of the business cycle which is fundamentally a temporary factor. Thus, excess capacity enabled a rapid adjustment in supply to meet the increase in demand without creating significant pressure on the supply side. The increase in productivity this year relative to 2004 was primarily the result of the increase in

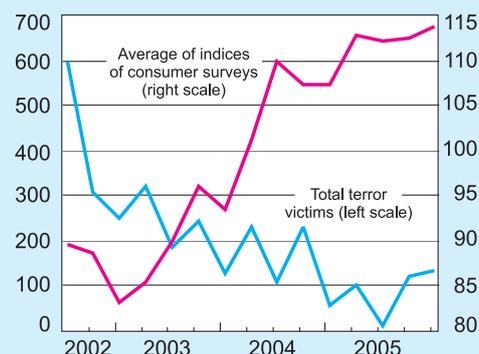
The supply side contributed to the rapid increase in GDP, primarily as a result of a temporary factor.

utilization which is characteristic of a recovery. The weakness of the supply constraints until now was also reflected in the substantial increase in profitability and in the slack in the labor market, which was reflected in a decrease in the unit labor cost and only a moderate increase in wages despite the increase in labor input. However, there are signs that the possibilities of increased utilization are being exhausted which could be seen in the beginnings of supply constraints and pressure in the labor market. Thus, the decline in the unit labor cost was more moderate than in the previous two years and the Bank of Israel's Survey of Companies showed a continuing increase in the rate of utilization in manufacturing. Several developments during the course of the year confirm this trend: the stabilization in labor productivity, the significant slowdown in export growth and the acceleration in the growth of wages and product prices. Unemployment among educated workers dropped to a low level and wages in the industries which are intensive in educated workers increased relatively fast. Supply pressure began to appear, primarily in the manufacturing export industries, although the rapid increase this year in the export of services which are intensive in highly educated labor was an indicator that the pressure was not yet significant. In contrast, there are no signs of supply pressure in industries which are intensive in less educated labor. The labor input in these industries increased substantially but wages remained almost unchanged. The rate of unemployment among the less educated also remained very high (among the population with up to 12 years of education it was 12.5 percent).

A number of factors on the demand side contributed to the rapid rate of growth.

On the demand side, a number of factors contributed to the particularly rapid rate of expansion of activity this year: The contribution of demand to the growth in GDP was

**Figure 1.3**  
Average of Indices of Consumer Surveys, and Total Terror Victims, June 2002–December 2005



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

**Figure 1.4**  
Commerce and Services Industry as a Percentage of Business-Sector Product,<sup>a</sup> 1980–2005



<sup>a</sup> Break in series in 1996 due to change in definitions.

SOURCE: Central Bureau of Statistics.

higher than normal since the import component in demand was relatively small. The reasons for this were the relatively high price of imports and the increase in the share of the service industries in GDP. The importance of domestic demand this year was also reflected in the increased sales of the manufacturing industries to the local market in comparison to the substantial slowdown in the expansion of manufacturing exports. An analysis of the components of growth shows that the acceleration in growth relative to 2004 was almost solely due to the increase in public consumption. The demand side also benefited from a low rate of interest which, as already mentioned, began to climb towards the end of the year.

Growth this year was biased towards the service industries and this was reflected in all the product uses: the rate of increase in the export of services, both computer and R&D services and tourism, was more rapid than that of manufacturing exports; within the expansion of private consumption, that of non-durables, which is service-intensive, was particularly noticeable; and domestic public consumption is also service-intensive. The bias towards services was also reflected in the composition of investment. Thus, investment in machinery and equipment and in buildings was low in comparison to the sharp increase in the investment in intangible assets (software) and particularly in startup companies (R&D services). The increase in the share of services (Figure 1.4) reflects in part long-run processes that characterize developed economies and in part transitory factors, such as the composition of private consumption and the recovery in tourism.

National saving increased this year and the decline in private saving only partially offset the increase in public saving. The rapid rate of growth supported the increase in the rate of private saving while the increase in public saving, the increase in the value of the public's portfolio of assets and the improvement in consumer expectations worked to reduce private saving.

The expansion in activity was biased towards the service industries.

National saving increased this year.

### 3. FISCAL POLICY

The government deficit totaled 1.9 percent of GDP this year which was significantly lower than the target of 3.4 percent. It was also lower than the deficit in 2004 of 3.8 percent (Table 6.9 in Chapter 6). This was the result of the fact that government expenditure this year was significantly lower than the amounts allocated in the 2005 budget while tax revenues met the budget forecasts. The ratio of gross public debt to GDP also fell significantly this year by 3.8 percentage points which represented a continuation of the smaller reduction in 2004 (Table 6.1). Contributing to the fall in the ratio were the reduction in the deficit, the manner of its financing (in part using privatization revenues) and the high rate of growth.

The government maintained fiscal discipline this year. A deficit target has been in place for several years but this year was the first time that the government operated with the framework of two targets: a deficit ceiling and a ceiling on the growth in expenditure. In practice, the deficit and the rate of increase in expenditure were lower

The government deficit totaled 1.9 percent of GDP which was significantly lower than its ceiling.

The government maintained fiscal discipline.

than the specified ceilings.<sup>3</sup> The deficit target was achieved for the second consecutive year. Fiscal discipline provided support for an expansionary monetary policy and also contributed to the stability in the financial markets—despite a number of political shocks—to the decrease in the economy’s risk premium and to the decline in long-term yields. The fall in the rate of private saving this year may also reflect, among other things, the increase in credibility associated with the reduction in the deficit and in tax rates.

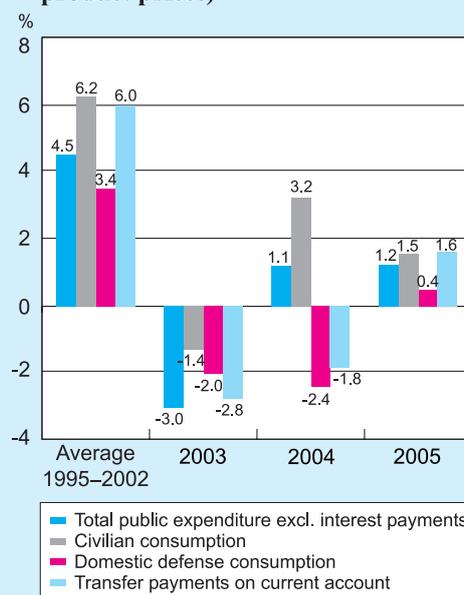
The underspending of the budget contributed to the reduction in the deficit. Revenues from privatization were used to reduce the public debt.

Beyond the commitment demonstrated by the government, part of its success in rapidly reducing the deficit and the debt relative to GDP was the result of the particularly favorable conditions that prevailed this year as well as other factors. These included the restraint in expenditure which contributed to the reduction in the deficit and part of which reflected underspending by the government ministries.<sup>4</sup> The manner of deficit financing also contributed to the reduction in the gross debt. Thus, the revenues from privatization which were used to reduce the debt, were unusually large; the redemption of the public’s debt to the government was much larger than the new loans granted (primarily as mortgages); and, in addition, the government this year exchanged a large amount of foreign currency deposits in order to finance its deficit rather than issue bonds. In addition, it is important to remember that growth lowers the deficit and the debt relative to GDP.

The reduction in the deficit freed up sources of financing for the business sector.

