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ECONOMIC DEVELOPMENTS AND MACROECONOMIC POLICY, 2003–2005

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A. ECONOMIC DEVELOPMENTS IN 2003

1. MAIN DEVELOPMENTS

In 2003, after two years of decline, economic activity stabilized, while domestic demand continued to contract and exports picked up slightly (this analysis relies on preliminary estimates and forecasts based on partial and incomplete data). GDP rose by 1.1 percent in 2003, and per capita GDP fell by 0.7 percent. Business-sector product expanded by 1.3 percent, significantly below its potential growth rate. Business-sector employment increased moderately, alongside a reduction in the number of hours worked per employee.

Domestic investment contracted by 11.4 percent and per capita private consumption continued to fall. Exports rose moderately, on the other hand, after falling for two years, with a marked improvement in the current account, which was in surplus for the first time in many years. The unemployment rate continued to rise, reaching 10.7 percent of the civilian labor force in 2003. A by-industry analysis of activity shows that most business-sector industries contracted, and only financial industries and commerce grew. Alongside the moderate economic activity of the business sector, public-sector activity declined in 2003, in contrast with 2002: public-sector consumption dipped moderately and employment in the public services expanded slightly.[1]

The CPI (Consumer Price Index) fell by 1.5 percent in the first nine months of 2003, and its overall increase for the year as a whole is expected to be below the lower limit of the price stability target (1 percent). The marked slowing in the rate of price increases reflected the notable local-currency appreciation—expressing the response of the markets to the reduction of uncertainty after the conclusion of the war in Iraq, the approval of the US government's loan guarantees, and the structural fiscal measures announced by the government in its economic package. In addition to the fiscal measures, the Bank of Israel adopted a cautious monetary policy, which served to bolster price and financial stability, particularly in view of the considerable uncertainty in 2003:I. All these measures led to a decline in nominal short-term yields, in real long-term yields, and in the inflation and price environment.

Developments in 2003 should be reviewed in the context of the continued impact of two major forces which had also been in effect in the previous two years—the continued security uncertainty, currently in its third year, hampering the recovery of domestic demand (especially consumption and investment), and the relatively slow rate at which world trade and the demand for high-tech

[1] In addition to public-sector employees, employment in the public services also includes private-sector employees in the public services, such as education, health, and welfare. Payment for a considerable part of private-sector activity in these spheres is via the public sector, however. Additional bias in the number of public-sector employees stems from the fact that some of them are employed via private employment agencies, and are hence ascribed to the business services industry.

products is recovering. In addition to these external factors, the moderate level of activity in 2003 was due to fiscal policy, which remained tight on the expenditure side, and to monetary policy, which served to reinforce price stability while maintaining financial steadiness, against the backdrop of the marked deviation of the government deficit from its pre-set path. Note, however, the offsetting and positive impact of real depreciation (by 7 percent)[2] in 2002 and at the beginning of 2003 on the expansion of exports and improvement in the balance of payments current account.

As stated, the moderate growth rate in 2003 reflects a 1.3 percent decline in domestic demand (estimated from domestic uses), and 2.9 percent expansion of world trade, which serves as a proxy for the increased demand for exports. Exports did not rise more significantly because there was no clear-cut recovery in global demand for high-tech products, which account for a large share of Israel's exports, and also because the terms of trade deteriorated and two components of export demand—tourism and exports to the Territories—continued to decline as a result of the security situation. The deterioration in domestic demand encompassed its salient components, expressing primarily the persistence of security uncertainty (except for a brief hiatus in the middle of the year) and the lower rate of expansion of public expenditure. Additional factors hampering the recovery of private consumption were the decline in the real wage and cuts in transfer payments.

As regards the composition of uses, there was a marked rise in domestic investment in 2003 and a continued decline in per capita private consumption; the reduction in investment, whose share of GDP has contracted consistently in recent years, encompassed most of its components, mainly as a result of the persistent security uncertainty, and was also due to the relatively high level of real long-term interest (at the beginning of the year) and the high short-term interest rate, which caused investment to be deferred. Per capita private consumption was down by 0.6 percent—after a 1.9 percent decline in 2002—due to a marked 6.4 percent drop in the real wage, further to the 2002 trend of a rise in unemployment and assessments that the recession would not be short-lived. Nondiamond exports rose by 2.3 percent in 2003—after falling in the two preceding years—due to the mild recovery of world trade and the real depreciation evident mainly in 2002.

Inventory levels were down in 2003 from 2002, in manufacturing and commerce as well as in startups.[3] This fall was due *inter alia* to the continued recession, which caused firms to sell off stocks—without any appreciable expansion of production. The reduction of inventories was also in part the result of the rise in real short-term interest, which increased the relative cost of holding stocks.

The government adhered to fiscal discipline on the expenditure side in 2003; on the income side two kinds of statutory changes were made, serving to increase taxes to some extent. Nonetheless, government revenues were considerably below the levels assumed in the budget, so that the deficit grew. An expression of the greater restraint on the expenditure side in 2003 can be found in the growth rate of public consumption, which fell from 5.7 percent in 2002 to 0.1 percent in 2003. The slowdown encompassed both defense and civilian consumption, the latter growing by only 0.3 percent in 2003, compared with 3.3 percent in 2002. The cuts in the government budget led to a decline of about 0.5 percentage points in the share of public expenditure in GDP, after this had risen

[2] Calculated as the difference between the rise in export prices and in the GDP deflator.

[3] A similar picture is obtained from a long-term view of the relation between the change in inventory and business-sector product.

by a total of over 4 percentage points in the previous two years. The cuts in the government budget were expressed in purchases and wage payments, and were particularly prominent in transfer payments, which fell by 0.5 percentage points. This was due mainly to legislative changes, which reduced national insurance benefits, especially unemployment benefits.

In 2003, as in 2002, the government had to introduce an economic emergency package because the, deficit swelled far beyond the 3 percent of GDP target set in 2002. Even after adopting measures intended to reduce expenditure, the deficit in 2003 will be far beyond the level originally forecast, and the government debt/GDP ratio will rise to 105 percent, compared with 102.2 percent at the end of 2002. The general government deficit is expected to be over 6.3 percent of GDP in 2003, so that the public debt/GDP ratio will grow from 105.2 percent at the end of 2002 to 108 percent in 2003. In the framework of the economic package, the government has also adopted far-reaching reforms in 2003, with a long-term effect on its expenditure and deficit. These include reforms in national insurance benefits and pension funds, preventing further growth in public services employment, and the acceleration of income-tax reform. Several measures were introduced in 2003 regarding direct and indirect taxes and which will remain in effect until the end of the year. Among these was the reinstatement of the ceiling on national insurance and Health Tax payments, on the one hand, and the extension of the period in which the increase of VAT to 18 percent remains in effect, on the other. In addition, the government decided to accelerate the reduction of income-tax rates in the†framework of the tax reform. Note that the (cumulative) statutory tax rate has risen by 0.7 percent of GDP in the last two years, hampering the ability of the economy to return to sustainable growth.

The unemployment rate continued to rise, from 10.3 percent of the civilian labor force in 2002 to 10.7 percent in 2003 (279,000 unemployed persons). At the same time the participation rate increased, accelerating the labor-force growth rate, so that the employment rate remained unchanged. In 2003, in contrast with 2002, the contraction in labor input encompassed both the business sector (down by 0.6 percent) and the public services (down by 0.7 percent). In both sectors labor input was reduced by cutting the number of hours worked per employee, while the number of persons employed rose slightly, by about 1.5 percent. Reducing the number of hours worked is a predictable response on the part of employers in a time of uncertainty regarding the length of the recession. The continued slump in the labor market was expressed not only in the slower rate at which new employees found work, dismissals, and the reduction of the number of hours worked per employee, but also in the longer period spent looking for work (an indicator of the depth of unemployment).

Government policy acted to dampen the expansion of public-services employment in 2003, both by restricting the possibility of taking on new employees and by making changes in the pension arrangements, which stimulated the retirement rate. As regards the composition of employment, for the first time the number of foreign workers fell substantially, alongside a moderate increase in the number of Palestinian workers and 2 percent rise in the number of Israelis employed. The reduction in the number of foreign workers stemmed from the implementation of the government's decisions in 2002 to curtail the number of permits issued for employing foreign workers, enforce the law more vigorously, impose penalties for employing workers without permits, and make these workers more expensive to employ. The reduction in the number of foreign workers has contributed markedly to expanding the employment of Israelis, illustrated by the fact that an additional 11,500 Israelis have found employment in construction despite the slump in the industry.

The real wage per employee post, which dipped by 6 percent in 2002, continued to fall in the first seven months of 2003 by a steep 5.5 percent relative to the equivalent period in 2002—by 4.9 percent in the business sector and 6.6 percent in the public services. This reflected mainly the notable 3.1 percent drop in the nominal wage due to the persistent recession and decline in demand. Fiscal restraint, the wage reduction due to the ‘growth stimulation package’ (tax), and the deferment of various payments in the framework of the economic package caused public-sector wages to decline.

The balance of payments current account, which has been in deficit since 1990, was in surplus of almost $ 1 billion in 2003. The improvement reflects the expansion of exports (by $ 2.2 billion) while imports remained virtually unchanged (an increase of only $ 0.3 billion). An analysis of saving and investment shows that the current account surplus expresses a marked decline in the investment/GDP ratio (2 percentage points), which was greater than the fall in the national saving rate (both public and private). Goods exports appeared to recover in 2003, after declining sharply in the previous two years. This development expressed the stability of high-tech exports, in view of the failure of global demand for these products to rally substantially, and an increase in the exports of the mixed and traditional industries supported by the marked real depreciation evident since 2002. Services exports (in current dollars) were up by about 4 percent over 2002, but their level was still 25 percent lower than in 2000, expressing the continued deep crisis in tourism and decline in software and R&D exports (although less steep than in the previous two years). As stated, the continued recession was expressed in the stability of both goods and services imports. With regard to capital flows, direct and portfolio inward investment by nonresidents amounted to $ 2.5 billion in the first eight months of 2003, while investment abroad by residents in that period amounted to a mere $ 0.3 billion. The approval of the US loan guarantees reinforced the government’s ability to borrow abroad, precluding the need to borrow domestically in order to repay its debts abroad.

