## *Chapter 1*

# *The Economy and Economic Policy*

- Positive developments continued in many spheres in 2007: GDP rose by 5.3 percent; the rapid growth was led once again by the business sector, based on favorable background conditions; the rapid expansion of exports persisted; unemployment plunged to its lowest level in a decade.
- The ongoing improvement in the state of the economy was also reflected in decisions by external entities: the OECD organization invited Israel to embark on the procedure for joining it, and Israel's credit rating was raised.
- The character of Israel's economic expansion is changing: as the output gap narrows, growth is based to an increasing extent on an increase in factor inputs. Both employment and investment rose sharply in 2007. The expansion of private consumption also accelerated and demand pressures began to emerge, reflected inter alia in the contraction of the surplus on the current account and a surge in imports.
- The Consumer Price Index (CPI) rose by 3.4 percent in 2007, so that inflation exceeded the upper limit of the target range. Inflation accelerated in the second half of the year despite marked local-currency appreciation against the dollar. The acceleration was caused by the rise in world prices of fuel and food, especially in the last two months of the year, as well as by the expansion of domestic demand.
- Monetary policy acted to return inflation to the target range. In the first half of the year the Bank of Israel continued to reduce the interest rate in view of the low level of inflation and its deviation below the lower limit of the target range. In the second half of the year the central bank began to raise the interest rate as a result of the rise in inflation and inflation expectations.
- Until the end of 2007 the effect of the global financial crisis on Israel's economy in general, and on the financial system in particular, was moderate. But the global financial crisis is not yet over, and there are concerns that at a later date it will have a more significant impact on Israel's economy, impacting directly on the financial system as well as indirectly due to the slowdown in global economic activity.
- The government adhered to its growth-sustaining fiscal policy: the budget deficit was eradicated and the public debt/GDP ratio continued to contract. The expenditure target was maintained and tax rates were further reduced. Tax receipts rose as a result of economic growth, and the decline in public expenditure as a share of GDP persisted.
- The capital market continued to flourish and the resilience of the financial system improved. However, attention should be paid to the development of

various risks in the financial system, inter alia against the backdrop of the boom and rapid structural changes. The regulatory and supervisory bodies should be adapted to these changes.

- Policy should persevere with measures that support sustainable growth, price stability and financial stability—also in view of the possible global economic slowdown and increase in risks. There should be a further reduction of the public debt/GDP ratio while steps should be taken to improve the level of the public services and reduce poverty. Policies aimed at allaying poverty should focus on a variety of measures designed to enable Israelis with a low level of education to find employment and increase their earning power.

## 1. MAIN DEVELOPMENTS

Rapid economic growth, led by the business sector, continued in 2007.

Rapid economic growth, mainly in the business sector and led by the expansion of demand and the prompt response of supply, persisted in 2007. GDP grew by 5.3 percent, unemployment plummeted, the public deficit was eradicated, and the public debt/GDP ratio continued to fall. The boom in the capital market persisted and the financial system remained stable. The ongoing improvement in the state of the economy was also expressed in the decisions of external entities: the OECD organization invited Israel to start the process of applying for membership, Israel's credit rating was raised, the level of foreign direct investment in Israel remained high, and the country's risk premium remained lower than it has been in the past. However, inflation overshot the upper limit of the target range, and economic pressures are beginning to emerge, as are capital market risks, as a result of the boom and the structural changes. Towards the end of the year a global financial crisis developed which may cause a slowdown in the global economy and also have an adverse effect on Israel.

Growth was based to an increasing extent on the expansion of factor inputs.

Concurrent with continued rapid economic growth, the shift in its character became more apparent in 2007. On the supply side, it was expressed in the transition from a rapid rise in productivity, based on the increased utilization of factors of production, to growth based on the expansion of these factors—a rapid increase in employment and investment—and the slower growth of productivity. On the demand side, the change was expressed in the accelerated expansion of private consumption—with a decline in private saving—and of investment. The rapid growth of supply and demand was accompanied by the development of demand pressures. The effect of these and of the narrowing of the gap between the national saving rate and investment was evident in the reduction of the current account surplus alongside a sharp increase in imports, real appreciation, and the contribution of domestic prices to the acceleration of inflation.

Israel benefited from global economic growth, but was also affected by the rise in world prices.

The effect of global developments on the economy was varied in 2007. Global prosperity continued to be a seminal factor in Israel's growth, as may be seen from the persistently rapid rise in exports, especially in the high-tech industry, the effect of global prosperity on the capital markets (mainly in the first half of the year), and of the low interest rates on the domestic capital market and foreign direct investment in Israel. The rise in world prices of fuel, raw materials, and food served to further worsen Israel's terms of trade, causing inflation to accelerate in the second half of the year. The effect of the global financial crisis on Israel was moderate until the end of 2007, inter alia because of the low exposure of its financial system to the sub-prime market as well as other characteristics of the system. The negative interest-rate differential vis-à-vis the US reached an unprecedented level in the first half of 2007, while in the second half of the year the Bank of Israel raised the interest rate, going against the global trend. The effect on the CPI of the weakening of the dollar worldwide, expressed in local-currency appreciation against it, was less than expected—partly because of the decline in the extent of dollar indexation of contracts in the housing market.