The substantial decline in the government deficit was manifested in the capital market beyond just the effect on the interest rates. The reduction in the amount of capital raised locally by the government, which was negative this year, freed up resources for the business sector and reduced the supply of government bonds for savers. This supported the

**Figure 1.5**  
Public Expenditure, Real Rates  
of Change, 1995–2005  
(deflated by index of business-sector  
product prices)

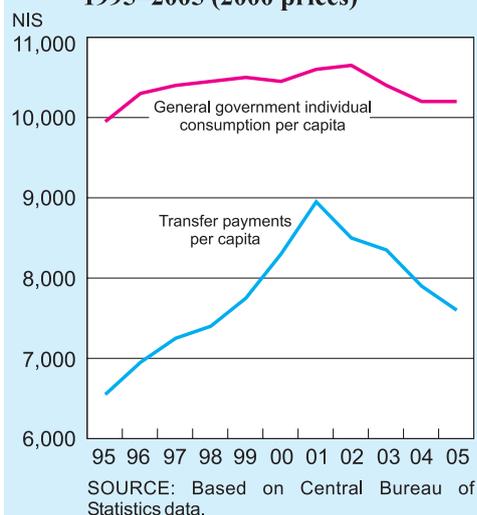


SOURCE: Based on Central Bureau of Statistics data.

<sup>3</sup> As part of the long-term targets, a ceiling of 3 percent of GDP was placed on the deficit and the growth in expenditure was limited to one percent. It was decided to increase the target for 2005 on a one-time basis in order to finance the Disengagement but the actual deficit and expenditure were even lower than the original targets.

<sup>4</sup> The underspending was concentrated in the civilian ministries (Table 6.10). Among other things, it is worth mentioning the non-implementation of the Dovrat Report which was budgeted at about NIS 1 billion.

**Figure 1.6**  
**Transfer Payments and General**  
**Government Individual**  
**Consumption per Capita,**  
**1995–2005 (2000 prices)**



significant increase in investments by institutional investors both in domestic private bonds and in debt instruments abroad.

Fiscal policy this year had a number of positive effects on economic activity: the reinforcement of fiscal discipline supported an expansionary monetary policy and the reduction in taxes supported the expansion of demand and the reduction in costs on the supply side. Although growth was led by the business sector, the acceleration in growth relative to 2004 was solely the result of the expansion in the product of public services and the number of employees in the public sector grew. However, the deficit was reduced, in particular the cyclically-adjusted deficit which approached

zero this year (Table 6.6), and public expenditure grew at a slow rate.

The share of public expenditure in GDP fell by almost two percentage points this year which is similar to its decrease in 2004. The sharp decline in total transfer payments since 2002 leveled off this year though the decline in real per capita transfer payments continued and the subsidization of mortgages decreased significantly. In addition to the reduction in transfer payments, the extent of services supplied by the public sector has eroded in recent years following its growth during the second half of the 90s. Thus, per capita public civilian consumption and per capita public individual consumption remained unchanged in 2005 following a decline during the previous two years (Figure 1.6).<sup>5</sup>

Tax revenues increased significantly this year due to the high rate of growth and their share in GDP even rose despite the major reduction in tax rates. The increase in revenues was primarily the result of taxes collected from corporations and the self-employed whose profits grew significantly as growth consolidated. During the last two years, tax rates have been reduced significantly and this year an additional cut in tax rates on labor income and profits was announced, which will be gradually implemented until 2010. In addition, the process of equalizing the tax rates on income from investments in Israel and abroad was completed and the rate of value-added tax was reduced.

The share of public expenditure in GDP fell by almost two percentage points.

Tax revenues grew substantially due to the expansion in economic activity and despite the significant reduction in tax rates.

<sup>5</sup> Public individual consumption reflects personal public services provided to individuals, such as education and health.

## 4. THE LABOR MARKET

The rate of unemployment fell to 9.0 percent.

This year, there was substantial improvement in the labor market: the rate of unemployment declined to 9.0 percent, which was solely due to the increase in employment, and wages increased. This improvement was a reflection of the gradual reaction of the labor market to the recovery of the economy. The first stage of recovery from the recession involved an increase in labor productivity and therefore the effect on the labor market was limited. At the completion of this stage, the demand for new workers increased, which led to an increase in employment and wages, yet the rate of full-time employment remained almost unchanged this year. The slack in the

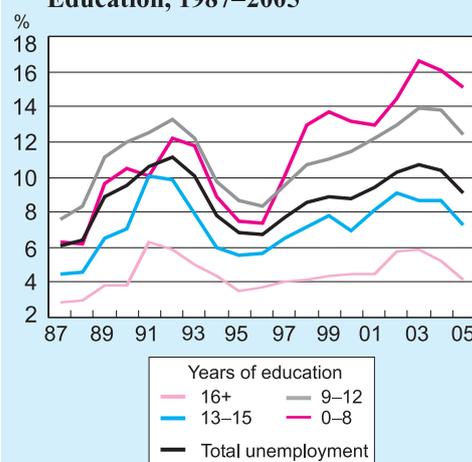
labor market in recent years provided support for a rapid expansion by enabling a rapid adjustment of output to the increase in demand. This situation also characterized 2005 since the increase in wages was lower than that in productivity and therefore the unit labor cost continued to decline. However, there were indications this year of excess demand for highly educated workers which is liable to lead to supply pressures in advanced industries which are intensive in these workers. The rate of unemployment among highly educated workers fell to a level similar to that in 2000.

In contrast to previous years, there was a rapid increase in the number of employed in the public sector this year which explains close to half of the decline in the rate of unemployment. However, the increase in the real wage in this sector was moderate relative to that in the business sector.

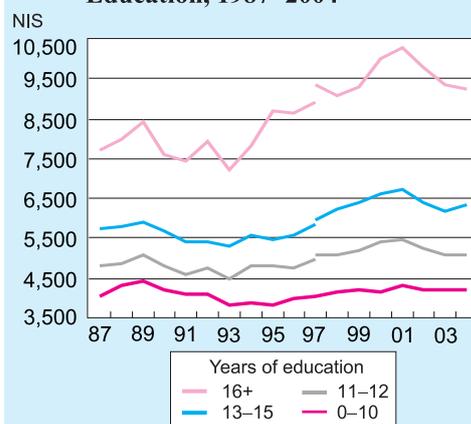
The expansion in activity this year benefited both more and less educated workers in terms of employment and wages. The rate of unemployment declined by a similar amount for all levels of education and the real wage increased in all industries. The composition of growth this year was even biased towards unskilled workers

**Figure 1.7**

**a. Unemployment Rate, by Years of Education, 1987–2005**



**b. Real Wages<sup>a</sup> by Years of Education, 1987–2004**



<sup>a</sup> 2000 prices.

SOURCE: Based on Central Bureau of Statistics data.

The number of employed in the public sector grew.

The growth in economic activity benefited both more and less educated workers.

and the expansion in employment was particularly large in the service industries (particularly hotels and catering) which are intensive in these workers. Nonetheless, the basic bias in favor of more educated workers in the labor market (Figure 1.7) has not changed. Thus, the rapid expansion of employment in these industries was accompanied by a negligible increase in wages while in the industries which are intensive in more educated workers, there was a more moderate increase in employment accompanied by a larger increase in wages.

The number of non-Israeli workers increased this year at a much higher rate than Israeli workers following a continuous decline in previous years. The main part of the increase was due to Palestinian workers although the number of foreign workers also grew somewhat. The increase in the number of foreign workers contradicts the declared policy of the government. The number of illegal foreign workers who were expelled from the country dropped significantly this year and there are indications of a weakening in enforcement. The planned increase in the tax on the employment of foreign workers was approved but only in part. The number of foreign workers in the economy is very large and many of them are residing in Israel illegally. Their presence harms the employment opportunities and the wages of unskilled Israelis, contributes to inequality in the economy and is inconsistent with the government policy of integrating Israelis with a low level of education in the labor market.

In recent years, the government adopted a policy of “transition from welfare to employment”. Up until this year, the policy had focused on a significant cutback in transfer payments with the goal of encouraging employment though there was only limited active assistance in obtaining employment. This year, the government began implementing intervention programs, such as Mehalev (the “Wisconsin Program” which is described in Box 5.1 in Chapter 5), but it is still too early to evaluate their effectiveness.

## 5. THE BALANCE OF PAYMENTS

This year there was a surplus of \$2.4 billion in the current account following smaller surpluses in the previous two years (Table 7.1). Its mirror image was an increasing net export of capital by the economy during those years.<sup>6</sup> The increase in the surplus reflected both long-run processes in the economy and developments that were unique to this year.