The CPI declined by 1.5 percent in the first nine months of 2003, and its annual rate is expected to be below the lower limit of the price-stability target (1 percent). The fall in prices in 2003 stemmed from the significant local-currency appreciation during the year, which contributed to the CPI in the short term¨ whether directly via the housing item or indirectly by affecting the prices of other items. In the background conditions of monetary developments in 2003, there is a marked difference between the first three months of 2003 and the rest of the year. The first few months were characterized by an economic environment of considerable uncertainty related to expectations of war in Iraq, the general election, and the establishment of a new government whose commitment to keeping the deficit down was not yet clear. In March, with the announcement of the government’s economic emergency package, the approval by the US government of the loan guarantees, and the (temporary) resumption of the peace process, followed by the speedy conclusion of the war in Iraq, uncertainty abated in the markets, as expressed by principal indicators such as inflation expectations, yield curves, and Israel’s risk premium. The Bank of Israel’s monetary policy responded appropriately: in 2003:I the interest rate remained relatively high, and subsequently, as the economic environment became clearer and the risk premium declined, the central bank steadily reduced the interest rate. Assuming that the appreciation will not persist, and that moderate depreciation might even be expected, the inflation rate in the next twelve months should return to within the target of price stability (1–3 percent).

The General Share-Price Index rose by some 37 percent from the beginning of the year to the end of September, expressing a continuous rising trend between February and July 2003, after declining in 2002 and at the beginning of 2003. The rise in domestic share prices was consistent with the trend in the US stock market, and went counter to the persistent recession in Israel. Daily turnover expanded from an average of about NIS 70 million at the beginning of 2003 to NIS 500 million in the middle of the year, later falling to about NIS 250 million. There also appears to be a mild rally in investment in ICT (Information Communication Technology) in 2003, after this had declined since the end of 2000.

2. PRIVATE CONSUMPTION AND GROSS DOMESTIC INVESTMENT

Private consumption rose by 1.1 percent in real terms (a per capita decline of 0.6 percent) in 2003. There was a particularly sharp drop—4.8 percent—in per capita purchases of durable goods, further to the 10.6 percent fall in 2002. The contraction of private consumption reflects the ongoing and marked fall in wages for the second consecutive year, the continued rise in the unemployment rate, and the public’s†realization that the factors responsible for the recession will persist, so that emergence from it will be slow and gradual. The contraction in consumption which began in the second half of 2003 was also due to the sharp cuts in national insurance benefits. On the other hand, the reduction in income tax, in the framework of the reforms in this sphere, offset some of the factors contributing to the contraction of consumption.

Gross domestic investment declined by a steep 11.4 percent in 2003, continuing its 12.4 reduction in 2002. Total domestic investment *less* inventory reduction (fixed investment) fell by 2.7 percent, further to the 9.2 percent contraction in 2002. This decline reflects *inter alia* a 4.5 percent reduction in investment in structures, against the backdrop of the continued slump in the construction industry. Investment in transport as well as in ships and aircraft plummeted, while that in machinery and equipment rose (by 3.4 percent), primarily in two industries—electricity and mining and quarrying. The local-currency appreciation during the year may have made purchases of imported equipment more worthwhile. Investment in the principal industries, excluding ships and aircraft, declined by 1.6 percent in 2003, after falling by 7.3 percent in 2002.

Residential investment declined moderately (by 1.2 percent), after falling steeply for several years. The fact that the decline in residential investment was checked expresses the stabilization of building starts, in view of their low level in 2002. The relatively high real interest on mortgages, especially at the beginning of the year, also appears to have hampered the recovery of demand in the industry. In addition, the slowdown encompassed investment in intangibles (software), which dipped by 1 percent, continuing the 2.8 percent decline in 2002. There are two main explanations for the contraction of investment in 2003: 1. The continued security and economic uncertainty in the wake of the terrorist attacks in Israel and the global slowdown; 2. The relatively high level of real long-term interest (at the beginning of the year), which served to reduce investment, as well as of real short-term interest, which impelled firms to postpone investments. In this connection, we undertook an updated simulation of the effect of real short-term interest on business-sector investment,[4] and found that about 0.6 percent of the 3.5 percent decline in gross business-sector investment stemmed from the rise in real short-term interest.

3. FISCAL DEVELOPMENTS

In 2003, as in 2002 the government had to introduce an economic package because the deficit had exceeded by far the target of 3 percent of GDP determined in 2002. The deficit grew because actual revenues (from taxes and other sources) did not increase as fast as expected at the time the budget was prepared, whereas expenditure was in line with the budget. The economic package included marked changes in national insurance benefits and the pension funds, a nominal freeze (anchored in the government's decision) on some government ministry budgets for the coming years, a check on the expansion of public sector employment, temporary wage cuts in the public sector, and the accelerated implementation of income-tax reforms—which could help to make Israel more competitive provided it is accompanied by an equivalent reduction in expenditure.

Although the economic package moved the course of the expected deficit to a significantly lower level than before, it is still expected to be far beyond the level originally forecast and 2 percent of GDP higher than in 2002 (on the basis of uniform definitions),[5] This obtains even though the real GDP growth rate is in line with the forecast, and the aid received from the US government is substantially higher than planned. As a result of the expansion of the government deficit in 2003, the government debt/GDP ratio at the end of the year is expected to reach 105 percent, compared with 102.2 percent at the end of 2002. The general government deficit is also expected to expand appreciably in 2003, to over 6.3 percent of GDP, so that the public debt/GDP ratio will rise from 105.2 percent at the end of 2002 to 108 percent at the end of 2003. The economic package will prevent the deficit from exceeding 6 percent of GDP, and some of the measures are even expected to help to reduce government expenditure and the deficit in the coming years, provided they are implemented as planned.

The cuts in the government budget led to a reduction of about 0.5 percentage points in the public expenditure/GDP ratio in 2003, after this had risen by 4 percentage points in the preceding two years. The public consumption/GDP ratio contracted by over 0.5 percentage points, mainly due to the reduction in wages per hour worked, which fell by about 4 percent in nominal terms, but also because the rapid growth of public sector employment was checked. The number of hours worked in that sector rose by only 0.4 percent in 2003, compared with an average annual growth rate of 3 percent in the previous two years. The share of defense consumption in GDP continued to increase in 2003, primarily due to the rise in domestic purchases and labor input, some of which was offset by the reduction in defense imports and wages. The share of transfer payments in GDP also fell by about 0.5 percent in 2003, largely because of the change in legislation, which cut national insurance benefits. Particularly notable is the real 37 percent fall (over NIS 1 billion) in unemployment benefits, due to stricter eligibility requirements.

[4] Y. Lavi (1990), "The Effect of Interest Rates on Nonresidential Investment in Israel's Business Sector, 1962–1988" *Economic Quarterly* 143 (Hebrew). In the simulation the sample was updated to 2003, and unindexed short-term local-currency interest was the relevant interest rate for 1986–2003.

[5] As of 2003 government investment in the railway is not recorded as budgetary expenditure (see Chapter 2 below).

The tax burden eased somewhat in 2003, mainly because of the sharp drop in income-tax receipts, reflecting the effect of the recession and, to a lesser extent, the tax reform. Indirect taxes also declined, due chiefly to the sharp drop in imports of durable goods in the first half of the year. VAT receipts also fell in 2003, despite the hike in this tax in mid-2002, the full effect of which was expressed in 2003. National Insurance Institute revenues increased in 2003 as a result of the hike in employers' contributions in mid-2002 and the annulment of the ceilings on these contributions. Nevertheless, the reinstatement of these ceilings in the summer of 2003 has caused revenues to fall†since August. All in all, the statutory tax rate has risen by 0.7 percent of GDP in the last two years, and this will impair the ability of the economy to return to sustainable growth once the external and internal shocks have passed.

4. THE LABOR MARKET

The protracted recession led to further slackness in the labor market: the unemployment rate continued to rise, reaching an annual average of 10.7 in 2003, with a steep increase in both the number and share of persons unemployed for a long time. Labor input in the business sector fell by 0.6 percent, and the wage per employee post contracted for the second year in succession, in both real and nominal terms. The adjustment of the labor market to the economic situation encompassed both the business and the public sectors but, in contrast with the past, the adjustment in the public sector was more extensive. The slack labor market was also expressed in labor unrest in the public sector.

The participation rate in the civilian labor force rose to 54.3 percent, *inter alia* because of the persistence of the long-term trend rise in the female participation rate due to the need for additional income because of the continued recession, reduction in wages, and fall in benefits. The higher participation rate explains almost all the rise in the unemployment rate in 2003, and in fact the employment rate, defined as the proportion of working-age persons (aged 15 and older who are employed) in the general population, remained stable at 48.5 percent.

In 2003, in contrast with 2002, the contraction of labor input (including Palestinian and foreign workers) encompassed both sectors: the business sector (by 0.6 percent) and the public services (by 0.7 percent). In both sectors labor input was reduced by cutting the number of hours worked per employee, while the number of persons employed rose, albeit by a modest 1.5 percent. Business-sector employment increased after declining in the previous two years, when employment in the public services expanded considerably (surpassing the growth rate of the civilian labor force), as employment in the latter sector tends to soar at times of slack demand for labor and rising unemployment in the business sector. The government spending cuts led to the cessation of this trend in 2003, by checking incremental employment and altering pension arrangements, thereby serving to accelerate the retirement rate.

The shifts in employment in the principal industries, in both the business sector and the public services, were not uniform: public-services employment fell in public administration but expanded in education and health, while in the business sector labor input in manufacturing and construction contracted markedly but grew in banking and insurance and in business services.

As regards the composition of business-sector employment, the number of foreign workers fell sharply (by 30,000), alongside an increase in the number of Palestinian workers (2,500) and a

30,000 rise in the number of Israelis employed (2 percent). These developments were affected to a great extent by the steps taken by the government since the end of 2002 in order to reduce the number of foreign workers in Israel,[6] among them reducing the number of permits issued to foreign workers, enforcing the law more strictly, and making it more expensive to employ foreign workers (imposing an employers' tax of 8 percent).[7] The reduction in the number of foreign workers appears to have been among the factors contributing to the expansion of employment of Israelis in 2003. This is evinced, for example, in the marked rise in the employment of Israelis in construction, an industry whose activity contracted in 2003. The number of Israelis employed in construction was up by 11,500, an increment that explains 40 percent of the rise in the number of Israelis employed in the business sector as a whole. The substitution of foreign workers by Israelis is also evident in the household services industry.