**Table 1.1**
**Israel: Basic Economic Data,[a] 1995–2007**

| | 1995–1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|
| Mean population ('000s) | 5,831 | 6,289 | 6,439 | 6,570 | 6,690 | 6,809 | 6,930 | 7,054 | 7,180 |
| Population growth rate (percent) | 2.6 | 2.7 | 2.4 | 2.0 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |
| Israelis employed ('000s) | 2,041 | 2,216 | 2,265 | 2,284 | 2,330 | 2,401 | 2,494 | 2,574 | 2,682 |
| GDP (NIS billion, 2005 prices) | 451 | 526 | 523 | 520 | 532 | 559 | 589 | 620 | 652 |
| GDP growth rate (percent) | 5.7 | 8.9 | -0.4 | -0.6 | 2.3 | 5.2 | 5.3 | 5.2 | 5.3 |
| Per capita GDP ($ '000s, current prices) | 17.8 | 19.2 | 18.5 | 16.6 | 17.3 | 18.2 | 18.9 | 20.1 | 22.5 |
| Unemployment rate (percent) | 7.7 | 8.8 | 9.3 | 10.3 | 10.7 | 10.4 | 9.0 | 8.4 | 7.3 |
| Real wage per employee post (percent change) | 2.2 | 6.2 | 3.0 | -6.2 | -3.0 | 2.5 | 1.0 | 1.3 | 1.9 |
| Nominal wage per employee post (NIS per month) | 5,409 | 6,850 | 7,133 | 7,074 | 6,909 | 7,051 | 7,220 | 7,468 | 7,647 |
| Change in real income of family in lowest quintile (percent) | 6.1 | 2.8 | 1.7 | -7.6 | -2.4 | -1.7 | 2.4 | 7.6 | .. |
| Rate of employment in - 25 to 64 - year age group (percent) | .. | .. | 66.4 | 66.0 | 66.2 | 66.7 | 67.5 | 68.5 | 70.1 |
| Inflation rate (during the year, percent) | 7.1 | 0.0 | 1.4 | 6.5 | -1.9 | 1.2 | 2.4 | -0.1 | 3.4 |
| NIS/$ exchange rate (percent change, during the year) | 6.9 | -2.7 | 4.8 | 9.8 | -6.4 | -1.2 | 6.2 | -8.9 | -7.1 |
| Public expenditure (percent of GDP) | 51.4 | 48.1 | 50.7 | 51.8 | 50.8 | 47.9 | 46.0 | 45.3 | 44.9 |
| Tax revenue (percent of GDP) | 37.3 | 37.9 | 37.8 | 37.0 | 36.0 | 36.1 | 36.1 | 36.5 | 37.0 |
| Actual budget deficit (percent of GDP) | 3.6 | 0.7 | 4.2 | 3.6 | 5.4 | 3.6 | 1.9 | 0.9 | 0.0 |
| Gross public debt (percent of GDP, year-end) | 101.9 | 87.1 | 91.9 | 99.8 | 101.7 | 99.9 | 95.7 | 86.6 | 80.6 |
| Goods and services exports ($ billion, current prices)[b] | 27.0 | 39.5 | 34.8 | 32.5 | 35.7 | 43.4 | 47.4 | 53.7 | 61.0 |
| Goods and services imports ($ billion, current prices)[b] | 32.7 | 40.3 | 38.4 | 36.1 | 37.2 | 43.6 | 48.4 | 53.3 | 64.1 |
| Current account (percent of GDP) | -3.1 | -0.8 | -1.1 | -0.8 | 1.2 | 2.4 | 3.3 | 6.0 | 3.1 |
| Net external debt (percent of GDP) | 13.8 | 5.2 | 1.1 | -0.7 | -4.3 | -8.0 | -15.9 | -21.4 | -24.0 |

[a] Annual averages.
[b] Excluding diamonds.
SOURCE: Based on Central Bureau of Statistics data.

Economic policy supported growth.

Economic policy in 2007 supported further growth. The contraction of the public deficit and debt continued, and tax rates were reduced. Monetary policy was expansionary, as may be seen from the low level of the real interest rate, especially in the first half of the year: both the Bank of Israel's key interest rate and real interest fell, and the negative interest-rate differential vis-à-vis the US widened.

The CPI rose by 3.4 percent; inflation overshot the upper limit of the target.

The CPI rose by 3.4 percent in 2007, so that inflation overshot the upper limit of the target range. The inflation rate shifted substantially in the course of the year: in the first half it fell below the lower limit of the target, while in the second it overshot the upper limit. The acceleration of inflation was caused by the rise in world prices of fuel and food, particularly in the latter part of the year, together with the development of domestic price pressures. This occurred despite the marked local-currency appreciation against the dollar, which could have been expected to serve to restrain price rises. This development is explained by both the strength of the forces exerting upward pressure on prices and the waning effect of the exchange rate on housing prices. In the first half of the year the Bank of Israel reduced the interest rate—continuing its policy at the end of 2006—in view of the low levels of inflation and inflation expectations; when those rose, in the second half of the year, the central bank began to raise the interest rate.

Unemployment fell to 7.3 percent, the lowest rate in ten years.

The persistent improvement in the labor market reflected accelerated economic growth and its growing reliance on the expansion of capacity. The rapid increase in the demand for workers was met by the rapid expansion of the amount of labor supplied. The employment and participation rates rose and unemployment fell to 7.3 percent (annual average), its lowest level for ten years. The rise in the real wage accelerated this year, but it is still low considering Israel's GDP growth rate. However, for the first time since the emergence from the recession at the beginning of the decade, unit labor cost and the share of labor in GDP rose. The number of foreign workers increased and the slackness in activity intended to reduce the extent of this, which has an adverse effect on wages and employment prospects of low-educated Israelis, persisted.

The surplus on the current account contracted.

There was a surplus on the current account of the balance of payments in 2007, for the fifth year in succession. However, the development of excess demand, expressed in the sharp rise in imports and the deficit on the goods and services account, caused the surplus on the current account to contract this year, in contrast to its steady rise in recent years. Extensive investment abroad by residents and in Israel by nonresidents continued, although both fell in comparison with 2006, and net capital outflow contracted.

Until the end of 2007 the effect of the global financial crisis on Israel was moderate.