In a long-run perspective, there has been a trend of improvement in the current account over the last decade. This improvement reflects a downward trend in the rate of domestic investment relative to GDP and fluctuations in the rate of national savings without a clear trend (Figure 2.9 in Chapter 2). The decline in the rate of investment reflects the end of the process of absorbing immigration which led to a high rate

<sup>6</sup> The net export of capital is recorded as a deficit in the financial account. The gap between the surplus in the current account and the deficit in the financial account is due to statistical discrepancies which this year were relatively large.

The number of non-Israeli workers grew. There are indications of a slack in enforcement of the policy to reduce the number of foreign workers.

Programs were initiated for encouraging integration in the workforce.

The surplus in the current account of the balance of payments increased.

There has been a favorable trend in the current account for the last decade.

of investment in the first half of the 90s and the end of the stage of accelerated accumulation of capital which characterizes a young economy. The developments in 2005 strengthened this long-run trend. Thus, although investment increased, its share in GDP is still low. In addition, the rate of growth in saving was more rapid and the surplus of saving over investment was directed to the accumulation of assets abroad. The process by which the economy has been transformed into a net exporter of capital was supported by the structural changes implemented in the capital market in recent years, particularly the lifting of restrictions on the export of capital. The import of capital has been considerable for many years and has been almost unhindered by structural constraints.

#### a. The current account

The deficit in the goods and services account remained unchanged.

The increase in the current account surplus was solely due to the increase in net income from investments abroad. At the same time, the deficit in the goods and services account remained unchanged. This is an indication of the reduced importance of exports in leading growth this year in contrast to the previous two years in which the deficit declined substantially. The fact that the deficit this year did not decline is particularly noticeable in view of the slowing in the real increase in imports relative to GDP. The stability in the deficit of goods and services, even though the real increase in exports was larger than that in imports, is the result of, among other things, the deterioration in the terms of trade.

The significant deterioration in the terms of trade was a result of the increase in oil prices.

The significant deterioration in the terms of trade this year was solely the result of the increase in world oil prices. This harmed the income of the economy and explains a major part of the real depreciation this year. The deterioration in the terms of trade has continued for a number of years and as a result the level of the terms of trade was particularly low this year from a long-run perspective.

There was a real depreciation this year.

The real depreciation this year, which continued the trend of the last three years, contrasts with the long-run trend of real appreciation. Furthermore, the exchange rate depreciated during the last three years even though the recovery was led by increasing demand which would be expected to put upward pressure on prices, i.e. a real appreciation. However, the continuing excess capacity worked to moderate the increase in prices in the economy. Apart from the output gap and the deterioration in the terms of trade, fiscal and monetary policy and the increase in residents' investment abroad also contributed to the real depreciation.

The real rate of growth in exports fell substantially.

The rate of real increase in exports decreased significantly this year and therefore so did its contribution to the expansion in GDP. The slowing of the rate of increase encompassed both manufacturing exports of all technological intensities (high-tech, mixed and traditional) and the export of services, apart from tourism. The slowing of the rate of increase in exports has been ongoing as is evident from half-yearly data from mid-2004, with a particularly low rate of increase in the second half of 2005. The slowdown in exports occurred in spite of the real depreciation and was of greater magnitude than the decline in the rate of expansion in world trade.

The changes in the components of exports this year reflect long-run trends and the current improvement in underlying conditions. Technological exports, both manufactured goods and high-tech services, have been growing at a rapid rate during the last two years, particularly in comparison to the rest of the manufacturing export industries. This reflects both the long-run trend of the economy's increasing specialization in advanced export industries (Figure 7.8 in Chapter 7) and the importance of the world recovery in these industries for the recovery in Israel. The rapid growth in tourism reflects the improvement in the security situation though tourism has not recovered to past levels. Another trend that has appeared in recent years is the increase in the share of the developing countries in Israel's export of goods, particularly goods that are used as manufacturing inputs (Table 7.4). This is explained by the shifting of world manufacturing production to these countries. As a result of the accelerated growth in the export of high-tech services and tourism, the expansion of the export of services was more rapid than that of the export of goods. In a long-run perspective, the share of services in total exports has remained stable although its composition has changed. Thus, the importance of tourism has declined and that of advanced services has increased, as did the share of advanced industries in manufacturing exports.

Advanced exports, both of the manufacturing industry and the hi-tech services industry, have grown rapidly in the past two years.

The rate of real increase in imports this year was low in view of the rate of expansion in the economy. The decline in the rate of increase relative to 2004 was solely the result of the import of goods since there was an increase in the rate of growth in the import of services which constitute about one third of total imports. The difference in development between the import of goods and the import of services is consistent with the general shift of the economy towards services. The slowing of the import of goods encompassed all its components apart from oil and can be explained by a number of factors: the real depreciation which raised the prices of all imports relative to local goods; the slow growth in the import of inputs which is related to the slow growth in manufacturing exports; and the slow growth in the import of consumption goods. There was a sharp quantitative increase in the import of oil despite the sharp increase in its price. This is an indication of the inelasticity of demand which magnifies the negative influence of the increase in oil prices on the economy.

The real rate of growth in imports was low.

### **b. The capital account**

The net export of capital increased this year to a total of \$6.1 billion. There were important developments in both of its components (and the interaction between them): investment abroad by residents and investment in Israel by nonresidents.

The net export of capital grew this year.

Investment abroad by residents grew significantly this year which continued the trend of recent years. This increase reflects the continuing adjustment by investors to structural changes implemented in previous years and to developments during the year, including the easing of restrictions on investment abroad by institutional investors, the process of equalization of taxation on investments abroad which was completed this year, the reduction in the local financing needs of the government

Investment abroad by residents grew substantially this year.

and the narrowing of the interest rate spread with respect to foreign interest rates. Within the composition of residents' investment abroad, the increase in the purchase of debt instruments was particularly noticeable which is consistent with the reduction in the supply of government bonds and the increased holdings of private bonds by institutional investors in Israel as well.

Investment in Israel by nonresidents increased this year.

Investment in Israel by nonresidents also grew this year though at a slower pace than in the previous two years and also at a slower pace than the growth in investment abroad by residents. In particular, there were substantial increases in investment in shares and direct investment. This was a reflection of the two main factors that contributed to the increase in nonresident investment this year beyond the general improvement in economic conditions: the increased interest of investors in emerging markets and the record level of privatization. Additional forces that influenced investment by nonresidents were the implementation of the Bachar reform (as a result of which nonresidents purchased some of the entities sold off by the banks) and the weakness in the NASDAQ market which was reflected in the slowdown in new issues of Israeli companies on foreign exchanges.

The accelerated growth in investment abroad by residents contributed to the real depreciation.

The mutual relationship between investment abroad by residents and the investment in Israel by nonresidents is expressed by, among other things, the foreign exchange rate and the composition of capital flows. The expansion of investment in Israel by nonresidents has for a long time been creating pressure for a real appreciation and this was particularly evident in 2000. The accelerated increase in residents' investment abroad during the last three years has worked to offset this pressure and this year contributed to the real depreciation. The difference between the composition of capital exports and that of capital imports is reflected in the tendency of nonresidents to invest in equity instruments in Israel (such as shares) in contrast to the tendency of residents to invest in debt instruments abroad (such as bonds). As a result, the economy has in recent years become a net lender even though its total liabilities abroad remain higher than its total assets abroad. An additional result is the increase in residents' interest income from abroad which this year made a significant contribution to the improvement in the current account.

## 6. INFLATION AND MONETARY POLICY

### a. Inflation

The CPI increased by 2.4 percent in 2005.

The CPI rose in 2005 by 2.4 percent (Figure 1.8.a) which was within the boundaries of the inflation target. The trend in prices during 2005 was not uniform. Thus, in the first quarter inflation was negative, continuing the low inflation of the previous year; later in the year there was a significant increase in inflation; and towards the end of the year, inflation moderated (for further discussion see Chapter 3).