The moderation of economic activity also impacted on wages. The real wage per employee post, which fell by 6 percent in 2002, continued to contract in the first seven months of 2003, and was down by 5.5 percent—4.9 percent in the business sector and 6.6 percent in the public services (this served to reduce the gap created in 2002 between the two sectors as regards the rate at which wages were eroded[8]). The reduction in wages reflects the 3.1 percent cut in the nominal wage and the increase in prices (relative to the equivalent period in 2002). In the business sector the nominal wage fell for the second consecutive year, but in 2003 the decline was steeper and was accompanied by a slight increase in labor productivity. The fall in wages encompassed all industries and, in contrast to the past, did not stem from a change in by-industry composition. The most marked decline in wages was in construction, banking and insurance, and business services. In construction the decline in wages reflected mainly the slump in the industry as well as the fall in the wages of foreign workers (which are denominated in dollars), due to the local-currency appreciation and decline in the average wage of Israelis, because new workers entered the construction industry, where wages are relatively low. Some of the decline in wages in banking and business services is explained by the shift in the composition of employment due to the entry of new employees, whose wages are lower than those of veteran employees who have retired.

In the public sector the decline in wages derived from the economic situation and the tight fiscal policy. The measures adopted included deferring payment of recuperation allowances, amounting to over NIS 1 billion, from June 2003 to January 2003, imposing wage cuts in the framework of the economic emergency package, and postponing the Jubilee Grant, amounting to NIS 200 million, from September 2003 to 2004.

5. THE BALANCE OF PAYMENTS

For the first time since 1990, the balance of payments current account was not in deficit in 2003, showing a surplus of $ 0.9 billion. This is a consequence of the continued recession, which prevented

[6] Additional measures intended to increase employment of Israelis were contained in the recommendations of the Tamir Committee, but these have not yet been implemented.

[7] Even after the imposition of this tax, the cost of employing a foreign worker is 65 percent that of a blue-collar Israeli worker.

[8] As a result of changes in the tax system which went into effect in the course of 2003 the real net wage fell by less.

imports from expanding (and in real terms they even contracted somewhat), and of the slight increase in exports. From the standpoint of savings and investment, the transition from deficit to surplus in the current account expresses a decline in investment, incorporating a reduction of 2 percent of GDP in the investment/GDP ratio—exceeding the contraction in the national saving rate (both pricate and public). As regards capital flows, portfolio and direct investment in Israel by nonresidents amounted to $ 2.5 billion in the first eight months of 2003, while investment abroad by residents in the same period was only $ 0.3 billion. The approval of the US loan guarantees increased the ability of government to borrow abroad, thereby obviating the need to borrow in the domestic market in order to repay debts abroad. Note that the guarantees will also serve to finance the domestic deficit. The 7–10 percent real depreciation evident in 2002 was maintained in the first half of 2003. This development, due to various macroeconomic developments, helped to reduce the current account deficit.

There was some recovery in goods exports in 2003, after these had plummeted in 2001 and 2002. This expressed the stability of high-tech exports in the last two years, as well as a rise in the exports of mixed and traditional industries. The stability of the real exchange rate, after the sharp depreciation of 2002, contributed to the rise in exports. However, the slow recovery of global trade (serving as an indicator of global demand, including that for Israel's exports)—by 3.9 percent in 2003—hampered export growth. Exports of high-tech goods, which accounted for three-quarters of export growth in the second half of the 1990s, remained sluggish due to the continued slump in global demand for these products.

Services exports were up by 4.4 percent in 2003 over 2002, though their overall level was 25 percent lower than in 2000, expressing the deep recession in tourism and exports of software and R&D. Exports of tourism services declined by $ 200 million in 2003, due to the reduction in the number of foreign workers in Israel.[9] The number of hotel bed-nights of tourists was up by more than 15 percent over 2002, but was only 30 percent of its 2000 level. Exports of software and R&D services continued to fall in 2003 (according to data for the first six months of the year), although less steeply than in the preceding two years.

Goods imports rose by only 1.7 percent in 2003, and in effect remained stable for the second year in succession. On the basis of data for the first three quarters, imports of investment goods and consumer goods were down by 8 percent, and imports of durable goods fell by 12 percent. These trends, further to the significant decline in 2002, expressed the depth of Israel's recession and the view that it will not be short-lived. On the other hand, imports of factor inputs, which are used for current production, rose by 4 percent in the first three quarters of the year. Services imports remained unchanged in 2003.

Israel's terms of trade, defined as the relation between import and export prices (excluding diamonds, ships, and aircraft), deteriorated by 1.5 percent in the first half of 2003, reflecting the 3.8 percent rise in†import prices while export prices went up by 2.3 percent. In view of Israel's large trade deficit (excluding diamonds) vis-à-vis Europe,[10] compared with that vis-à-vis the US, the exchange-rate cross-rates affect Israel's terms of trade. According to a Research Department study

[9] Domestic expenditure by foreign workers is recorded as tourism revenue in the balance of payments.
[10] In 2002 the trade deficit vis-à-vis the EU was almost $ 5 billion.

of the relation between the euro-dollar exchange rate and Israel's terms of trade,[11] the strengthening of the euro against the dollar in the first half of 2003 by over 11 percent vis-à-vis the preceding six months contributed between 1.7 and 1.9 percentage points to the deterioration in the terms of trade.

The deficit in the factor inputs account (capital and labor) contracted by about $ 400 million in 2003 due to the reduction in the number of foreign workers in Israel, serving to cut the costs of importing labor services from abroad by $ 600 million.

Israel's country risk, measured as the gap between the required yield on Israel government dollar bonds traded in the US and that on US government bonds with a similar term to maturity, declined from the beginning of December 2002 to 2003:III. This trend was based primarily on the global trend of a lower risk premium on risky assets. In June, against the backdrop of the approval by the US government of the loan guarantees and the reduction of the risk premium, the government issued 'free'[12] 10-year bonds abroad in the amount of $ 750 million at 153 basis points above the cost of equivalent US bonds. In September the government utilized the first tranche of guarantees, $ 1.6 billion, and by the end of the year it expects to borrow up to $ 1.4 billion by means of bonds backed by US government guarantees. These borrowings exceed the government's debt-servicing needs, and are hence expected to help to increase the foreign-exchange reserves, and possibly to finance part of the domestic deficit

Nonresidents' portfolio and direct investment in Israel amounted to $ 2.5 billion in the first eight months of 2003, compared with $ 2 billion in the equivalent period of 2002. Total investment by nonresidents is still significantly below its level before the global crisis in the high-tech industry and the Intifada. Direct investment, which is highly concentrated, amounted to $ 2.7 billion in the first eight months of the year, while the repatriation of portfolio investment was $ 0.2 billion.[13] Direct and portfolio investment abroad by residents amounted to $ 0.3 billion in the first eight months of 2003, compared with $ 3 billion in the same period in 2002.

In July 2002 the Bank of Israel announced the cancellation of the Tier-2 reserve requirement on foreign-currency deposits—a gradual process which has been ongoing for ten months. This measure caused compulsory deposits in the Bank of Israel to be drawn down and about $ 1 billion to be transferred abroad in the second half of 2002; another $ 1 billion was transferred abroad in the first half of 2003. These amounts were recorded in the balance of payments as capital outflow of the banking system, despite the technical nature of the transfers.

Israel's surplus assets in debt instruments (negative external debt) continued to grow in the first half of 2003, and stood at $ 7 billion. This development reflected *inter alia* a current-account surplus and excess investment in Israel by nonresidents over investment abroad by residents. Almost 80 percent of Israel's debt instruments—some $ 56 billion—are short term, compared with 40 percent of its liabilities, about $ 28 billion. Notwithstanding these data, which appear to indicate financial robustness, the banking system is still vulnerable because of the surplus of short-term liabilities, amounting to over $ 6 billion.

[11] Y. Friedman and H. Kaiser (2001), "The Effect of Changes in the Euro/Dollar Exchange Rate on Israel's Terms of Trade" (internal memorandum) (Hebrew).

[12] Without US government guarantees.

[13] About $ 1 billion of direct investment is in fact a transaction between nonresidents—the purchase of shares from financial investors by a single investor. This transaction did not affect total direct or portfolio investments by nonresidents, but did influence their composition.

6. PRICES AND MONETARY POLICY

The objective of monetary policy in 2003 was to bolster the price and financial stability attained after the sharp interest-rate hikes of mid-2002, and to attain the price stability target by means of as low an interest rate as possible, thereby fostering Israel’s economic recovery. The moderation of uncertainty regarding the background conditions in 2003:II, attesting to an improvement in the indicators of inflation expectations, made it possible to reduce the interest rate by a cumulative 3.5 percentage points in the first ten months of 2003.

The rate of price increases in 2003 is expected to be below the lower limit of the target of price stability (1 percent), largely because of the significant and exceptional local-currency appreciation during the year which supported a lower rate of price increases than that of long-term equilibrium. Assuming that the appreciation does not persist and that there may even be moderate depreciation, the inflation rate in the next twelve months should return to the range of the price-stability target (1–3 percent).

Even though the inflation target was undershot in 2003, it was not deemed appropriate to reduce the interest rate hastily. This would have caused the rapid erosion of the interest-rate differential between Israel and abroad, among other things, and could have undermined the stability of the financial markets, hampering recovery. The interest-rate reduction path reflects the various factors which monetary policy must take into account, including the fact that Israel is open to capital flows and the uncertainty that characterizes the wider economic environment. The gradual reduction of the interest rate reduces the risk of undermining price and financial stability, which would damage both real economic activity and the chances of recovery.

In August 2000 the government decided that the annual inflation target for 2003 would be 1–3 percent, a range defined as price stability. Since the inflation target is no longer defined in terms of the calendar year but rather in terms of the next twelve months, brief and temporary deviations in either direction are permissible. This approach obviates the need for sharp changes in the interest rate which could undermine stability, particularly since the ability of monetary policy to offset transient effects is anyway limited, because it exerts an influence via the various channels of activity with a lag.