The boom in the capital market continued, and the resilience of the financial system improved. Nevertheless, there was a marked difference between the two halves of the year because of the global financial crisis. Until the end of 2007 the effect of this crisis on Israel was moderate, but as the crisis is not yet over there are apprehensions as to its effect in the future, both directly, in view of the possible exposure of Israel's financial system to markets that have been affected by the crisis, and indirectly, because of the probability that there will be a global economic slowdown. Furthermore, attention should be paid to the development of various risks in the financial system, inter alia

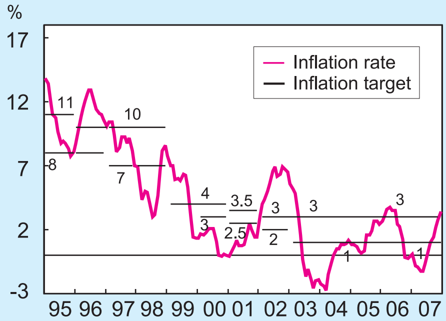
**Table 1.2**
**Basic Economic Data: International Comparison[a], 1997-2007**

| | 2006 | | | | 2007 | | | | Average 1997–2007 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Israel | US | Euro zone | OECD | Israel | US | Euro zone | OECD | Israel | US | Euro zone | OECD |
| GDP growth rate | 5.2 | 2.9 | 3.3 | 3.9 | 5.3 | 2.2 | 3.1 | 3.5 | 3.7 | 3.0 | 3.1 | 3.3 |
| Per capita GDP growth[b] | 3.4 | 1.9 | 2.6 | 3.1 | 3.4 | 1.2 | 2.4 | 2.9 | 1.6 | 2.0 | 2.5 | 2.7 |
| Per capita GDP ($'000s, current prices)[b] | 20.1 | 44.1 | 39.8 | 34.8 | 22.5 | 44.6 | 40.8 | 35.8 | 18.6 | 37.3 | 29.5 | 26.2 |
| Population growth rate[b] | 1.8 | 1.0 | 0.7 | 0.7 | 1.8 | 1.0 | 0.7 | 0.7 | 2.1 | 1.1 | 0.6 | 0.6 |
| Civilian labor force participation rate | 55.6 | 75.2 | 72.3 | 73.3 | 56.3 | .. | 72.6 | 73.6 | 54.5 | 76.8[d] | 69.7 | 72.4 |
| Unemployment rate | 8.4 | 4.6 | 6.9 | 6.3 | 7.3 | 4.6 | 6.4 | 5.7 | 9.0 | 4.9 | 7.4 | 6.8 |
| Inflation rate (during year) | -0.1 | 2.5 | 2.2 | 2.8 | 3.4 | 4.1 | 3.4 | 3.7 | 2.7 | 2.6 | 2.4 | 4.3 |
| Exports (percent of GDP)[c,d] | 37.8 | 11.2 | 57.2 | 48.2 | 39.3 | .. | .. | .. | 32.7 | 10.6 | 52.6 | 43.7 |
| Gross investment (percent of GDP)[d] | 18.9 | 19.6 | 22.3 | 23.2 | 20.4 | .. | .. | .. | 20.1 | 19.3 | 21.9 | 22.6 |
| National saving (percent of GDP)[d] | 24.5 | 13.7 | 21.7 | 21.9 | 23.4 | .. | .. | .. | 20.8 | 15.4 | 21.9 | 21.7 |
| Current account (percent of GDP) | 6.0 | -6.2 | -0.2 | -1.1 | 3.1 | -5.6 | 0.0 | -0.5 | 0.7 | -4.4 | 0.6 | -0.2 |
| Public expenditure (percent of GDP) | 45.3 | 36.7 | 45.1 | 43.0 | 44.9 | 37.4 | 44.7 | 42.8 | 48.9 | 35.8 | 45.7 | 43.6 |
| Tax revenue (percent of GDP)[d] | 36.5 | 28.2 | 38.5 | 37.5 | 37.0 | .. | .. | .. | 36.9 | 28.0 | 38.3 | 35.9 |
| Gross public debt (percent of GDP)[e] | 86.6 | 61.9 | 63.3 | 58.5 | 80.6 | 62.2 | 62.2 | 58.2 | 95.1 | 60.9 | 67.9 | 61.0 |

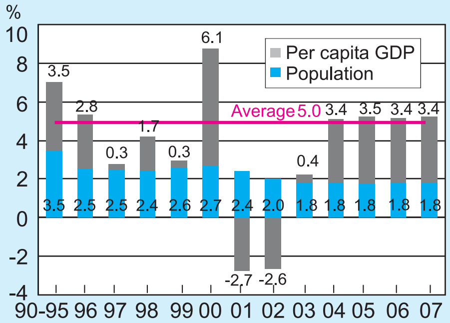
[a] Figures for the Euro zone and OECD countries are simple averages of the countries in each group.
[b] Population figures for the US, Euro zone and OECD countries for 2007 are estimates.
[c] For Israel, exports excluding diamonds.
[d] The international data are calculated for the period 1997–2006.
[e] At year end.
Source: OECD Economic Outlook, 2007; World Economic Outlook, 2007, and Bank of Israel.

**Figure 1.1**
**Key Economic Indicators, 1990–2007**

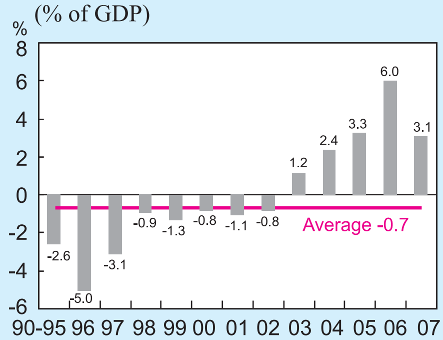
**Inflation Rate and Target, 1995–2007**