The sources of the upward pressure on prices this year were primarily external to the economy.

The upward pressure on prices this year originated primarily outside the economy while there was relatively little pressure from the output gap. The external factors

included the strengthening of the dollar relative to other currencies, the increase in the prices of raw materials, particularly oil, and the more moderate rise in the prices of finished goods. The combination of the depreciation during the course of the year, which was partially the result of internal factors, and the global increase in prices was reflected in a substantial increase in import prices. Furthermore, the depreciation contributed to the increase in housing prices (Figure 1.8.a), which played a major role in the rise of the CPI this year. In contrast, there was no major pressure on prices from within the economy since despite the accelerated growth in activity, there was still a significant gap between actual and potential output and, as already mentioned, no significant supply side pressure has yet appeared. This is evident from, for example, the decrease in unit labor cost, the real depreciation and the moderate increase in product price. An additional reason that growth has not so far led to a major increase in prices is that the increase in demand resulting from consumption and tourism has focused on industries which are intensive in less educated workers whose rate of unemployment is high and whose wages increased by only a small amount this year. The reduction in tax rates also helped to restrain the increase in prices. The significant increase in the price of housing does not indicate substantial excess demand since the increase did not exceed the rate of depreciation in the NIS/dollar exchange rate.

Even though the output gap this year still acted to restrain price increases, there were indications during the year of the development of internal inflationary pressures in the economy as the output gap narrowed. Thus, the increase in the CPI excluding fruit and vegetables and clothing and footwear reached the upper boundary of the inflation target range in contrast to its low levels during the previous two years; the decrease in unit labor cost was smaller than in the previous two years; the price of business sector GDP increased following decreases during the previous two years and despite the reduction in tax rates this year; the increase in the output price in manufacturing beyond the increase in its product price indicates that producers passed on the rise in the prices of inputs while in recessionary conditions they would have been forced to absorb a large part of it; and although housing prices rose this year at a rate similar to the depreciation, this followed a significant decrease in 2004 beyond the appreciation that year.

As the output gap narrows, internal inflationary pressures begin to appear.

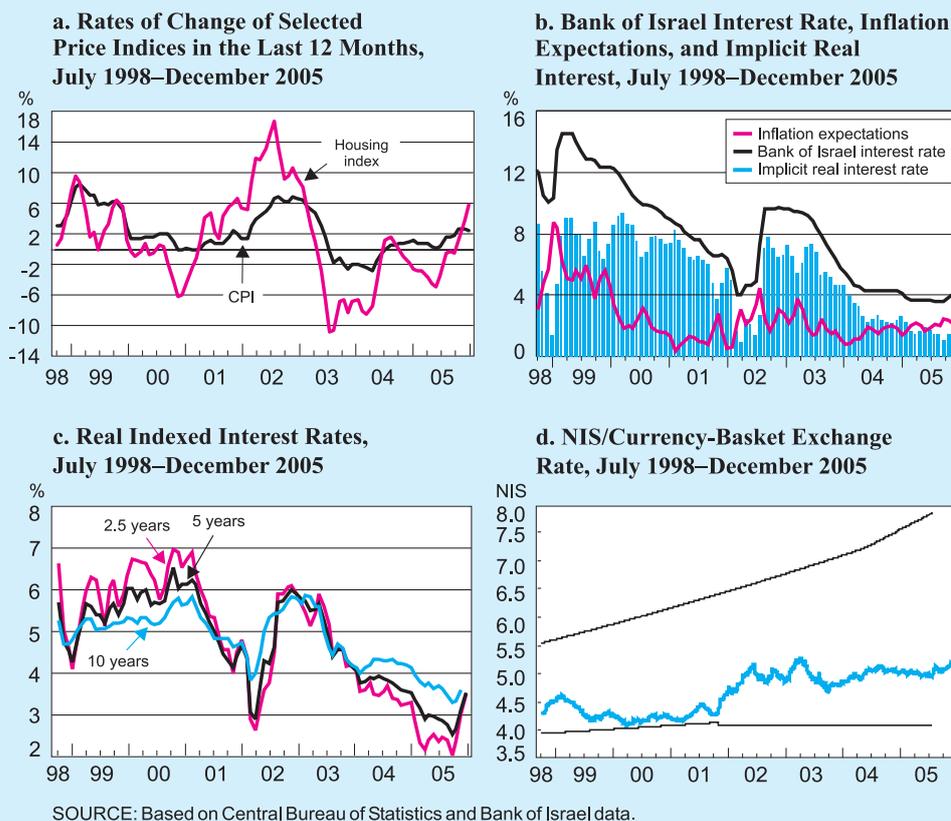
## **b. Monetary policy**

Monetary policy in 2005 maintained price stability while taking into consideration real economic activity. This year monetary policy was expansionary which was a continuation of the policy in 2004.<sup>7</sup> This can be seen from the expected real rate of interest which fell to a particularly low level this year despite the acceleration in the economy's growth. The real rate of interest reflects the monetary policy tool, i.e. the Bank of Israel rate of interest, and the expectations of inflation (Figure 1.8).

Monetary policy was expansionary this year.

<sup>7</sup> For a detailed discussion of monetary policy, see Chapter 3.

Figure 1.8



The interest rate and its spread against US interest rates reached particularly low levels; toward the end of the year there was a turnaround in the trend of the interest rate.

Two main phenomena characterized the Bank of Israel rate of interest this year: On the one hand, the rate of interest and its spread vis-a-vis the US rate of interest reached particularly low levels while on the other hand, towards the end of the year, there was a turnaround in the trend in the rate of interest and the interest rate spread. The downward trend in the rate of interest (which fell from a level of 9.1 to 3.5 percent since the end of 2002) came to an end in February. This low rate was maintained until September and towards the end of the year the Bank raised the rate of interest several times by a cumulative amount of one percentage point. The raising of the rate of interest also ended the continuing reduction in the interest rate spread with the US, which in September was actually negative, and in the last quarter the spread increased. The real rate of interest also increased. Despite the increase in the rate of interest towards the end of the year, the real rate of interest and the interest rate spread remained very low in historical terms. The raising of the interest rate was no surprise to the markets as can be seen from the changes in the yield curves during the year.

The low level of the interest rate which prevailed during the year, while maintaining price stability, reflected a number of factors: This level was made possible by the low interest rates abroad, although these can only provide a partial explanation since the interest rate spread also declined to an especially low level. Thus, the low level of

the interest rate also reflected the improvement in the economic environment and the maintenance of fiscal discipline which brought down the economy's risk premium and the long-term yields on bonds and allowed the Bank of Israel to maintain a low rate of interest—while allowing the interest rate spread to fall—without threatening price stability. The low level of the rate of interest despite rapid economic growth was also made possible by the lack of any real supply side pressure due to the excess capacity. The low level of the rate of interest was maintained despite a number of political shocks which were liable to undermine the stability of the financial markets.

The increase in the rate of interest towards the end of the year reflected the reaction of the Bank of Israel to the acceleration in the actual rate of inflation and the increase in expectations of inflation. The increase in expectations is to a large extent related to the interest rate spread, although the process of reduction in the spread is not in itself a sufficient explanation, since such a process also characterized the previous two years during which expectations did not increase. Thus, the rise in expectations was influenced by the particularly low level reached by the interest rate spread this year. The Bank of Israel rate of interest remained unchanged during most of the year. The increases in the US rate of interest, which began in the previous year, contributed to the depreciation of the shekel and the rise in expectations and required an increase of the interest rate in Israel in order to reduce those expectations. The series of increases in the interest rate in Israel during the last quarter of 2005, which exceeded the rate of increase in the US, restored the interest rate spread to a level that reduced expectations of inflation to the center of the target range and halted the depreciation. Nonetheless, the rapid growth of the economy and the low level of the real interest rate create expectations of the development of demand pressure in the future and therefore of price increases as well. Furthermore, it is possible that the cumulative depreciation has not yet been fully reflected in local prices and the recognition of that fact also influences expectations.