Until September 2003 the CPI declined by 1.5 percent. In the last twelve months the CPI has fallen by 1.9 percent; it rose by 0.8 percent in the first quarter but the rest of the year was characterized by price reductions which amounted to 2.3 percent. The development of the CPI is affected to a great extent by the path of the exchange rate. This impacts on the prices of tradables, and of housing in the short run. Since the index of housing prices accounts for 20 percent of the CPI, exchange-rate shifts have a considerable influence on the general CPI. Adjusting for this item, the CPI has fallen by 0.6 percent in 2003. The low level of real economic activity served to moderate prices in 2003, too, but because there was no marked change in real activity from 2002 this cannot be considered to account for the slower rate of price increases than in 2002 (when the CPI rose by 6.5 percent, largely because of the effect of the rapid local-currency depreciation in the first half of the year). Prominent among the items of the CPI was clothing and footwear, the price of which continued to decline—by 7.9 percent in the last twelve months. Food prices rose by 1.2 percent, in contrast.

The difference in the background conditions of monetary developments in the first three months of 2003 and the subsequent period is notable: the first three months were characterized by an economic environment of considerable uncertainty with expectations of war in Iraq, the general election, and the subsequent formation of a new government whose commitment to maintaining the deficit was not yet clear. In March, with the announcement of the government's economic package, the approval of the US government loan guarantees, and the (temporary) revival of the peace process and, later, the rapid conclusion of the war in Iraq, the uncertainty in the markets abated, as expressed by the principal indicators—inflation expectations, the yield curves, the exchange rate, and Israel's country risk.

Inflation expectations for twelve months ahead, whose development is generally in line with that of the exchange rate, rose in the first two months of 2003 to above the upper limit of the inflation target range (3 percent), in view of the rapid local-currency depreciation at that time. From March, alongside local-currency appreciation, inflation expectations moderated, and since April they have fluctuated around the upper part of the target range. Private forecasters' predictions changed during the year, in accordance with expectations derived from the capital market. The development of expectations for longer terms, as derived from the capital market, was similar to that of expectations for a year, moderating†from about 4–6 percent at the beginning of the year to some 3 percent for terms of up to 3 years and 3.5–4 percent for longer terms in October. These levels do not deviate significantly from the upper limit of the target range of long-term price stability.

The development of long-term expectations reflects a decline in nominal and real yields. Nominal yields for the various terms have fallen by 3–4 percentage points since the beginning of 2003. The real yield was 5 percent for the short term (1–3 years) at the beginning of the year, and about 6 percent for longer terms. Since March the slope of the real curve has changed, with short-term interest rates exceeding the long-term ones, and a flattening of the curve. Since July the curve has been almost completely flat, at 4.5–5 percent. At the beginning of October the real long-term interest rate was below 4.5 percent—lower than the average of the last few years (except for the first half of 2002).

In view of the marked deviation of the government deficit from its target, the relatively moderate level of real interest rates and long-term inflation expectations may indicate that the public perceives the deficit as being dependent on a low level of economic activity, affecting government revenues¨ and to a lesser extent as a structural deficit, which will be problematic in the long run. This is particularly evident against the backdrop of decisions about long-term cuts in the framework of the government's economic package.

Israel's country risk, which was relatively stable at the beginning of 2003, began to decline in March, as the part played by some of the reasons for the uncertainty became clear, and in view of the general downward trend in the country risk of developing countries. This fell more steeply than the interest-rate differential created in mid-2002—to ensure the stability of the financial markets—thus leading to local-currency appreciation. Israel's credit rating has remained steady in 2003,[14] despite the expected deviation of the deficit from its target and the deterioration in the security and political situation in mid-2003. The activity of nonresidents was consistent with the development of the risk premium, and for most of the period constituted the major factor affecting the development of the exchange rate. At the beginning of 2003 nonresidents bought foreign currency, and from

[14] Until September.

February (until June), in view of the interest-rate differential between Israel and abroad, they bought large quantities of local currency. Residents bought foreign currency throughout most of the period.

The difference between the two periods described above—from the beginning of the year until February and from March onwards—found expression in the Bank of Israel's monetary policy. After continuous interest-rate hikes in mid-2002 amounting to a cumulative 4.5 percentage points, in view of the rapid local-currency depreciation, the key interest rate stood at 9.1 percent at the beginning of 2003. Just before January 2003 the Bank of Israel cut the interest rate by 0.2 percentage points, but in the context of the uncertainty that prevailed at the beginning of 2003, and especially apprehensions of a rise in the inflation environment, the Bank left the interest rate unchanged in February and March.

As economic uncertainty abated, expressed *inter alia* in the decline in inflation expectations, assessments were that it would be possible to attain the inflation target while reducing the interest rate. Consequently, the Bank of Israel reduced interest by increasing rates—ranging from 0.2 percentage points in April to 0.5 percentage points in July, August, and September. In October the Bank lowered the interest rate by 0.4 percentage points, and in November by another 0.5 percentage points, to stand at an (announced) rate of 5.6 percent. The real interest rate, calculated as the key interest rate *less* inflation expectations, which was 6–7 percent for most of the first half of 2003, fell to less than 5 percent in October, because the decline in expectations was more moderate than the reduction in the interest rate.

The M1 aggregate rose by only 4.0 percent in the last twelve months (up to September), in line with the rate of expansion throughout the first half of 2003, and by a considerably lower rate than in 2001 and the first half of 2002—over 15 percent. The moderate rate of expansion of the money supply was consistent with the low level of real activity and price stability, against the backdrop of the relatively high interest rate for most of the period. The broader M2 aggregate, which also includes interest-bearing unindexed local-currency deposits (excluding Treasury bills), expanded too, but only by a modest 2 percent. The share of short-term assets (up to three months) in M2 rose from about 85 percent in 2002 to 90 percent in 2003:III. Deposits in and indexed to the dollar rose by 7 percent in dollar terms in the last twelve months, but because of the local-currency appreciation their value in NIS terms fell by 0.6 percent.

The balance of total nondirected credit contracted by 1.9 percent in the last twelve months. This expresses the 5 percent reduction of credit denominated in and indexed to foreign currency (in local-currency terms),[15] because of local-currency appreciation—a moderate 4 percent rise in unindexed credit and a dip of over 4 percent in CPI-indexed credit. Although real economic activity has remained moderate for the third consecutive year, the contraction of credit in 2003 was notable after this had expanded by an annual 10 percent in the preceding two years. The decline in credit in 2003 expresses not only the effect of local-currency appreciation but also the cumulative impact of the recession on the ability and desire of firms to borrow in order to invest for future expansion. In addition, the risk banks ascribe to credit has risen as the recession continues, so that their readiness to extend credit has also declined.

From early 2003 to the beginning of October the government borrowed tradable debt in the amount of NIS 14 billion—all of it unindexed—from the public. The reduction of real interest

[15] In dollar terms this credit remained stable.

during the year supports the view that the government's request to increase the domestic debt has not created excess demand for sources of finance, in view of the moderate level of economic activity and decline in investment.

The General Share-Price Index rose by 37 percent from the beginning of the year until the end of September. This expresses a continued upward trend from February to July 2003, after a decline in 2002 and at the beginning of 2003. The rise in domestic share prices is in line with the trend in the US stock market, despite Israel's ongoing recession. Turnover increased from a daily average of about NIS 170 billion at the beginning of 2003 to some NIS 500 million in the middle of the year, later falling to about NIS 250 billion.

B. MACROECONOMIC POLICY

1. THE 2004 BUDGET: INITIAL ASSESSMENT AND IMPLICATIONS FOR THE DEFICIT AND DEBT PATHS IN THE MEDIUM TERM

a. The budget proposal and targets

The main macroeconomic targets set by the government in the 2004 budget include stimulating growth and increasing the employment rate among the disadvantaged sections of the population. The government also aims to make the public services more efficient by accelerating the computerization of ministries and introducing reforms that will reduce bureaucracy, especially with regard to land use and registration.

Government policy intended to move the economy to a sustainable growth path is based on reducing the share of the public sector in the economy, so that it will be possible to cut its financing needs and reduce the tax burden. In order to achieve these aims the government set a deficit target of 4.0 percent of GDP for 2004, and decided that between 2005 and 2010 its expenditure would not rise by more than 1 percent a year in real terms, and that the deficit in each of those years would not exceed 3.0 percent of GDP. It also decided to cut civil service employment in 2004 by closing departments and to reduce retirement costs. The latter will be achieved by lowering pension benefits and reducing the number of persons eligible for early retirement. The government also resolved to change the administrative structure of the sea-ports and make this important industry more efficient, as well as to boost investment in the railway infrastructure, which is vital for economic growth.

The stimulation of employment among the weaker segments of society is based on stepping up efforts to reduce the number of foreign workers—thereby increasing demand for Israelis—and reducing national insurance benefits while improving enforcement of the rules for eligibility, thereby increasing the participation rate. In order to enhance this process, the government also decided to subsidize the employment of persons from weaker sections of society in the labor market and to set up employment centers. If the program to establish employment centers is finally implemented in 2004—with an adequate budget and appropriate legal framework—this will make a significant contribution to the transition from welfare to work.

The process of preparing the 2004 budget involved the approval of over 120 decisions (some of which contained many important sub-sections) regarding the composition of the budget, as well as of various economic measures which the government has approved or intends to place before the Knesset for approval. A preliminary analysis of these decisions indicates that they will serve to reduce the budget deficit by about NIS 12 billion (Text Table 1). Excluding the effect of the decision not to reduce VAT (as the government promised to do when it raised it) to 17 percent, the other measures are expected to reduce the deficit by NIS 9.3 billion. In addition, the government has approved various resolutions which may also serve to cut the deficit, but lack of clarity regarding the intensity and timing of their effect, and even regarding the probability of their implementation, does not allow for their quantification.