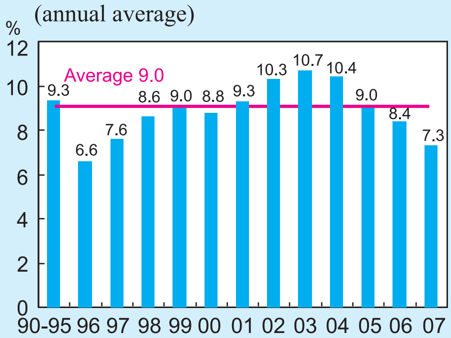

**Growth Rate of GDP, 1990–2007**



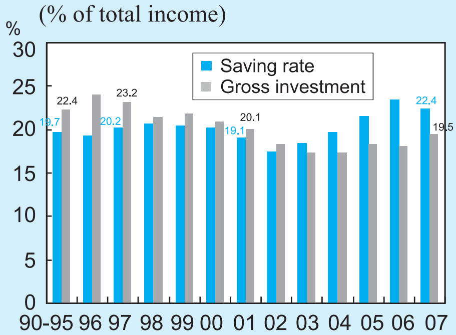

**Balance of Payments Current Account, 1990–2007**
(% of GDP)



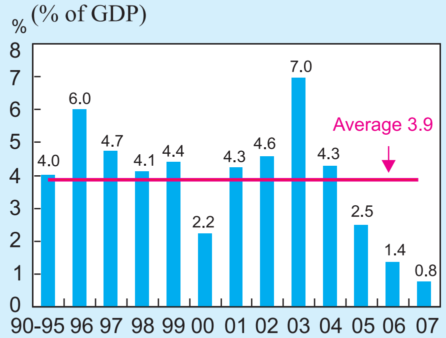

**Unemployment Rate, 1990–2007**
(annual average)




**Gross National Saving Rate and Investment, 1990–2007**
(% of total income)




**Public Sector Overall Deficit, 1990–2007**
(% of GDP)




SOURCE: Based on Central Bureau of Statistics data.

against the backdrop of the boom and the rapid structural changes, and the need to adjust the regulatory and supervisory bodies to these changes.

The rise in the incidence of poverty was checked; entry into the labor market still did not guarantee emergence from poverty.

The rise in the prevalence of poverty has been checked in the last two years, and the improvement is concentrated in those segments of the population which are connected with the labor market—indicating that the effect of economic growth has spread to some parts of the underprivileged population. However, the poverty level in Israel is one of the highest in the developed countries. The labor force participation rate of weaker segments of the population has risen in the wake of the economic expansion and cuts in transfer payments, but entry into the labor market still does not guarantee emergence from poverty. However, the inequality of income distribution declined in 2007, for the first time since its persistent rise of the last few years.

Policy should support growth and stability in view of a possible slowdown and increase in risks.

The positive developments, based on both cyclical and structural elements, pose several challenges for economic policy. A distinction should be made between these two categories, and a policy delineated which will bolster ongoing growth and stability even in the case of a possible slowdown and rise in risks. Attention should be paid to potentially problematic processes, particularly in the capital markets, as well as to fiscal policy, whose effect is not notable during periods of prosperity but which could exacerbate the adverse effects of future shocks. Policy should act to improve the situation with regard to poverty and the public services, where the contribution of economic growth is not enough and in which there has even been some deterioration in recent years, inter alia because policy was focused on ameliorating the macroeconomic situation.

## 2. GDP AND ITS USES

GDP rose by 5.3 percent; there were changes in the characteristics of growth.

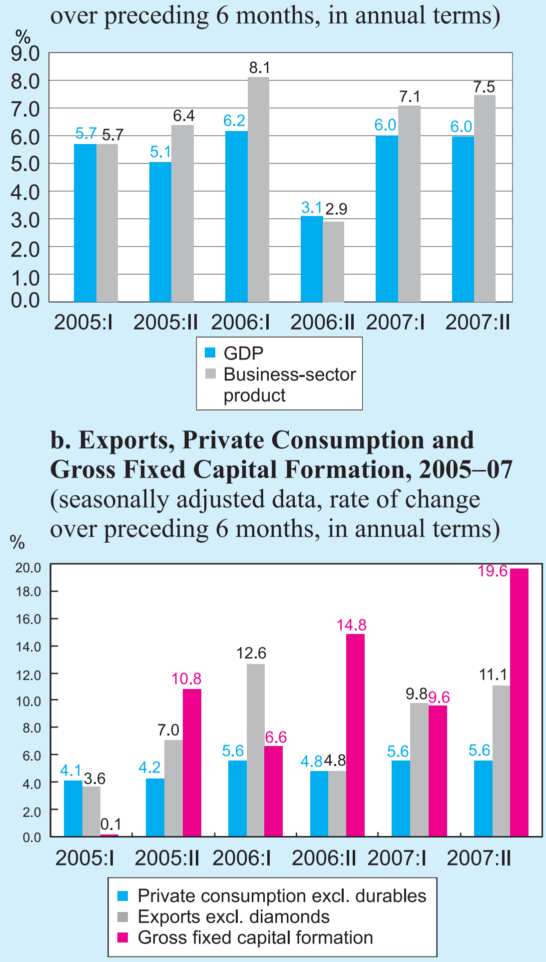
Rapid economic growth continued in 2007 and GDP rose by 5.3 percent. As was the case in previous years, growth was led by the business sector, which expanded by 6.1 percent. This year, too, it rested on favorable background conditions—global economic expansion, a stable and relatively comfortable security situation, and macroeconomic policy that supported growth—alongside the rapid, although not full, response of supply to the growth in demand. These developments have characterized the economy since the beginning of the recovery in 2003. However, there were some changes in the characteristics of growth this year, among them the strengthening of trends that had begun to emerge in 2006. The shifts in the development of supply and demand and the gap between them reflect the economy's gradual transition from the stage of emergence from the recession to a more advanced stage of growth.

The present stage of growth is characterized by a slower rise in productivity.

On the supply side, the change in the growth stage was expressed in the transition from expansion based primarily on the greater utilization of existing factors of production, alongside the rapid expansion of productivity, to growth based on an increase in factors, and with it a slower rise in productivity due to technological improvements. The entrenchment of this change in 2007 found expression in both the labor market and capital investment. In 2006, too, labor input and the participation rate rose in the business sector, while unemployment fell, but this year all these accelerated. The cyclical decline in the growth rate of productivity was also expressed by an increase in labor unit cost, for the first time since the emergence from the recession, although the rise in the real wage also contributed to this. In the first stage of the recovery investment in the principal industries increased only slightly; in 2006 it rose notably, and in 2007 it accelerated greatly. The completion of the cyclical element on the supply side was expressed most clearly in manufacturing this year (see section on manufacturing in Chapter 2).