The Bank of Israel raised the rate of interest in reaction to the acceleration in the rate of inflation and the increase in expectations of inflation.

## 7. THE CAPITAL MARKETS AND THE FINANCIAL SYSTEM

In 2005, the Israeli capital market flourished while changes took place in the composition of assets, the sources of financing and the cast of players. The stability of the financial system improved even though there remained significant challenges in this area.<sup>8</sup> Most of the factors behind these developments, which are related to the improvement in the economy and the structural changes in the capital market, began to have an effect already in 2004 and some of them even before that.

The capital market flourished and underwent structural changes.

The boom in the capital market this year was reflected in a significant increase in share indices, as well as in the growth in the volume of trade, the increase in capital raised by the business sector and the increase in the value of the public's portfolio of assets, all of which continued the trend of the previous two years. The underlying

<sup>8</sup> For a detailed analysis of the financial markets, see Chapter 4.

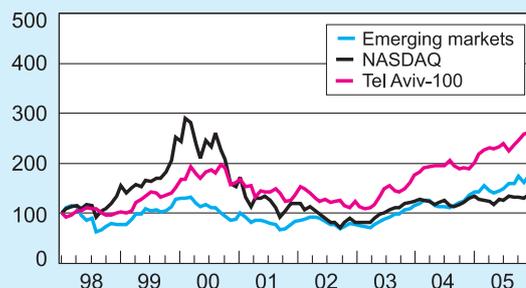
forces driving the boom were the continuing improvement in the situation of the economy, the macroeconomic environment and the optimism regarding the future. The improvement in the macroeconomic environment was reflected in the reduction in yield spreads between Israel and the rest of the world (Figures 1.9.b and 1.9.c) and in the maintenance of stability in the financial markets despite the decline in spreads and a number of political shocks. The substantial increase in the investment of nonresidents on the Stock Exchange this year also contributed to the increase in share prices. This increase is partially related to the rising interest of investors in emerging economies since the stock exchanges of those countries also boomed this year (Figure 1.9.a). While economic activity contributed to the boom in the capital market, this effect also worked in the opposite direction. Thus, the increase in the value of the asset portfolio contributed to the increase in private consumption and lower financing costs contributed to the expansion of domestic investment and supply.

Two important reforms in the capital market went into effect this year: The first was the completion of the gradual reduction of tax rates (which began in 2004) on all types of foreign securities to the same rates that apply to local securities. The second was the start of the implementation of the recommendations of the Bachar Committee to reduce the holdings of the banks in provident and mutual funds. The recommendations

The tax rates on foreign and local securities were equalized; the implementation of the Bachar Committee recommendations began.

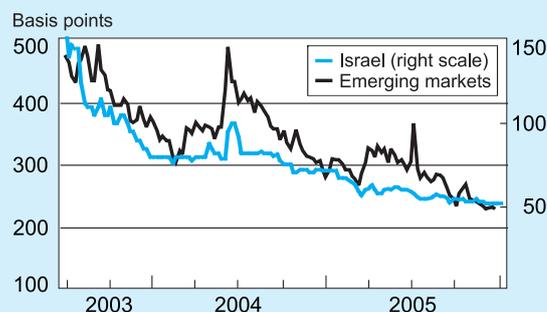
**Figure 1.9**

**a. Share Index Developments in Israel and Abroad,<sup>a</sup> 1998–2005**



<sup>a</sup> Index of shares in emerging markets, Morgan Stanley.

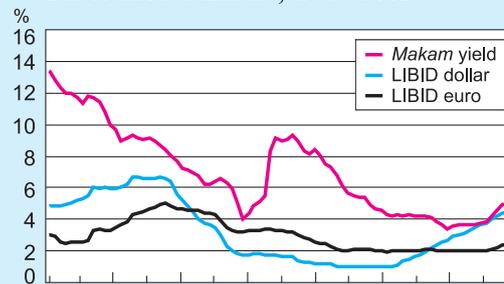
**b. Risk Premium, Israel<sup>a</sup> and the Emerging Markets,<sup>b</sup> May 2003 to December 2005**



<sup>a</sup> Relative to the US on Israel government 10-year bonds.

<sup>b</sup> Index of emerging markets calculated by J.P. Morgan (excluding Argentina).

**c. Yields on Three-month Makams and Three-month LIBID, 1999–2005**



SOURCE: Bank of Israel calculations.

were meant to increase competition in the capital market and to prevent conflicts of interest. The reforms that were carried out this year were in addition to a series of structural changes made in the capital market in recent years, including, among others, the reform of the pension funds and the easing of investment restrictions on institutional investors. These reforms initiated a gradual process of change in the characteristics of the market. The processes which took place in 2005 reflected the continuing adjustment of the market to the reforms carried out in previous years and the beginning of the internalization of reforms that went into effect this year.

The amount of capital raised by the government in the local market declined substantially this year, following a smaller decline in 2004, and the net amount of capital raised this year was in fact negative. The reduction in the amount of capital raised locally was made possible by the decrease in the government deficit and the large revenues from privatization and is one of the most important factors in understanding the processes in the capital market this year. Beyond its contribution to the freeing up of resources, which helped the business sector increase the amount of capital it raised locally, there was also an effect on the composition of capital raised by the business sector and the composition of the public's asset portfolio as seen in the increase in the issue of private bonds. The reduction in the need for local financing and in the government deficit also contributed to the decline in yields on long-term government bonds.

The amount of capital raised by the government in the local market declined substantially.

#### **a. The public's asset portfolio**

The changes in the composition of the public's asset portfolio in 2005 (apart from the increase in the proportion of shares as a result of the substantial increase in their prices) were, as already mentioned, a continuation of the processes that have been going on for several years although some of them intensified this year (Figure 1.10.a<sup>9</sup>). Their main characteristics were: the increase in the share of tradable assets (whose value is not guaranteed at all times but changes with fluctuations in the market); the decrease in the share of government bonds in the portfolio and the increase in the share of assets abroad. The implications of these changes include greater diversity in the asset portfolio, the increased capability to diversify risk, greater opportunities of increasing average yield but also exposure of the public to greater volatility in the value of its financial assets and to higher risk. These changes relate to both pension savings and short-term savings.

The changes in the composition of the asset portfolio have continued for the past several years.

These changes reflect a number of developments in the capital market, among them the reforms carried out in recent years. The fall in the share of assets whose value is not guaranteed is related to the reduction in the issue of designated bonds (as part of the reform of the pension funds and the process of making the government debt tradable), as well as to the continuing decline in the share of deposits and savings plans

The changes in the composition of the portfolio reflect the implementation of reforms and the reduction in the amount of capital raised by the government.

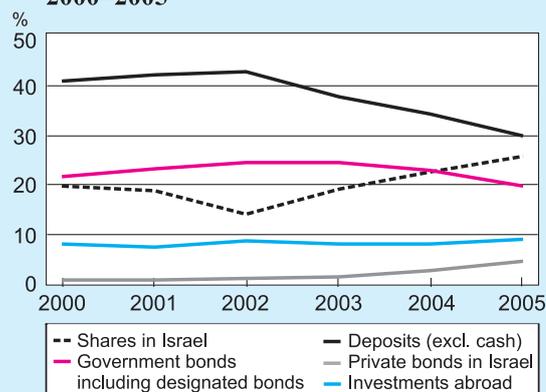
<sup>9</sup> The figure presents the composition of the asset portfolio including shares. Even without shares, a similar picture of the changes in the composition of the portfolio is obtained.

with the banks. The overall fall in the share of government bonds is a result of the pension reform, which has induced the funds to increase their holdings of assets of the business sector, and the reduction in the amount of capital raised by the government in the local market. Thus, there was an increase in the share of assets issued by the business sector which are riskier and subject to greater fluctuations in value than government bonds. It appears that the accelerated growth in the share of private bonds in the asset portfolio of institutional investors during the last two years is also in fact related to the relative decrease in the supply of government bonds since private bonds can serve as partial substitutes for government bonds. This is particularly true in the case of the pension funds which hardly invest abroad or in shares. The shift to investment abroad is related to the easing of restrictions on institutional investors, the reduction in the discriminatory taxation of revenue from abroad and the reduction in the amount of capital raised locally by the government. In contrast to recent years, there was a shift this year from unindexed shekel assets to indexed assets as a result of the rise in inflation and the increase in the issue of private bonds, most of which are CPI-indexed.