Reducing the deficit involves cutting government spending by NIS 6.5 billion, NIS 4.2 billion of it across the board, and another NIS 830 million in defense budget cuts. Revenue is expected to rise by NIS 2.8 billion as a result of these decisions (about 30 percent of the total deficit reduction[16]), some NIS 1.6 billion of it due to one-off receipts from the transfer of motor vehicle insurance surpluses from government insurance companies to the government—albeit with the government's acceptance of these companies' future obligations. The measures included in the budget proposal are expected to increase the government's receipts from new tariffs and taxes by some NIS 700 million, alongside the gradual reduction of the stamp tax, at an annual cost of NIS 150 million. Government investment in the transport and water infrastructure (excluding the railway, see below) will fall by NIS 300 million in 2004, after apparently remaining unchanged in 2003. The stability of investment in 2003, despite decisions to increase it, and its decline in 2004 reflect the vulnerability of infrastructure investment to across-the-board budgetary cuts[17] and the government's decision to reduce public works implemented by the local authorities.

b. Other issues related to the presentation of the budget

The low level of reported investment in the transport infrastructure compared with previous years reflects *inter alia* an accounting change introduced by the government: because the railway is now a public-sector corporation, the government's investment in it is recorded as investment in the company's share capital and hence is not included in government expenditure.[18] Since the government's transfers to the railway are expected to amount to NIS 1.9 billion in 2004, and more than NIS 2 billion in each of the subsequent four years, this causes a marked downward bias in the deficit data. Furthermore, the government has decided to make the Public Works Department a public-sector corporation in 2004, making it possible to record some of the expenditure on the roads infrastructure in a similar way.

One problematic aspect of the proposed budget is the under-funding of the security fence, whose cost is expected to be high. On the basis of the government's statement about the importance of making rapid progress on it, this item embodies a significant threat to the budget framework, or will require a supplementary allocation in the course of the year. Although the budget contains a reserve enabling attainment of the deficit target, it is not sufficient to cover the expected cost of the fence and should in any case be kept for its original purpose.

Another aspect of the budget to which attention should be paid is the method of recording the budgetary cost of issuing government bonds backed by US government guarantees. Upon issue, a percentage of the receipts are transferred to the US government in order to cover the budgetary risk premium (scoring). The cost of issuing $ 3 billion is about NIS 1 billion, but most of this amount is

[16] About NIS 600 is a result of the decrease in child allowances, which will lead to an increase in government revenue due to the rise in the National Insurance Institute's surplus, which is transferred to the government. Adjusting for this item, the increase in revenue will account for 25 percent of the deficit reduction.

[17] This is due to the small share of wages and the effects of legislation on infrastructure investment—components to which across-the-board cuts do not apply.

[18] In accordance with national accounting rules, as opposed to the budget reporting method, these transfers are included in government expenditure.

not recorded as expenditure in the budget in the issuing year. In other words, upon issue, the government debt rises to the issue's full amount, but the budget resources increase by only that amount *less* the cost of scoring. Since the difference between the increase in the government debt and the issuance receipts is not included in government expenditure at the time the debt is created, there is a discrepancy between the deficit figures and the development of the debt.

c. Forecast of the deficit and the fiscal aggregates for 2004

The forecast development of the fiscal aggregates in 2004 indicates that the government deficit is expected to deviate from the target of 4.0 percent of GDP, according to both the macroeconomic scenarios presented below in Section C (Text Table 2).

In the optimistic scenario, the deficit is expected to reach 4.5 percent of GDP, down by 1 percent of GDP from 2003 but half a percentage point above the target. In the pessimistic scenario the deficit is expected to be just above 5.0 percent of GDP, slightly less than in 2003 and about 1.0 percentage points of GDP above the target. In both scenarios the contingency reserve intended to safeguard the deficit target will apparently be insufficient for that purpose, although in the optimistic one the deviation *less* the reserve is not great. The deviation from the deficit target is expected to be due to a shortfall of tax receipts from the budget prediction. This is because of the expected composition of growth—and especially the real wage freeze—and the tax reductions decided on in 2003, which will cause tax receipts to rise by less than the GDP growth rate. In the pessimistic scenario the GDP growth rate will be below the budget prediction.

The deficit in 2004 is expected to be smaller than in 2003 due to the forecast 1.8 percent real reduction in government expenditure. Moreover, net government expenditure,[19] excluding interest and repayment of principal to the National Insurance Institute, is expected to drop in real terms by almost 3 percent—an unprecedented amount since the Economic Stabilization Program of 1985. Concurrently, however, revenue is expected to fall significantly, primarily because of the smaller aid grant from the US government than in 2003, when it included a large sum due to the deferment of aid from 2002 and a one-off defense grant.

The relatively large deficit is expected to lead to a further rise in the government debt/GDP ratio. In the optimistic scenario, this ratio is expected to be 106.5 percent of GDP by the end of 2004, while in the pessimistic one it will be 108.7 percent of GDP. Note that the development of the debt/GDP ratio also reflects those components that are not included in the definition of the budget—government financing of investment in the railway and scoring costs (see above).

d. Forecast development of the fiscal aggregates in the medium term

According to the optimistic scenario for 2004–2005, and assuming that the economy will converge to full employment in the next few years,[20] the debt/GDP ratio is expected to stabilize at 106 percent of GDP, and to begin declining in 2007 (Text Table 3). This is based on the government's

[20] In other words, in 2006–2009 GDP will grow by 4 percent a year, and subsequently by 3.2 percent a year.

decisions regarding the freeze on public-sector wages and employment and regarding benefits, as well as on the long-term trends of revenue and expenditure.[21] Notwithstanding, this analysis does not reflect the government's decision to restrict the real annual rise in its expenditure to only one percent in 2005–2010. On the basis of the pessimistic scenario, the government debt/GDP ratio is expected to grow to over 111 percent in 2006 and to return to its end-2003 level only at the end of the decade. The optimistic scenario sees the government deficit declining to less than 3 percent of GDP only in 2007, while according to the pessimistic scenario this will happen only in 2008 or 2009. Nonetheless, on the basis of both scenarios the government expenditure GDP ratio is expected to contract significantly. An important factor underlying the slow decline of the deficit in both scenarios is the conclusion of the temporary wage reduction from mid-2003 to mid-2005 agreed on by the government and the General Federation of Labour, and the nonrecurring nature of the transfer of the motor vehicle insurance surplus in 2004.

The analysis of the scenarios also shows that the government decision to curtail the real annual rise in its expenditure[22] to only 1 percent from 2005—given a deficit target of 3.0 percent of GDP—will require a considerable budgetary adjustment towards 2005. While the expected growth rate of government expenditure in 2005, according to existing decisions, is not much more than 1 percent (Text Table 4) in order to attain a deficit of 3.0 percent of GDP expenditure will have to fall by 1 percent in real terms, according to the optimistic scenario. Moreover, the expenditure path expected on the basis of the decisions made by the government attests to a faster growth rate than the target set by the government, so that additional government decisions will have to be made in order to slow the growth rate to 1 percent.

Text Table 4 shows the implications of the government's decisions to cut the growth rate of its expenditure to 1 percent a year, as of 2005. The implementation of the decision will cut the deficit rapidly, leading to a budgetary surplus at the end of the decade, with a significant drop in the debt/GDP ratio (assuming that the government does not†reduce taxes or other revenues beyond its current decisions; this could be the case, given the new framework decided upon by the government, provided the deficit is less than 3 percent of GDP). In 2010 the government debt will be 90 percent of GDP according to the optimistic scenario, and 98 percent of GDP according to the pessimistic one. Alternatively, the government could ease the tax burden and slow the rate of debt and deficit reduction.

2. MONETARY POLICY

According to the government's 2000 decision, as of 2003 the inflation target is an annual 1–3 percent, defined as price stability. Consequently, the target of price stability is henceforth not based on a calendar year but is constant and continuous. Thus, the Bank of Israel acts to maintain price

[21] The calculation for the next few years is based on the long-term elasticity of the tax receipts/GDP ratio, which is 1.1. If the elasticity of revenues at the time of emergence from the slump is greater than long-term elasticity, the deficit may contract more rapidly. Thus, for example, elasticity of 1.5 in 2005 and 2006 could serve to reduce the deficit by about 1 percent of GDP from 2006 in the optimistic scenario. However, past experience indicates that there is a tendency to increase expenditure when revenues soar, so that the overall effect on the deficit could be smaller.

[22] Lacking the specifics of the government decision, we interpret it to refer to a real annual growth rate (deflated by the CPI) of 1 percent excluding interest and the repayment of principal to the National Insurance Institute.

stability at all times, while allowing brief, temporary deviations in either direction. Temporary deviations may occur as a result of shocks in fiscal policy, in the foreign-currency market, or in external factors such as prices abroad, which cannot be offset by monetary policy in the short run.

In 2003 the Bank of Israel acted to reinforce the price and financial stability attained after the sharp interest-rate hikes of mid-2002, by means of the lowest interest rate consistent with maintaining price and financial stability. The reduction of uncertainty in 2003:II with regard to the economy's background conditions, as well as the improvement in the various indicators of the expected inflation environment, made it possible to reduce the interest rate by a cumulative 3.5 percentage points by November.

The Bank of Israel will continue to act to maintain price stability in 2004 by setting an appropriate interest rate, while encouraging economic activity and a return to growth and maintaining the stability of the financial markets. According to current assessments, the rate of price increases can be maintained around the mid-point of the target range while the key interest rate is reduced. Nevertheless, external and domestic economic factors could jeopardize this, so that it is necessary to monitor and reassess the required interest-rate path closely and continuously. Responsible fiscal policy will aid monetary policy in attaining these aims. A policy posture that maintains price stability and reduces the threat to the stability of the financial markets is particularly important because of the increased vulnerability of the economy in view of the moderate level of activity and global financial crises.

Text Table 1
The Effect on the Deficit of the Measures in the 2004 Budget

(NIS million)

		2004
Total contribution to deficit reduction		11,848
of which Excl. cancellation of VAT reduction		9,348
Spending cuts		6,524
of which	Across the board	4,149
	Defense budget cuts	830
	Other	1,545
Additional revenues		2,824
of which	One-off transfer of motor vehicle insurance surplus	1,600
	Increase in tax receipts	294
	Cut in child allowances[a]	600
	Other	330

[a] The cuts in child allowances increase the National Insurance Institute surplus transferred to the government, hence its effect on the budget is recorded as an increase in revenues.