**Figure 1.2**
**a. GDP and Business Sector Product, 2005–07**
(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)

**b. Exports, Private Consumption and Gross Fixed Capital Formation, 2005–07**
(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)




SOURCE: Based on Central Bureau of Statistics data.

Private consumption and investment have expanded rapidly.

The development of resource use in 2007 also attests to the transition to the second stage of growth. The economic recovery was led initially by a rapid rise in exports, which made a signal contribution to growth at that time (Table 2.3). Exports expanded notably in 2007, too, continuing to play a seminal part in sustainable growth. However, their share in GDP growth declined sharply this year because of the rapid rise in domestic resource use, as is consistent with the current growth stage. The steep increase in private consumption this year reflects the persistence of growth and other factors. As stated, domestic investment also expanded, as the need to increase production capacity grew. The direct contribution of public consumption to the expansion of demand was small, as has been the case in recent years, reflecting macroeconomic policy and the role of the business sector in spearheading growth.

Excess demand has begun to develop due to the ongoing narrowing of the output gap.

There are several indications this year of the development of excess demand due to the continued reduction of the output gap. Domestic resource use rose significantly faster than GDP, and this was expressed in the transition from surplus to deficit on the goods and services account, due primarily to the rapid increase in imports rather than to a significant slowing in exports, and goes against the trend of improvement in this account in recent years. This transition also explains the contraction of the surplus on the current account, despite the improvement in its other components, even after its steady increase in the last few years. The development of excess demand supported the real appreciation that was evident this year. Excess demand is also indicated by the rise in domestic prices in spite of the local-currency appreciation against the dollar and its contribution to the acceleration of inflation beyond the rise in world prices of fuel and food, as well as by the steeper increase in product prices of nontradables than of tradables. Further evidence is provided by the faster rise in sales of the manufacturing industry to the domestic market in 2007 than in its total production—for the first time in many years—and the decline in traditional manufactured exports despite the rise in production. Nonetheless, the greater importance of sales to the domestic market was also due to other factors (see section on manufacturing in Chapter 2).

Offsetting these indications of the development of excess demand is the fact that the GDP deflator remained virtually unchanged in 2007, and the moderate pace of the rise in the real wage despite the decline in unemployment is particularly notable. Although several factors could help to explain the moderate rise in wages (see section 4 below), it could indicate that excess demand is still low. However, the acceleration of the rate at which the real wage rose in 2007, and the increase in the labor share[1] and unit labor cost, for the first time since the emergence from the recession, signal that excess demand has begun to find expression in the labor market. It could find a more substantial expression at a later stage, in view of the low unemployment rate, especially among persons with a high level of education.

The private saving rate declined but its level is still high.

The growth rate of private consumption accelerated markedly in 2007 in comparison with previous years, and the private saving rate fell, after rising in the preceding two years. The increase in disposable income against the backdrop of economic growth, the improvement in the labor market, the reduction of tax rates, the rise in the value of individuals' property, especially the financial assets portfolio, and the increase in the public saving rate—have all been in evidence for several years and serve to continuously expand private consumption. However, on their own they are not sufficient to explain the change that has taken place this year—the intensity of the increase in consumption and the decline in the private saving rate after this had risen in the preceding two years. The change would appear to indicate that the persistence of the positive developments gave individuals confidence in their sustainability. The decline in the private saving rate this year may also reflect the public's delayed adjustment to the surprise deriving from the rapid increase in the public saving rate in 2006. Despite the fall in the private saving rate this year, its level, as well as that of the public saving rate, was high in comparison with its past level, and this is explained by long-term factors.[2]

[1] For a more detailed account of the labor share, see Box 2.1.
[2] For a discussion of these factors, see Chapters 1 and 2 of the 2006 edition of this publication.

The sharp rise in private consumption and the decline in the private saving rate were evinced by several developments: the rise in consumption supported growth, was expressed in the increased contribution of domestic resource use to growth, and contributed to the development of excess demand and to the rapid increase in imports. The composition of private consumption accentuated its effect on imports because the surge was concentrated in the consumption of durable goods, which are import-intensive, while the growth rate of current consumption, which is intensive in domestic product, was only slightly higher than in 2006. The decline in the private saving rate led to a fall in national savings despite the rise in the public saving rate, and hence served, together with the increase in domestic investment, to reduce the surplus on the current account and net investment abroad.

All the components of investment in the principal industries rose sharply.

Investment in the principal industries rose markedly in 2007, expressing the notable increase in all its components—machinery and equipment, non-tangible assets (primarily software), and nonresidential structures. In addition to the aforementioned change in the characteristics of economic growth, the expansion of investment reflects the low cost of borrowing against the backdrop of the low level of real interest in Israel and abroad, the structural changes in the capital market and the surge in it throughout most of the year, the continued downward trend of the relative price of capital goods, and the further reduction of corporate tax rates.

There was no real recovery in housing construction.

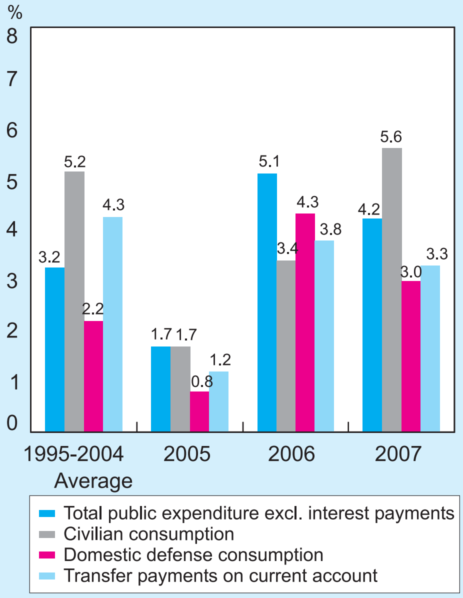
Despite the rapid economic growth, the sharp rise in private consumption and investment in the principal industries, and the decline in financing costs, there was no real rally in the extent of residential construction. This conclusion is based on a wide range of quantitative indices, and it would seem that the extent of activity in this industry was even less than was required by the increase in the number of households. The rise in the price of housing in areas of high demand was not reflected in the national index of house prices. These features can be explained in part by factors associated with the low availability of land in areas of high demand, the effect of the excess supply of housing in the periphery on nation-wide prices, etc. It is reasonable to assume that progress in projects of urban renewal, as well as the spillover of excess demand in Tel Aviv and several focal points to the larger towns in the central region, will make a supply response possible, bringing with it an increase in activity. Nevertheless, although there were several indications of an improvement in this industry in 2007, it is difficult to provide an overall explanation for its condition (for further analysis, see section on construction in Chapter 2).