There was a further decline in the share of the banks in the financing of the business sector.

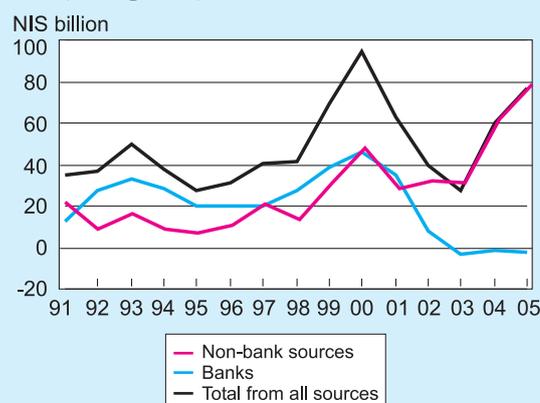
**Figure 1.10**

**a. Components of Asset Portfolio,<sup>a</sup> 2000–2005**



<sup>a</sup> Total assets include also *Makam* bonds, cash held by the public and other assets.

**b. Total Capital Raised by Private Sector from all Sources,<sup>a</sup> 1991–2005 (2003 prices)**



<sup>a</sup> Banks - in Israel. Non-bank: stock markets in Israel and abroad, venture capital funds, and banks abroad.

SOURCE: Bank of Israel calculations.

**b. Sources of financing for the activity of the private sector**

The downward trend in the share of the banks in the total sources of financing of the business sector, which has continued for the past several years, also characterized 2005 (Figure 1.10.b). The transition to non-bank channels is accompanied by the deepening and sophistication of these markets and diversifies the business sector's sources of financing. The banks are being replaced as a source of credit by institutional investors

who are providing the business sector with most of the additional credit it requires. This phenomenon is related on the one hand to the reforms mentioned above and the decline in the government's need for local financing which have induced institutional investors to purchase assets of the private sector in place of government bonds. On the other hand, it is related to the reduction in the supply of credit from the banks which is due to, among other things, the tightening of regulatory restrictions on their credit activity. This process is reflected in the accelerated growth in the issue of private bonds. Even though the issue of shares has grown rapidly in the last two years and its rate of growth this year was similar to that of the issue of bonds, its overall volume has remained smaller than the total volume of bonds issued which is in contrast to the situation in 2000.

The raising of capital abroad by Israeli companies declined this year despite the improvement in the economy's performance and the growth of investment in Israel by nonresidents. This is consistent with the relative weakness in the NASDAQ market and the boom in the local capital market which made it easier to raise capital in Israel.

There was a decline in the amount of capital raised abroad by Israeli companies.

### c. Changes in the market players

Simultaneous with the changes in the composition of the asset portfolio and the sources of financing this year, the process of change in the importance of the various types of players in the capital market continued and even intensified.

The decline in the share of the banks in financial activity has continued for several years and, as already mentioned, this is reflected in a variety of financial aggregates, such as the banks' share of credit to the business sector and of the management of private sector assets. This was augmented by the accelerated sale of the banks' provident and mutual funds at the end of the year although the Law allows them to sell off these funds over a period of several years. The banks have primarily been replaced by institutional investors (pension funds, insurance companies and provident funds) both in the provision of business credit and in the management of the public's assets. The banks sold their provident and mutual funds primarily to insurance companies but also to nonresident investors. These changes in the relative position of the banks and other financial institutions are likely to increase competition and efficiency in the capital market.

Institutional investors have become increasingly important in the capital market.

The involvement of nonresidents in the local capital market is not new but its scope has grown over time. This year, there was a significant increase in nonresident activity on the local stock exchange, in the purchase of companies that the government privatized and in the purchase of some of the entities sold off by the banks. The increasing involvement of nonresidents, simultaneous with the increase in investment abroad by residents, is strengthening the integration of the Israeli capital market with global markets as part of the wider process of globalization.

The involvement of nonresidents in the Stock Exchange has increased.

The involvement of the government in the domestic capital market has also decreased as a result of, among other things, the reform in the pension funds and its reduced need for domestic financing. In contrast, a precedent was set with the entry of municipalities into the capital market. Until now, only one municipality has issued

The government has reduced its involvement in the capital market.

bonds but others are expected to do so in the near future. In the past, municipalities borrowed only from the banks.

#### **d. The stability of the financial system**

There were positive developments in the stability of the financial system.

The favorable underlying economic conditions in Israel and worldwide reinforced the stability of the financial system this year which followed the significant improvement in the previous two years. In addition, the resilience of the financial markets and of the financial institutions, and in particular the banks, also improved this year. The capital adequacy of the banking system continued to improve and its credit risk was reduced. The capital ratios of the insurance companies were maintained although there was an acceleration in the growth of credit.

The reforms will increase the resilience of the system in the long run but involve increased risks during the transition period.

The various reforms, which were manifested in a reduction of the share of the banks and an increase in the share of institutional investors, are expected to reinforce the resilience of the financial system in the long run. Nonetheless, the period of adjustment to the changes in the financial infrastructure involves increased systemic risk, primarily in the form of credit risk, among institutional investors. Therefore, adjustments are required in the regulatory and information disclosure mechanisms, particularly with respect to institutional investors and, foremost among them, the insurance groups (for a detailed discussion see Chapter 4).

### **8. FUTURE TARGETS AND POLICY**

Economic policy should support sustainable growth while reducing poverty.

The main objective of economic policy is to support sustainable growth. In order to do so, macroeconomic policy must maintain fiscal discipline, price stability and financial stability. In addition, there is a need for an ongoing policy to reduce poverty. A well-devised policy with regard to infrastructure and the enhancement of competition in the economy will contribute to growth and the quality of life.

#### **a. Fiscal policy**

The government should maintain fiscal discipline over time.

The government must persevere in maintaining fiscal discipline over time. This will allow a significant reduction in the public debt to GDP ratio and a monetary policy which supports growth while maintaining price stability. Fiscal discipline is essential in maintaining the stability of financial markets, especially in an age of increasing openness in world capital markets that enables investors to quickly move to alternative markets when they sense a reduction in credibility and an increase in risk to their investments in the economy.

The ratio of debt to GDP should be reduced.

In recent years, the government has determined a series of long-term targets and has implemented a number of reforms which essentially define a long-run macroeconomic policy that is consistent with the main requirements for the support of enduring growth. Starting in 2005, the government has been working within the

limits of a double multiyear target: the ceiling on the deficit and the limit on the annual growth of expenditure. Meeting the deficit and expenditure targets will enable a significant reduction in the debt to GDP ratio if the growth of the economy continues (for a long-term analysis, see Chapter 6). Taking into consideration its high level in Israel, a downward path for the debt ratio is essential. It should be mentioned that the international credit rating companies regard such a step as highly important. The government should also endeavor to achieve a downward path for the deficit itself. Expenditure and the deficit this year were lower than the ceilings set for them and the debt to GDP ratio fell by a significant amount. This has increased the credibility of the government and contributed to two positive phenomena in the capital market: the reduction in yield spreads on government bonds and the maintenance of stability despite political shocks. Nonetheless, some of the reduction in the deficit was a result of the particularly favorable conditions that prevailed this year, transitory factors and underspending by the ministries. Indeed, it is desirable to exploit the increase in tax revenues in good years in order to lower the deficit below the ceiling and to accelerate the reduction in the public debt. Yet the restraint in expenditure should be a result of the budget process and not of underspending.