Text Table 2
Budgetary Aggregates, Assuming Full Implementation of the 2003 Economic Package and the 2004 Budget Proposal: 2000–2005

(percent of GDP)

				Forecast	Optimistic scenario		Pessimistic scenario	
	2000	2001	2002	2003	2004	2005	2004	2005
Total revenue (excl. credit)	**39.6**	**37.5**	**39.4**	**37.5**	**36.7**	**36.4**	**36.7**	**36.5**
Grants frrom abroad	2.5	2.1	3.1	3.1	2.4	2.2	2.4	2.3
Taxes[a]	31.6	31.1	30.3	28.9	28.6	28.6	28.6	28.6
Other revenue	5.6	4.3	6.0	5.5	5.7	5.6	5.7	5.6
of which Revenue used for contingent expenditure	2.3	2.2	3.0	2.6	2.4	2.3	2.4	2.4
National Insurance surplus	1.5	0.9	1.6	1.6	1.8	2.1	1.7	2.0
Other (royalties, interest, Lands Administration)	1.8	1.3	1.4	1.2	1.6	1.2	1.6	1.2
Total expenditure (excl. credit)	**40.3**	**41.9**	**43.2**	**42.9**	**41.1**	**40.4**	**41.8**	**41.4**
Defense, gross	9.5	9.9	11.5	10.7	9.7	9.3	9.9	9.5
Interest	6.0	5.9	5.6	6.6	6.7	6.6	6.8	6.8
Repayment of principal to National Insurance	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.3
Expenditure excl.repayment of principal to National Insurance and defense	23.8	25.1	24.9	24.4	23.5	23.3	23.8	23.8
of which Transport and water infrastructure (incl. transfer to municipalities)	0.8	0.9	1.1	0.9	0.8	0.8	0.8	0.8
Memorandum:								
Net expenditure excl. interest and National Insurance principal	31.0	32.8	33.4	32.5	30.8	30.2	31.3	31.0
Deficit excl. credit (–)	**–0.7**	**–4.4**	**–3.8**	**–5.5**	**–4.5**	**–3.9**	**–5.1**	**–4.9**
Incl. transfer to railway[b]	—	—	—	–5.7	–4.9	–4.3	–5.4	–5.3
Public debt (gross)[c]	91.4	96.8	105.3	108.0	109.4	109.1	111.6	113.7
of which Government debt	88.2	93.7	102.2	105.0	106.5	106.3	108.7	110.8
GDP (real change, percent)	7.4	–1.0	–0.9	1.1	2.4	3.3	0.8	2.0
Real change in expenditure, percent	5.8	5.0	1.1	0.3	–1.8	1.3	–1.8	1.1
of which Net expenditure excl. interest and repayment of principal to National Insurance	3.7	6.7	0.1	–1.8	–2.9	1.3	–2.9	1.0

[a] After 2004, if there is no legislative change other than the implementation of the tax reform; assuming that there is no reduction in VAT in 2005 either.
[b] As of 2003 government investment in the railway is recorded as ‘capital transfers,’ and hence is not recorded as government expenditure in the budget.
[c] Assuming that the debt of the municipalities remains at the same real level as at end-2002 throughout the period.

Text Table 3
Main Fiscal Aggregates: the Optimistic and Pessimistic Scenarios, 2002–2010

(percent of GDP)

	Actual	Forecast							
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total revenue (excl. credit)									
Optimistic scenario	39.4	37.5	36.7	36.4	36.3	36.5	36.9	37.1	37.3
Pessimistic scenario	39.4	37.5	36.7	36.5	36.3	36.5	36.9	37.1	37.3
Total expenditure (excl. credit)									
Optimistic scenario	43.2	42.9	41.1	40.4	39.6	39.4	38.7	38.4	38.0
Pessimistic scenario	43.2	42.9	41.8	41.4	40.7	40.5	39.9	39.6	38.9
Net expenditure (excl. interest and repayment of principal to National Insurance)									
Optimistic scenario	33.4	32.5	30.8	30.2	29.4	29.2	28.9	28.6	28.4
Pessimistic scenario	33.4	32.5	31.3	31.0	30.2	29.9	29.6	29.3	29.0
Deficit excl. credit (–)									
Optimistic scenario	–3.8	–5.5	–4.5	–3.9	–3.3	–2.9	–1.8	–1.3	–0.7
Pessimistic scenario	–3.8	–5.5	–5.1	–4.9	–4.4	–4.0	–3.0	–2.4	-1.7
Public debt (gross)									
Optimistic scenario	105.3	108.0	109.4	109.1	108.8	107.1	104.1	101.3	98.3
Pessimistic scenario	105.3	108.0	111.6	113.7	114.2	113.3	111.2	109.3	106.0
of which Government debt									
Optimistic scenario	102.2	105.0	106.5	106.3	106.1	104.5	101.6	98.9	96.0
Pessimistic scenario	102.2	105.0	108.7	110.8	111.4	110.7	108.6	106.8	103.7

Text Table 4
Main Fiscal Aggregates, at 1 Percent Annual Growth in Expenditure,[a] According to the Two Scenarios, 2002–2010

(percent of GDP)

	Actual	Forecast							
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total expenditure (excl. credit)									
Optimistic scenario	43.2	42.9	41.1	40.2	39.4	38.6	37.4	36.5	35.6
Pessimistic scenario	43.2	42.9	41.8	41.4	40.6	39.8	38.6	37.7	36.6
Deficit excl. credit (–)									
Optimistic scenario	–3.8	–5.5	–4.5	–3.8	–3.1	–2.1	–0.5	0.6	1.7
Pessimistic scenario	–3.8	-5.5	–5.1	–4.9	–4.3	–3.3	–1.7	–0.6	0.7
Public debt (gross)									
Optimistic scenario	105.3	108.0	109.4	109.0	108.5	106.1	101.8	97.3	92.1
Pessimistic scenario	105.3	108.0	111.6	113.7	114.1	112.6	109.3	105.6	100.2
of which Government debt									
Optimistic scenario	102.2	105.0	106.5	106.2	105.8	103.5	99.3	94.9	89.7
Pessimistic scenario	102.2	105.0	108.7	110.8	111.3	109.9	106.7	103.1	97.8
Memorandum:									
Percentage real change in expenditure according to existing decisions, optimistic scenario	1.1	0.3	–1.8	1.3	2.0	3.4	2.3	3.1	2.1
of which Net expenditure excl. interest and repayment of National Insurance principal	0.1	–1.8	–2.9	1.3	1.2	3.2	2.9	2.9	2.6

[a] The government decision to restrict the rise in expenditure in 2005–2010 to 1 percent is interpreted here as a real rise (deflated by the CPI) in net expenditure excluding interest and repayment of principal to the National Insurance Institute.

C. FORECAST DEVELOPMENTS IN 2004 AND 2005

a. General

After two years of acute recession, indications that economic activity was stabilizing emerged during 2003. The question is what rate of recovery can be expected in the near future? The answer depends on global economic developments and the political-security situation in Israel, as well as on economic policy.

In the wake of the considerable uncertainty of the last few years regarding the timing and pace of the positive shift in the global economy, a reasonably rapid rate of economic growth and the recovery of world trade is expected, according to recent assessments. However, this growth is not expected to be led by the high-tech industry, in which Israel's exports specialize, so that the growth rates which characterized these exports in the 1990s are not expected to†return.

The continuation of the terrorist attacks and the uncertainty surrounding the political process could hamper Israel's economic activity in the near future, too. Assuming, however, that there is no significant deterioration in the security situation, the incremental damage inflicted by the continuation of the Intifada is expected to abate.[23]

Taking the expected development path of the global economy and the political-security uncertainty in the Middle East into account, the macroeconomic forecast for the Israeli economy in 2004 and 2005 is presented in two scenarios, representing the reasonable range of developments. The difference between them derives from varying assessments of the intensity of the conflict with the Palestinians and global economic developments. Government policy, and especially its fiscal component, is the same in both scenarios.

The pessimistic scenario (Scenario A) is based on the assumption that Israel's background conditions—the security situation and the growth rate of global demand for high-tech products—will not facilitate emergence from the recession. In this scenario GDP is expected to grow by as little as 0.8 and 2.0 percent in 2004 and 2005 respectively. The optimistic scenario (Scenario B) assumes much better background conditions, supporting more rapid growth rates of 2.4 and 3.3 percent a year.

Recent developments indicate that there is a greater likelihood that the economic situation will be closer to the pessimistic scenario than to the optimistic one. In that case, in order to attain the deficit target of 4 percent of GDP in 2004 it will be necessary to make a fiscal adjustment in addition to that already made by the government, as the budget's contingency reserve intended for this purpose will not suffice.

b. Policy assumptions

As stated, fiscal policy is identical in both scenarios, but leads to different deficits (5.1 and 4.5 percent of GDP in 2004), as a result of distinct macroeconomic developments and tax receipts. The

[23] The economic damage due to the Intifada in 2002 is estimated at between 3.1 and 3.8 percent of GDP (Bank of Israel, *Annual Report 2002*, Box 1.1).

assessment of the effect of fiscal policy is based on the government's decisions, which include a fiscal adjustment of NIS 10 billion in 2004, as well as on its decisions regarding the 2005 budget: cuts in expenditure and transfer payments,[24] the cessation of the public-sector wage reductions implemented in 2003, completion of the reform of direct taxation, structural economic reforms, and measures to slash the number of foreign workers. The government's decision regarding 2005 and subsequent years limits expenditure to a one percent annual increase alongside a deficit ceiling of 3 percent of GDP. Note that even in the optimistic scenario the fiscal policy measures adopted to date are not sufficient to attain the deficit target in 2005.

The protracted recession of the last few years expresses not only the economic cycle but also the high price of the conflict with the Palestinians. The horizon of the conflict is not clear, and its cumulative deleterious effects are depleting Israel's resources, so that long-term national income is declining. This situation requires the downward adjustment of public expenditure in order to avoid a rise in the debt/GDP ratio in the long run. At present it is difficult to evaluate whether the economic policy proposed by the government embodies the required adjustment.

Both scenarios assume a significant rise in infrastructure investment, in line with the Bank of Israel's recommendations, about 10 percent in 2004 and 15 percent in 2005 (the increase being financed mainly by extra-budgetary sources), even though the government has not yet made decisions supporting this expansion. If the arrangements required for this investment are delayed, economic growth will be impaired.

The government decisions of the last two years (raising VAT to 18 percent, imposing an employers' tax, capital gains tax, etc.) increased the statutory tax rate. This was partly offset by the reduction of income tax on labor as part of the reform of direct taxes. Statutory tax rates are expected to decline in the next two years, however, as a result of the completion of the reform in direct taxation—and this will increase private consumption and stimulate the labor supply, helping the economy to come out of the recession.