## 3. FISCAL POLICY

The budget deficit was eradicated; the public debt/GDP ratio fell to 81 percent.

There was further improvement in the main fiscal indices in 2007, continuing the trend of the last few years. The budget deficit, which has declined consistently since 2003, was eradicated this year, and the government met its expenditure target (adjusted

**Figure 1.3**
**Public Expenditure, Real Rates of Change, 1995–2007 (deflated by index of business sector product prices)**




SOURCE: Central Bureau of Statistics.

for the items which were excluded from it[3]). The share of public sector expenditure in GDP continued to decline, reaching its lowest level since the late 1960s. Tax revenues rose again despite the reduction in tax rates. The (gross) public debt/GDP ratio fell to about 81 percent of GDP, also reaching its lowest level since the 1960s.

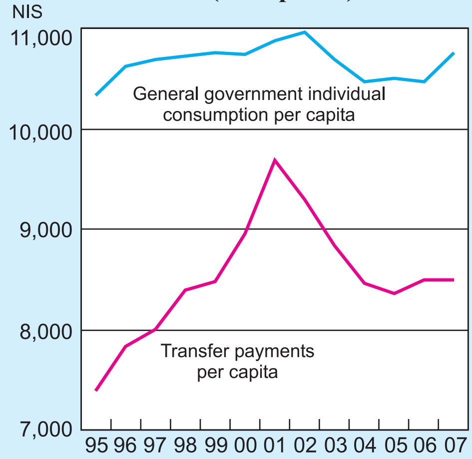
The improvement in the fiscal indices reflects fiscal discipline and rapid growth.

The continued improvement in the fiscal indices stems primarily from the government's adherence to its commitment to fiscal discipline as well as from rapid economic growth. Fiscal discipline is expressed first and foremost in adherence to the expenditure target in spite of the marked increase in tax revenues and pressures to increase defense and civil expenditure. Notwithstanding, some of the restraint in spending derives from the under-spending by civilian ministries, a problem which has been evident for several years (discussed in Chapter 6, primarily Box 6.1, below), as well as the reduction of government transfers to public nonprofit organizations, whose deficits have grown. The effect of economic growth is evident in the rapid rise in tax revenues, which has exceeded budget forecasts and explains most of the differential between the actual deficit and the deficit ceiling. In 2007 import taxes made a major contribution to the increase in tax revenues, providing evidence of the rapid growth of private consumption. The decline in the debt reflects these developments, illustrating the government's determination to divert a large part of its surplus income to reducing the debt. The decline in the debt/GDP ratio was also due to local-currency appreciation against the dollar, privatization receipts, and the repayment of the public's debt to the government (mainly from mortgages). On the other hand, the rise in the CPI relative to product prices served to increase the ratio.

The improvement in the fiscal situation was made necessary by the economic crisis at the beginning of the decade, and has played an important role in the rapid recovery since then as well as in the many other positive developments of the last few years: the decline in Israel's risk premium and lower cost of financing the public

[3] The expenditure target refers to the increase in expenditure over the preceding year in the Budget Law, rather than to the actual rise in expenditure. Certain items of expenditure arising from the withdrawal from the Gaza Strip and the Second Lebanon War were excluded from the expenditure target, as was also the case in 2006.

**Figure 1.4**
**Transfer Payments and General Government Individual Consumption[a] per Capita, 1995–2007 (2005 prices)**




[a] General government services supplied to individuals, e.g. health and education.

SOURCE: Based on Central Bureau of Statistics data.

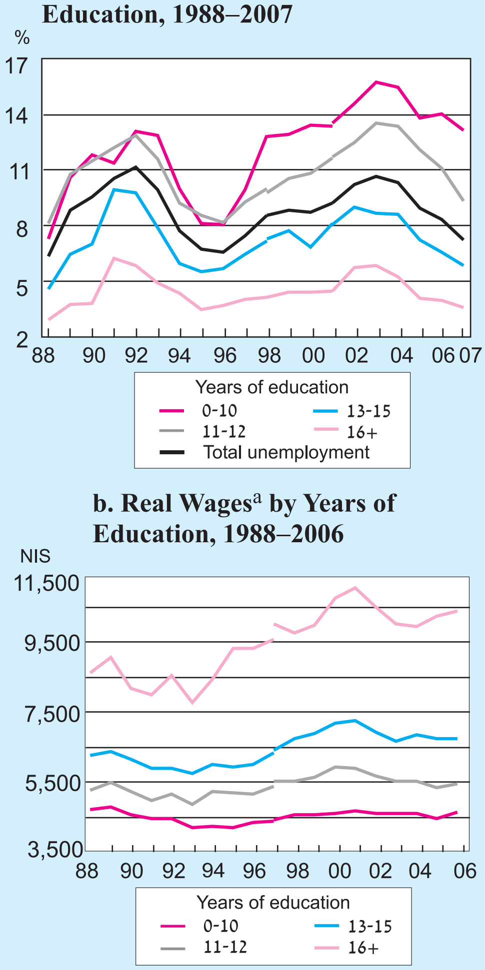
debt, the reduction of the interest rate as expressed, for example, in the creation of an unprecedented negative interest-rate differential vis-à-vis the US, the stability of the capital markets in spite of the interest-rate differential and significant shocks; the freeing of capital market sources for the business sector; substantial savings in debt servicing payments, etc. Perseverance with fiscal policy of this kind, headed by the continued reduction of the debt, is important both to maintain these positive trends and to increase the economy's immunity to crises, making it possible to conduct a counter-cyclical policy in a future recession. However, the fiscal improvements were attained at the price of the erosion of the extent of the public services and had a negative impact—at least in the short term—on the weaker segments of the population. The decline in the share of civilian public consumption and transfer payments in GDP continued in 2007, although in the last two years these two categories had risen in terms of per capita expenditure, after declining in 2002–2005, and the rise in the incidence of poverty had been checked. This raises a question regarding the desirable path of fiscal policy which will strike an appropriate balance between these needs. In addition, it is necessary to take into account the rising path of defense expenditure. This subject is discussed at greater length in the final section of this chapter and in Chapter 6.