The share of public expenditure in GDP in Israel is high in international terms, primarily due to defense expenditure and interest payments. Following the large increase from 2000 to 2002, the share of public expenditure has since fallen by 5 percentage points and its level this year was the lowest since 1970. This was a result of, among other things, the determination of the government in recent years to restrict public expenditure. As already mentioned, starting in 2005, the government has also specified a ceiling for the annual growth in expenditure and has kept to it this year. In addition, the government has in recent years implemented a number of reforms which have had only a small effect on current expenditure; however, their contribution to credibility has been significant since they will assist in the limiting of expenditure in the future. Examples include the transfer of new workers in the public sector to a funded pension, the reduction in the issue of designated bonds and raising the age of retirement. In addition, the reduction in the public debt will decrease the government's interest expenditure. Much of the restraint in expenditure in recent years was achieved by sharp cutbacks in National Insurance benefits. Though the cutbacks were part of the "from welfare to work" policy, they were to the detriment of weaker segments of the population in the short run. It appears therefore that the potential for cutting welfare benefits has been exhausted. The determination of a multiyear defense budget is important for many different reasons, one of which is the transparency of the implications of the long-term expenditure targets for per capita public civilian expenditure in coming years.<sup>10</sup>

The share of public expenditure in GDP in Israel is high in international terms.

<sup>10</sup> The long-term analysis in Chapter 6 provides a calculation of this sort under certain assumptions regarding the defense budget and other variables. It should be mentioned that the expenditure growth target relates to the budget and not to actual expenditure in the preceding year. Therefore underspending this year makes it possible to significantly increase actual expenditure next year without exceeding the expenditure target.

Israel's tax burden is similar to the average of the developed countries.

A carefully considered reduction in tax rates contributes to growth, to the competitiveness of the economy and even to fiscal credibility if it is an indicator of the government's intention to restrain expenditure. Tax rates were significantly lowered in recent years and this year the government decided on a further reduction that will be gradually implemented until 2010. Currently, the tax burden in Israel is similar to the average of the developed countries and the planned reductions will bring it to below this average. Therefore, in the future the emphasis in fiscal policy should be on continuing to substantially reduce the share of the debt in GDP.

### **b. Monetary policy**

Macroeconomic policy to maintain price stability also operates within a framework of targets set by the government. Thus, monetary policy is assigned to maintaining the rate of inflation within the range of 1–3 percent. This year the target was achieved and a particularly low real rate of interest was reached which was conducive to growth. The low rate of interest was possible as a result of fiscal discipline, the low rate of interest abroad and the decline in Israel's risk premium. Maintaining fiscal discipline will assist the Bank of Israel in achieving the inflation target while supporting the level of economic activity.

It is important to complete the enactment of a new Bank of Israel Law.

As in other countries which have recently updated their laws regarding the activity of the central bank, it is important to complete the enactment of a new Bank of Israel Law. The new legislation should ensure the independence of the central bank and will clearly define its goals. The main goal should be defined as maintaining price stability in accordance with the target set by the government while supporting other objectives—including growth and employment—without compromising price stability and the proper functioning of the financial system. The Bank will be given full independence in employing the instruments necessary to achieve its goals. It is proposed that two new bodies be established: the Monetary Committee and the Administrative Council which will also include members from outside the Bank who have the appropriate qualifications and are free from any conflict of interest. The Monetary Committee, headed by the Governor of the Bank of Israel, will make decisions in the area of monetary policy. The Administrative Council will have a majority of members from outside the Bank, one of whom will head the Council, and will approve administrative policy such as the Bank's budget and the salaries of its workers. Both of the new bodies will report to the public and the Law will define a list of periodic reports which the Bank is obligated to publish.

### **c. The financial infrastructure**

The management of macroeconomic policy in coming years in accordance with the guidelines set out above will also increase the financial resilience of the economy and the financial strength of the business sector and will thus enhance financial stability.

In order to maintain financial stability, it is also important to strengthen the financial infrastructure. The many changes carried out in the financial infrastructure in recent years are expected to increase the resilience of the financial system in the long run once its new structure has taken form. However, the changes create challenges today for the regulatory authorities. First among these is the increasing systemic risk, primarily in the form of credit risk, among institutional investors during the transition period of the reforms. Therefore, the authorities should already begin taking steps in the areas of supervision, regulation, and availability of information to the public, primarily in the area of the capital adequacy of the insurance groups with respect to growing credit risk.

The regulatory mechanisms should be strengthened, particularly with respect to institutional investors.

The rapid changes in the system and the challenges they will involve during the transition period require that emphasis now be placed on completing the changes that are now in the midst of implementation. These include the completion of the enactment of legislation relating to new financial instruments, the removal of barriers to increased efficiency in the asset-backed securities market and its regulation, the continuation of reforms in the payments and clearing system, including RTGS and netting and their accompanying legislation, and the modification of the clearing system for securities in order to meet international standards. At the same time, there should be continued planning of more long-term reforms.

The changes in the payments and clearing system should be completed.

#### **d. The reduction of poverty**

The reduction of poverty and the increase in social mobility require an economic policy that supports sustainable growth as described above. Additionally, a variety of measures need to be implemented as part of a long-term plan to reduce poverty among the poorest sectors of the population—low-salaried workers, the elderly, the ultra-Orthodox and the Arabs. These measures will assist in reducing poverty according to all measures.

A long-term plan is needed to reduce poverty.

Following are some of the steps required to reduce poverty:<sup>11</sup>

- Among the population of low-salaried workers and those who have difficulty finding employment, steps should be taken to increase their income in the case of the former and to improve the chances of finding employment in the case of the latter while tailoring the measures to the characteristics of the various sectors involved. These steps include reducing the number of foreign workers and making them more expensive to employ; expanding the coverage of subsidized daycare, increasing government subsidization of the children of low-salaried workers within existing and new frameworks, lengthening the hours of daycare, etc.; subsidization of public transportation for low-salaried workers and increasing its supply in

Steps should be taken to improve the chances of employment and the level of income among the population of working age with low earning ability.

<sup>11</sup> Some of these recommendations were formulated by a team put together for that purpose which included representatives of the Ministry of Finance, the Prime Minister's Office, the National Insurance Institute and the Bank of Israel.

high-unemployment areas; increasing earning ability and chances of employment through the expansion of vocational training programs and improving those programs together with the completion of basic education; and strengthening the enforcement of labor laws, in particular the minimum wage law for all workers (including foreign workers) and among manpower agencies, along with increased penalties.

The policy of reducing the number of foreign workers should be implemented in earnest.

- The issue of foreign workers should receive more attention. Following a period in which the policy to reduce the number of foreign workers was implemented in relative earnest, this year was characterized by a slack in enforcement. The number of workers expelled from the country dropped significantly and, following two years in which the total declined, their numbers increased somewhat this year. The proposal by the government to increase the tax on foreign workers in agriculture and construction was approved but only in part. It is important to earnestly implement a policy to significantly reduce the number of foreign workers. A determined policy of enforcement should also be implemented among employers including the improvement in collection of fines which are currently ignored to a large extent. The number of permits issued for foreign workers in the various industries should also be reduced. The large-scale presence of foreign workers harms Israeli unskilled workers and increases wage differentials and poverty. The decrease in expelling illegal workers, despite the declared policy of the government, is not consistent with the goal of encouraging Israelis with a low level of education to seek employment. The importance of reducing the number of foreign workers increases as global production of goods, which are intensive in unskilled workers, shifts to countries with extremely low wages. With local production in these industries declining, the only alternative for the employment of unskilled Israelis is in activities that cannot be transferred abroad, such as construction, hotels and catering and cleaning services, all of which employ large numbers of foreign workers. The high availability of foreign workers at low wages also decreases the incentive to adopt new technology and thus harms productivity (a phenomenon that is particularly evident in the construction industry).
- It is recommended that assistance be provided for business development in areas with large Arab or ultra-Orthodox populations. In addition, changes should be made in the Law for the Encouragement of Capital Investment in order to increase its effectiveness in encouraging employment in the periphery. This could be done by, for example, creating a connection between the size of the grant and the increase in employment.
- The seniority increment in the payment of old age pensions should be made more progressive and priority for long-term care benefits should be given to those who need it most, both according to level of functioning and level of income. It should be mentioned that already in 2005, the income supplement payments were increased for the elderly who have no income beyond the old age pension (which itself was increased by 2.5 percent).