Monetary policy will differ between the two scenarios, in accordance with macroeconomic developments. In Scenario A the need to finance a deficit which is above the target will raise the cost of capital, making it difficult for the Bank of Israel to continue lowering the short-term interest rate. Lack of improvement in the security situation will prevent the reduction of Israel's country risk, so that in this scenario both long- and short-term interest rates will be relatively high. Low demand and a high level of risk will generate real depreciation.

In Scenario B a lower deficit and decline in Israel's country risk will allow a further decline in long-term interest, preparing the ground for the continued reduction of the Bank of Israel's key interest rate, provided the financial markets are convinced of the government's determination to attain its long-term fiscal targets and reduce the debt/GDP ratio. Given tight fiscal policy and economic policy that does not utilize Israel's potential for economic growth to the full, the low interest rates will support real depreciation, stimulating domestic activity by increasing exports and reducing imports.

[24] The cuts in transfer payments will be expressed in a per capita decline of 4.5 and 2.7 percent in 2004 and 2005 respectively.

c. Scenario A

According to this (pessimistic) scenario, growth in 2004 will be extremely slow, in line with the 2003 growth rate: GDP will rise by 0.8 percent (a 0.9 decline in per capita GDP), and business-sector product by a meager 1.4 percent. The slow GDP growth rate expresses the effect of two opposing forces: the recovery of exports and the budgetary cuts, which will have a restricting effect in the short run. Despite the marked reduction in public spending, the deficit will overshoot the target, so that in spite of slow economic growth, long-term interest will not decline, hampering the recovery of investment.

Because of the high unemployment rate, fiscal restraint, decline in transfer payments, and pessimistic expectations of recovery, per capita private consumption and nonresidential investment will continue to decline, while residential investment will inch up. The growth rate of nondiamond goods and services exports will be below that of world trade.[25] This is because on the basis of this scenario the expansion of world trade will not be biased towards the high-tech industry, which dominates Israel's exports; tourism exports will not expand at all because of the security situation.

In view of the slow recovery, the utilization of factor inputs will increase, but labor productivity will be relatively low. Since the extent of unemployment will prevent wages from rising, the unit cost of labor will fall, and this will provide certain supply-side incentives for growth, to some extent offsetting some of the effect of the restrained aggregate demand.

Alongside the freeze in investment in fixed assets, we assume a slower decline in the rate of inventory investment, after the massive downward adjustment of its level in the last three years. As a result of these developments gross investment will increase and the current account deficit of the balance of payments will contract, alongside a rise in the national saving rate.

The slow expansion of the business sector and job losses in the public sector are expected to cause unemployment to rise. Under these conditions, the reduction in the number of foreign workers by 35,000, assuming that they will gradually be replaced by Israelis, will moderate the rise in the†unemployment rate, which will reach an average of 11 percent of the civilian labor force in 2004. The substitution between foreign and Israeli workers, the first signs of which could be seen in 2003, is supported by the reduction of the negative incentives to work through the reduction of transfer payments, and in particular the greater stringency of the conditions of eligibility for unemployment and income support benefits, as well as the cuts in the size of the benefits. In spite of the rise in labor productivity, the real wage will not increase, because of the expansion of unemployment.

The rate of economic recovery will accelerate slightly in 2005 due to the increase in demand for exports and the response to this of consumption and investment—a process which depends to some extent on the security situation. In 2005 the economy is expected to grow by 2.0 percent (up by 0.3 percent per capita), business-sector product by 2.8 percent, and exports by 6.4 percent. The rise in business-sector product will stem primarily from the improved utilization of factor inputs: labor

[25] According to the updated IMF forecast (September 2003), world trade will expand by 5.5 percent, while the imports of advanced countries, which are more relevant for Israel's exports, will rise by only 4.8 percent.

productivity will increase by about 2 percent, together with a slight rise in the number of persons employed. Consequently, the unemployment rate will hardly decline at all, to stand at 10.9 percent in 2005, above its average level in 2003.

Provided no new decisions are made, the government deficit in this scenario is expected to be above the 4 percent target in 2004 and the deficit ceiling of 2005.

d. Scenario B

According to this (optimistic) scenario, there will be a shift in the growth trend in 2004: GDP will rise by 2.4 percent, and per capita GDP will go up for the first time since 2000. Economic recovery will be clearly expressed in the 3.9 percent increase in business-sector product, after remaining static—and even declining—in recent years.

In this scenario, the 2004 growth rate rests on several principal forces: the accelerated expansion of exports due to the revival of demand for high-tech products and marked recovery of tourism; the expansion of investment as a result of the decline in Israel's country risk, and the resulting reduction in long-term interest rates, which will also attract foreign investment; private consumption will expand due to optimistic expectations regarding the conclusion of the recession and the fall in the unemployment rate to 9.6 percent. Labor productivity will increase by 2 percent, building a solid base for future sustainable growth.

In 2005 business-sector product will expand at a rate that is similar to its long-term growth rate—4.7 percent. There will still be excess capacity in the economy, however, as a result of the slump of the previous years. GDP will rise by a more moderate 3.3 percent, due to the additional contraction in the public sector. The unemployment rate will fall to 8.7 percent despite the public-sector cuts, as a result of economic growth and a further reduction in the number of foreign workers. Rapid economic expansion will be attained in 2005 by virtue of soaring exports, increased nonresidential investment, and the acceleration of residential investment and private consumption—developments which are contingent primarily on an improvement in the security situation.

Table 1
Indicators of Economic Development, 2000–2005

	2002	Estimate 2003	Scenario A 2004	Scenario A 2005	Scenario B 2004	Scenario B 2005
Sources and Uses	(real change, percent)[a]					
GDP	–0.8	1.1	0.8	2.0	2.4	3.3
Business-sector product	–2.8	1.3	1.4	2.8	3.9	4.7
Per capita private consumption	–1.9	–0.6	–0.2	0.5	0.5	1.1
Public consumption excl. defense imports	5.1	0.1	–3.4	–0.8	–3.4	–0.8
of which Civilian consumption	3.3	0.3	–2.6	–0.1	–2.6	–0.1
Fixed investment	–9.2	–2.8	–1.3	2.7	2.8	7.3
Domestic uses (excl. defense imports)	–1.0	–1.3	0.8	1.8	2.1	2.8
Goods and services exports	–3.0	2.5	3.8	6.4	6.4	8.9
Civilian imports	–3.1	–3.6	3.4	5.6	5.4	7.2
Balance of Payments	($ billion, current prices)					
Civilian import surplus: goods and services	1.9	0.3	–0.3	–1.0	–0.6	–1.8
Current account deficit	1.4	–0.9	0.0	–0.4	–0.3	–1.2
Current account deficit *plus* capital transfers	1.2	–1.3	–0.4	–0.9	–0.7	–1.6
Foreign-exchange reserves of Bank of Israel (end-year)[b]	23.7	24.8				
Population, Employment, and Prices	(rate of change, percent)					
Immigrants during year ('000s)[c]	33.6	21.1	18.0	18.0	18.0	18.0
Mean population	2.0	1.8	1.7	1.7	1.7	1.7
Unemployment rate	10.3	10.7	11.0	10.9	9.6	8.7
Total Israelis employed	0.9	1.7	1.4	1.8	2.9	2.8
of which In business sector	0.0	1.8	2.2	2.5	4.4	3.9
Business-sector product epr employee (labor productivity)	–1.9	0.8	1.3	2.4	1.8	3.0
Rise in CPI during year[b]	6.5	–1.5				
Central Government	(percent of GDP)					
Total revenue	39.4	37.5	36.7	36.5	36.7	36.4
Total expenditure	43.2	42.9	41.8	41.4	41.1	40.4
Overall government deficit, excl. (planned) new credit	3.9	3.0	4.0	3.0[d]	4.0	3.0[d]
Overall government deficit, cash data (% of GDP)	3.8	5.5[e]	5.1	4.9	4.5	3.9
Government debt	102.2	105.0	108.7	110.8	106.5	106.3
General Government						
Public-sector deficit[f]	5.3	6.3	6.1	5.8	5.4	4.7
Public debt	105.2	108.0	111.6	113.7	109.4	109.1
Change in statutory taxes (incl. National Insurance)	0.6	0.1	–0.3[g]		–0.3[g]	

[a] At previous year's prices.
[b] In 2003, to end-September.
[c] In 2003, to end-August, annualized.
[d] Deficit ceiling.
[e] From 2003 the deficit includes the effect of the change in the method of recording the budget of Israel Railways.
[f] Excluding Bank of Israel profits.
[g] Excluding NIS 650 million tariff on water provision.

Table 2
Resources and Uses, 2002–2005

	Current value	Quantity change over previous year (percent)									
			Est.		Est.	2003		Scenario A		Scenario B	
	2002	2002	2003	2002	2003	1st half	2nd half (est)	2004	2005	2004	2005
	(NIS million)										
Total resources	716,152	6.9	0.6	–1.2	–0.3	–2.0	2.5	1.6	3.0	3.3	4.4
Gross domestic product	491,260	4.5	0.4	–0.8	1.1	0.5	0.6	0.8	2.0	2.4	3.3
Imports of goods and services	224,892	12.6	0.9	–2.3	–3.5	–6.0	5.0	3.5	5.4	5.4	6.9
of which Civilian imports	211,307	12.6	1.1	–3.1	–3.6	–4.5	3.2	3.4	5.6	5.4	7.2
Total uses	716,152	6.9	0.6	–1.2	–0.3	–2.0	2.5	1.6	3.0	3.3	4.4
of which Excl. direct defense imports	702,567	6.8	0.6	–1.5	–0.3	–1.8	2.2	1.6	3.0	3.3	4.4
Private consumption	291,620	5.5	1.6	0.1	1.1	0.3	2.3	1.4	2.1	2.2	2.7
General government consumption	153,113	4.2	–0.7	5.7	–0.1	–1.6	1.1	–2.6	–0.5	–2.6	–0.5
of which Excl. direct defense imports	139,528	3.5	–0.5	5.1	0.1	–0.8	–0.4	–3.4	–0.8	–3.4	–0.8
Gross domestic investment	89,457	7.0	1.9	–12.4	–11.4	–18.3	14.2	5.8	4.7	12.0	8.3
of which In fixed assets	87,233	7.8	2.3	–9.2	–2.8	–0.4	–1.1	–1.3	2.7	2.8	7.3
Value of exports at domestic prices	181,962	11.6	–0.7	–3.0	2.5	1.9	–0.8	3.8	6.4	6.4	8.9
Gross business-sector product	322,600	3.9	2.0	–2.8	1.3	1.0	0.3	1.4	2.8	3.9	4.7