## 4. THE LABOR MARKET

Rapid growth boosted the demand for labor.

Developments in the labor market in 2007 reflect a combination of rapid economic growth since the emergence from the recession and the gradual change in its character in the last two years—serving to constantly increase the demand for labor. The trends which have been apparent since the emergence from the recession, and were in evidence this year, too, were the continued decline in the unemployment rate alongside an increase in the participation and employment rates. The change in the characteristics of growth—a gradual shift away from the cyclical improvement of productivity to the expansion of factor inputs—is expressed in a significant acceleration in the increase in labor input: the growth rates of both labor input and the number of employees in the business sector have accelerated substantially in comparison with 2006, reaching

**Figure 1.5**
**a. Unemployment Rate, by Years of Education, 1988–2007**




[a] At 2005 prices.

SOURCE: Based on Central Bureau of Statistics data.

their highest level since the emergence from the recession. The rise in the participation rate in 2007 was also the highest since the emergence from the recession, and the decline in the unemployment rate was steeper than in 2006. The unemployment rate stood at 7.3 percent (annual average) in 2007, the lowest for ten years, albeit not unprecedented when viewed over a longer period.

The participation rate rose to an unprecedented level.

The amount of labor offered also increased in 2007, continuing the trend of the last few years, as expressed inter alia by the continued rise in the participation rate, which reached an unprecedented level. This increase reflects a cyclical element—increased entry into the labor market due to the rise in the demand for labor—as well as long-term trends, among them the higher participation rate of women and the improved education level, supplemented in the last few years by the gradual increase in retirement age. The government's policy of encouraging people to go to work by reducing benefits may also have served to increase the participation rate. However, the ongoing reduction of the unemployment rate attests to the fact that the increase in the supply of labor fell below the greater demand for it.

The rise in the real wage was moderate given the rate of economic growth.

The rise in the real wage this year was moderate bearing in mind the growth rate and its characteristics. This has persisted since the emergence from the recession, but the problem in explaining it increases as the demand for labor expands relative to its supply, as reflected by the contraction of unemployment. This is particularly apparent among more educated workers (those with at least 16 years of education), among whom unemployment has fallen to a particularly low level (3.6 percent). Several factors served to moderate the rise in wages: the decline in the tax rate on labor, which persisted in 2007, makes it possible to increase the net wage more rapidly than the gross wage; the rapid increase in the participation rate expresses inter alia the entry of new workers with low earning power or little experience, which operates to reduce the average wage; wage policy in the general government, expressed in the particularly low increase in the real wage in this sector in the last three years (wage increments promised recently to teachers and other groups were expressed only partly in 2007); the negative inflation rate in 2006 and at the beginning of 2007 also appears to have acted to restrain the rise in the nominal wage—whose rate of increase in the business sector this year was lower than in the preceding two years—while the acceleration of inflation later in the year has not yet been fully expressed in new agreements, which react with a lag to unexpected inflation developments; given a long-term perspective, it is possible that ever-increasing globalization also serves to curb wage increases, whether by increasing competition in the goods markets or by expanding the possibilities of transferring production activities abroad.

Despite the moderate increase in the real wage, the labor market also displays several signs of the development of excess demand. The growth rate of the real wage in the business sector accelerated in 2007 despite the slower rise in productivity, and for the first time since the emergence from the recession there has been an increase in unit labor cost and the labor share. In addition, for the first time in several years, there was a substantial rise in wages in construction, commerce, and the hospitality and catering industries, which are unskilled-labor-intensive. The rise in wages, together with the decline in unemployment among the unskilled, indicates that economic growth has also benefited workers with a lower level of education. It also reflects the composition of economic growth in 2007, in which domestic consumption played a significant part. Nevertheless, the unemployment rate among persons with a low level of education is still high. The increase in wages in the construction industry may also reflect the reduction in the number of foreign workers in that industry, and is in line with other signs of a recovery in its activity during the year.

The number of foreign workers rose; their presence has an adverse effect on the wage and employment of Israelis with a low level of education.

The number of foreign workers rose in 2007, after declining slightly in 2006. This reflects the continued laxity in implementing the declared policy of reducing their numbers, after several years in which there was a significant diminution. Their presence has an adverse effect on the wages and employment chances of Israelis with a low level of education, and goes against the government's policy of helping these Israelis to enter the labor market and reducing poverty, particularly with regard to households whose members are in the labor market. Their availability also serves as a disincentive to the adoption of new technologies, holding back the rise in productivity and economic growth in the long run, and creating long-term social problems beyond those in the labor market.

## 5. THE BALANCE OF PAYMENTS

The surplus on the current account declined for the first time in several years.

There was a surplus of $ 5 billion on the current account in 2007, constituting 3 percent of GDP. This was the fifth consecutive year in which there was a surplus but the first in which it contracted. This is explained above by the growth characteristics and the development of savings and investment this year, and is not surprising in view of the exceptional extent of the surplus in 2006. However, long-term forces are at work within the economy which support the existence of a surplus on the current account, and this is also consistent with the leading role in growth played by exports: in 2007, too, as has been the case every year since the emergence from the recession, nondiamond exports rose faster than GDP and domestic resource uses.

### a. The current account

The reduction of the surplus on the current account derived mainly from the steep increase in imports.