The Law for the Encouragement of Capital Investment should be made more effective in increasing employment in the periphery.

Modifications are needed in old-age and long-term care benefits.

- Additional measures need to be taken with respect to welfare benefits. Thus, the conditions for eligibility for unemployment benefits should be eased (the period of eligibility and the period of NII contributions) in order to increase the ability of the unemployed to find appropriate employment. It is recommended that some of the National Insurance payments should be indexed to the median wage rather than the CPI.
- In order to improve equality of opportunity and social mobility in the long run, the pre-compulsory kindergarten education system should be expanded and additional improvements should be made in the allocation of resources in elementary education in favor of low-income populations. It is recommended that the provision of hot meals to school children be expanded (for further discussion, see Chapter 8).

The indexation mechanisms of some benefits should be changed.

Pre-compulsory and elementary education should be improved.

#### *Earned Income Tax Credit (a “negative income tax” system)*

Poverty among families with a wage earner has grown in recent years. Therefore, the institution of a negative income tax system,<sup>12</sup> similar to those which have been adopted by several developed countries, is recommended in Israel. This measure is consistent with the policy of encouraging a transition from “welfare to work”. The principal advantage of this system is the increased potential for reducing poverty<sup>13</sup> among families with wage earners while encouraging entry into the labor market (and discouraging exit). Following are the main characteristics of the desired system as formulated by the committee which discussed the establishment of a negative income tax in Israel:<sup>14</sup>

A “negative income tax” should be instituted to reduce poverty among families with wage earners.

- The grant should be dependent on the level of combined income of both spouses and on family status (eligibility only for parents of children) in order that the cost of the program be consistent with the budget targets for coming years and in order to significantly reduce poverty among working families.
- Since the benefits are intended for workers, a threshold should be determined below which the individual is not considered a worker (for example, below an earned income of NIS 1,500 per month). The reason for this is the difficulty in monitoring an individual’s actual number of hours worked. It should be mentioned that an individual who is employed for 20 hours per week at minimum wage will

<sup>12</sup> The more accurate term is the Earned Income Tax Credit system. Recall that a negative income tax system as suggested by the economist Milton Friedman does not distinguish between those who are employed and those who are not. In the system being proposed for Israel, only the income of the employed is subsidized.

<sup>13</sup> This system, which could be implemented with a budget of NIS 1.3 billion, would raise about 16 percent of working families above the poverty line. See A. Brender and M. Strawczynski (2005), “Characteristics of an Optimal Negative Income Tax System in Israel in View of the Characteristics of Labor Supply and the Incidence of Poverty among Individuals with Low Earning Potential”, Discussion Paper 2005.07, Bank of Israel, Research Department.

<sup>14</sup> The committee included representatives of the Ministry of Finance, the National Insurance Institute and the Bank of Israel.

earn about NIS 1,500 per month and there are very few families in which the main breadwinner earns this amount at a high wage per hour (according to the Survey of Income).

The payment should be made directly from the government to the worker.

- It is important that in implementing the program, the payment should be made directly from the government to the worker rather via the employer. The annual cost of the required mechanism is estimated in the tens of millions of shekels. In order to preserve the integrity of the program, it is desirable that the tax authority or the National Insurance Institute receive a periodic reporting from employers which will include the Identification Number of the workers receiving the tax credit. It may be worthwhile to request that recipients of the benefit fill out a short request form in which they verify the information on their wages. Other household income (such as financial income, rental income, etc.) can also be taken into account but these criteria are not commonly used in the granting of other welfare benefits. Although the inclusion of these criteria would be justified, their practical significance in the suggested program would be very small and therefore would not be worthwhile from a cost-benefit viewpoint.

#### e. Infrastructure and increased competition

In addition to increasing supply, in some infrastructures demand should be restrained.

An appropriate level of infrastructure is essential to the proper functioning and growth of the economy. In recent years, large amounts have been invested in the expansion of infrastructure and a number of reforms have been implemented to increase competition in its provision. These reforms should be continued in a number of areas. In some of the infrastructure sectors, such as roads, electricity and water, there should be an effort to restrain demand and not just to increase supply, in order that users bear at least part of the cost of the negative externalities that they are causing.

In recent years, significant investments have been made in roads and recently the government approved a long-term program for additional investment in inter-urban highways. However, the expansion of the road infrastructure alone will not solve the problem of overcrowding and it involves not insignificant externalities (air pollution, use of limited land resources, etc.). Therefore, it is important to give unambiguous priority to encouraging public transportation. Recently, there has been significant investment in the public transportation infrastructure, including the long-term development plan for Israel Railways and the program to establish light rail systems in Jerusalem and Tel Aviv. It is important that the expenditure on establishing the light rail systems be part of a long-term plan. Apart from the investment in infrastructure, the use of public transportation should be encouraged through the reduction in the price of its use and the improvement in its service. The reform of bus service is currently being implemented in which concessions for operating bus lines, which until now were under the control of Egged and Dan, are granted to additional companies. According to the Ministry of Finance this has brought about an improvement in frequency and a drop in prices. However, the government collects royalties in exchange for concessions which

Priority should be given to encourage public transportation.

are equivalent to a distortionary tax on users of public transportation. It is important that tenders focus on the improvement in service and the reduction in prices rather than on the level of royalties paid to the government.<sup>15</sup> With the improvement in the public transportation system, the price of traveling in a private vehicle during peak hours should be increased through an appropriate levy, the restriction of the supply of parking in city centers, etc. The distortion in the tax system, according to which the marginal cost to those driving a company car is zero, should be eliminated.

The airline industry in Israel is not open to unrestricted competition. The low level of competition has a negative influence on the welfare of the Israeli consumer and the number of incoming tourists. Therefore, the government should act to expand competition in the industry though this should be done with caution. (For more detailed discussion, see Box 2.5 in Chapter 2.)

Competition in the airline industry should be expanded, but with caution.

The reform of the electricity industry has not made any progress. The activity of the Israel Electric Corporation has not been divided among separate companies for production, transmission and distribution<sup>16</sup> although the date set for this to happen has passed. In order for the Israel Electric Corporation not to be in a position in which it is producing without a concession, it was recently decided to extend it. Competition from private electricity producers is also problematic since the price of natural gas has recently increased, thus reducing the profitability of private electricity production. This year, the construction of an undersea and overland gas pipeline system continued. The expansion of the use of natural gas is of the highest importance since it is a relatively cheap and clean source of energy. It is also important to ensure a variety of sources of gas for Israel. The State has purchased the Israel Corp.'s share in the Oil Refineries company, thus enabling its breakup and sale in 2006.

The establishment of the Communications Authority has been delayed despite the government decision in this regard. The regulation of the communications industry through an authority rather than a government ministry is quite common in Western countries. In view of the concentration of ownership of telephony and broadcast infrastructure, an authority is needed which will better consider the overall picture since the regulation of one area has implications on others. The postal industry is gradually being opened to competition. Thus, following a partial introduction of competition in 2003, a large part of mass mail delivery, which was previously the exclusive domain of the Postal Authority, was opened to competition at the beginning of 2006. The Postal Authority became a government corporation from the beginning of 2006.

<sup>15</sup> In certain cases, the royalties to the government have been at the expense of service to passengers. For a detailed discussion, see the section on Transportation and Communications in Chapter 2.

<sup>16</sup> See Box 1.8 in the Chapter on "Output and the Principal Industries" in the 2004 Bank of Israel Annual Report.