Table 3
National Product and Income, 2000–2005

	Current value 2002	2002	Real change over previous year[a] Estimate 2003	Scenario A 2004	Scenario A 2005	Scenario B 2004	Scenario B 2005
	(NIS million)	*(percent)*					
Gross national product (market prices)	477,993	–1.0	0.6	0.8	2.0	2.4	3.3
Depreciation	85,903	8.5	5.2	4.5	4.0	4.5	4.0
Indirect taxes on domestic production	67,908	3.6	–1.2	1.4	–0.4	2.2	0.2
Subsidies on domestic production	2,953	–16.1	9.9	–0.3	0.6	0.7	1.4
Subsidy component of government loans	25	–46.1	–5.5	–5.0	–5.0	–5.0	–5.0
National income	327,160	–4.2	–0.1	–0.4	1.9	1.9	3.7
Depreciation in private sector	77,907	8.7	4.9	4.5	4.0	4.5	4.0
General government's domestic income from property	8,054	182.2	–44.7	4.0	4.0	4.0	4.0
Direct taxes (incl.. levies and tariffs)[b]	101,996	–8.0	–4.2	–0.1	3.2	2.2	4.4
Net domestic transfer payments[c]	79,708	–4.6	3.7	–2.9	–1.1	–2.9	–1.1
Private transfers from abroad	11,097	7.2	0.3	1.0	1.0	1.0	1.0
Gross private disposable income from all sources	354,445	–2.1	3.8	0.0	1.5	1.4	2.8
Gross private saving rate from all sources (actual percent)		17.7	19.8	18.7	18.2	19.2	19.3

[a] Nominal change, adjusted by prices of private consumption.
[b] Including payments to the National Insurance Institute.
[c] Including transfer payments to households and private nonprofit organizations, including domestic interest payments.

Table 4
Public Expenditure, 2002–2005

	Current value 2002	2002	Real change over previous year Estimate 2003	Scenario A 2004	Scenario A 2005	Scenario B 2004	Scenario B 2005
	(*NIS million*)	(*percent*)					
Public consumption							
Civilian consumption	104,161	3.3	0.3	–2.6	–0.1	–2.6	–0.1
Labor input	67,765	2.7	–0.3	–1.5	0.0	–1.5	0.0
Purchases	28,400	4.3	0.3	–7.0	–1.5	–7.0	–1.5
Depreciation	7,996	5.0	5.1	3.0	3.0	3.0	3.0
Net defense consumption	48,952	11.5	–0.8	–1.4	–0.8	–1.4	–0.8
Gross domestic defense consumption	36,709	10.0	0.0	–3.9	–2.0	–3.9	–2.0
Labor input	20,436	5.7	–2.9	–3.0	–2.0	–3.0	–2.0
Purchases, incl. construction	16,273	16.0	3.6	–5.0	–2.0	–5.0	–2.0
Direct imports	13,699	13.2	–2.0	5.0	2.0	5.0	2.0
Sales	1,456	–8.6	9.9	–5.0	–2.0	–5.0	–2.0
Total net public expenditure	153,113	5.7	–0.1	–2.6	–0.5	–2.6	–0.5
Public consumption, excl. direct defense imports	139,414	5.1	0.1	–3.4	–0.8	–3.4	–0.8
Other expenditure							
Transfer payments	68,983	–1.5	–2.2	–0.6	1.5	–0.6	1.5
Budgetary investment in transport and water infrastructure[a]	5,257	21.9	–19.8	–8.3	–6.0	–8.3	–6.0

[a] In 2003 the railway became a government company, so that a large part of the government's transfers to the railway is recorded as credit and capital transfers (subsidies to the business sector), and is therefore not given here. On the other hand, investment in the railway is included in the infrastructure investment item in Table 5.

Table 5
Gross Investment, 2002–2003

	Current value 2002	Real change over previous year 2002	Est. 2003
	(NIS million)	*(percent)*	
Gross investment	89,457	–12.4	–11.4
Fixed assets	87,233	–9.2	–2.8
Residential construction	20,750	–8.2	–1.2
Nonresidential investment	66,483	–9.5	–3.2
Ships and aircraft	1,224	–61.2	–91.3
Nonresidential investment excl. ships and aircraft	65,259	–7.3	–1.6
Structures and earthworks	22,061	–0.8	–4.5
Equipment and machinery	29,581	–9.6	3.4
of which Imported	19,514	–14.6	10.8
Domestic production	10,067	0.7	–11.1
Land transport equipment	7,821	–18.7	–12.3
Intangible assets	5,796	–2.8	–1.0
Infrastructure investment (budgetary and extra-budgetary)[a]	16,944	–5.1	12.2
		(percent of GDP)	
Change in inventory	2,224	0.5	–1.2

[a] Infrastructure investment includes electricity, transport excluding vehicles, water and sewage, and communiacations (see also note a to Table 4).

Table 6
The Balance of Payments, 2002–2005

	2002	Estimate 2003	Scenario A 2004	Scenario A 2005	Scenario B 2004	Scenario B 2005
			(Current $, billion)			
Goods and services exports	38.3	40.5	43.0	46.9	44.1	49.1
Goods and services imports	42.7	43.2	45.2	48.5	46.1	50.1
Total defense imports	2.4	2.4	2.6	2.7	2.6	2.7
Civilian import surplus: goods and services	1.9	0.3	–0.3	–1.0	–0.6	–1.8
Net expenditure on factors of production abroad	3.6	3.2	4.3	4.6	4.3	4.6
Net current unilateral transfers	6.5	6.8	6.6	6.7	6.6	6.7
Current account deficit	1.4	–0.9	0.0	–0.4	–0.3	–1.2
Capital transfers	0.2	0.4	0.4	0.4	0.4	0.4
Current account deficit *plus* capital transfers	1.2	–1.3	–0.4	–0.9	–0.7	–1.6

Table 7
Population, Labor Force, and Employment, 2002–2005

			Change over previous year					
		Estimate		Estimate	Scenario A		Scenario B	
	2002	2003	2002	2003	2004	2005	2004	2005
	('000s)		(*percent*)					
Mean population	6,570	6,688	2.0	1.8	1.7	1.7	1.7	1.7
Working age population (15 yrs +)	4,706	4,793	2.2	1.9	1.4	1.7	1.4	1.7
Civilian labor force	2,547	2,601	1.9	2.1	1.7	1.8	1.7	1.8
Employed in business sector[a]	1,910	1,913	–0.9	0.2	0.1	0.4	2.0	1.7
Employed in public services[a]	654	662	3.1	1.3	–0.8	0.1	–0.8	0.1
Total Israelis employed	2,284	2,323	0.9	1.7	1.4	1.8	2.9	2.8
Unemployed persons	262	278	12.1	6.1	4.5	1.2	–8.3	–8.3
Foreign workers	247	217	–0.1	–12.1	–13.6[b]	–15.8[b]	–13.6[b]	–15.8[b]
Palestinian workers	33	35	–35.0	7.7				
Percent								
Working age/total population	71.6	71.7			71.5	71.5	71.5	71.5
Participation rate in civilian labor force[c]	54.1	54.3			54.4	54.5	54.4	54.5
Unemployment rate	10.3	10.7			11.0	10.9	9.6	8.7
Employment rate	48.5	48.5			48.5	48.5	49.2	49.8

[a] Including foreign and Palestinian workers.
[b] In 2004 and 2005 the rate of change reflkects the change in the number of foreign and Palestinian workers.
[c] The civilian labor force *divided by* the working-age population.

Table 8
Selected Interest Rates, 2001–2003 [a]

(averages, percent, in annual terms)

			2002		2003	2003		
	2001	2002	First half	Second half	(till August)	Q1	Q2	Q3 (till August)
Credit lines and overdrawn demand deposits	13.4	13.6	11.4	15.7	14.6	15.6	14.7	13.1
Unindexed local-currency term credit	8.8	8.6	6.7	10.5	10.2	10.7	10.2	9.4
Resident time deposits	6.2	6.0	4.1	8.0	7.4	8.0	7.5	6.4
SRO deposits	5.6	5.8	3.7	7.9	7.0	7.7	7.1	6.0
Yield to maturity on Treasury bills	6.5	7.4	6.0	8.8	7.5[b]	8.5	7.6	6.5[b]
Gross yield to maturity on 5-year CPI-indexed bonds	4.9	4.8	3.8	5.8	5.1[b]	5.6	5.2	4.5[b]

[a] All interest rates are effective nominal rates, except for yields on bonds, which are in real terms.
[b] Till September
SOURCE: Bank of Israel.

Table 9
Monetary Indicators, 2001–2003[a]

	Average reserves (NIS mill.)			Change (percent)			
				Since beginning of year (to Sep, annual terms)		Over same period in previous year	
	2001	2002	2003 (to Sep.)	2002	2003	2002	2003
M1	27,223	31,475	31,340	9.2	7.9	26.8	–1.7
SRO and time deposits	202,092	202,920	205,439	–5.1	1.2	1.9	1.9
M2 (excl.. Treasury bills)	229,314	234,395	236,779	–3.4	2.1	7.2	1.4
Deposits in and indexed to foreign currency[b]	64,797	77,522	80,958	25.1	3.2	22.2	4.5
M3	294,111	311,917	317,736	2.5	2.3	10.6	2.2
Total assets in banks and Bank of Israel[c]	496,645	524,021	529,674	4.8	–2.3	7.8	1.7
Total nondirected credit	480,591	531,045	541,533	12.8	–3.3	13.6	3.0
Unindexed and CPI-indexed credit	358,878	384,333	395,763	8.4	–2.5	9.6	4.2
Credit in and indexed to foreign currency	121,712	146,712	145,770	25.7	–5.7	25.7	0.1

[a] Data are final to August, and preliminary to end-September.
[b] Including time deposits, resident and demand deposits, unrestricted deposits (individuals and corporations), residents' nonresident deposits of up to one year, and CPI-indexed deposits of up to one year.
[c] Including M3, restitutions deposits, savings schemes.