The decline in the surplus on the current account this year stemmed entirely from the reduction of the surplus on the goods and services account, primarily because of the steep quantitative rise in imports. The relatively large deficit on the goods and services account in 2007 checked the trend of improvement in this account in recent years, which peaked in the exceptional surplus of 2006. It mainly reflects the changes in the characteristics of economic growth: the emergence from the recession was led by exports, alongside a moderate rise in private consumption, and rested initially on the increased utilization of existing factor inputs; consequently, at first there was a significant improvement in the goods and services account. At the present stage of growth, however, private consumption has soared, investment has accelerated, and existing factors of production are being fully utilized, so that the combination of these developments caused imports to rise sharply in 2007. Real appreciation and the deterioration in Israel’s terms of trade also served to increase the deficit this year.

There was a real appreciation in 2007.

The real appreciation (the decline in export and import prices relative to those of GDP) in 2007 contributed to the expansion of the deficit on the goods and services account, as it serves to increase imports and also, to a lesser extent, to dampen the expansion of exports. The appreciation stemmed from the development of excess demand, which is characteristic of the present stage of growth, as well as from the decline in net demand for investment abroad, and the weakening of the dollar relative to other currencies.[4] The large surplus on the current account in 2006 also supported the process of real appreciation in 2007.

The deterioration in the terms of trade (excluding diamonds) continued this year. This trend has been in evidence for the last five years, and its direct cost to the economy is estimated at about $ 5 billion a year. Apart from its contribution to the increase in the deficit on the goods and services account, it acts to moderate real appreciation and reduce disposable income. The deterioration stems from the continued increase in world prices of fuel and raw materials, as well as in the prices of foodstuffs.[5]

Exports continued to expand rapidly.

Exports of nondiamond goods and services continued to increase rapidly in 2007, although at a slightly lower rate than in 2006. This decline is in line with the slowdown in the rate of expansion of world demand (see also Figure 7.3). Israel is economically

[4] For a discussion of the various definitions of the real exchange rate, see the section on the current account in Chapter 7.

[5] For a discussion of the effect of China and India on these price increases, see Box 3.1.

dependent to a great extent on global demand, and this has even increased over time as it has specialized in export-biased high-tech industries in which the ability to switch sales from the global to the domestic market, in response to changes in demand or relative prices, is very limited. Thus, this specialization increases Israel's vulnerability to a global slowdown; the economy is especially exposed to a slowdown in the US, because of its extraordinary importance for Israel's exports. In the short term the process of specialization also reduces the elasticity of exports to changes in the real exchange rate (for further discussion, see Chapter 7).

A by-industry analysis indicates that in 2007 there was a marked slowing in the rate of expansion of high-tech exports (both manufactured and services, see Table 7.4), which account for about half of total exports and have led the rise in exports since the emergence from the recession. It would appear that beyond the long-term downward trend in the share of traditional industries in exports, the absolute decline in their extent this year reflects the strength of domestic demand, because these industries have the greatest ability to divert sales from exports to the domestic market. The sharp rise in the export of tourism services reflects the recovery of the industry from the effects of the Second Lebanon War, and its share in total exports returned to its level in 2005.

The sharp rise in imports was due to the expansion of private consumption and investment.

As stated, the sharp rise in imports this year derived mainly from the increase in private consumption and investment, and this was also expressed in the composition of imports. There was a particularly rapid rise in imports of consumer goods, especially consumer durables, as well as of capital goods. The decline in the relative price of imported consumer goods[6] and the reduction of taxes on imported goods also contributed to the expansion of imports this year. The import of production inputs rose moderately, continuing the trend of the preceding two years. This development is in line with the moderate increase in manufactured product, as well as the long-term trend of a transition from industry which is raw-material-intensive to industry which is human-capital-intensive as well as to services. The increase in the share of imports from the US in total imports in 2007, in opposition to the long-term trend, appears to stem from the weakening of the dollar, which makes imports from the US cheap in relation to those from the rest of the world (Table 7.7).

In 2007, for the first time, the income account was in balance, and the trend of improvement in this account continued, explaining a considerable part of the improvement in the current account in recent years (Table 7.3). This trend derives from two factors—the rise in the net income of Israelis from interest payments and the low return to nonresidents on their capital assets in Israel. The rise in net interest income stems from Israel's transition from net liabilities in debt instruments to a growing surplus in assets of this kind (Table 7.8), as well as from the rise in short-term interest abroad. It is difficult to explain the low return to nonresidents, and the balance on the

[6] In some consumer goods, such as clothing and footwear, there is a long-term downward trend in their price in dollar terms; this is explained to a great extent by the expansion of imports from China and India. For further discussion, see Box 3.1.

income account accentuates this puzzle because nonresidents' surplus of capital assets is greater than residents' surplus of debt instruments (see Chapter 7).

**b. The financial account**

The basic trends characterizing the financial account in recent years persisted in 2007, namely, net capital outflow, reflecting the surplus on the current account, and extensive investment abroad by residents as well as by nonresidents in Israel, reflecting globalization as well as structural changes in Israel's capital market. The decline in net capital outflow this year reflects the cyclical development of saving and investment. The sharp drop in investment flows in both directions in comparison with 2006 stems to a great extent from particularly large transactions in 2006. The effects of the global financial crisis on capital flows to and from Israel were moderate (see Chapters 4 and 7).

Some of the prominent features of the capital flows to and from Israel were not confined to Israel alone, and are connected with world trends, especially similar developments in emerging economies—among them increased capital flows to and from these markets, and direct investment in particular, as well as net capital outflow from these markets. These processes are nourished, inter alia, by global prosperity (until the global financial crisis), by emerging economies' capital reservoirs, and by the US's large current account deficit.

Extensive investment in Israel by nonresidents continued.

Extensive investment in Israel by nonresidents persisted in 2007, with the increase in the direct investment component (adjusted for the particularly large transactions in 2006) being especially notable. These investments focused on the high-tech industry, and investment in startups also increased.[7] This focus, which generally characterizes direct investment in Israel, distinguishes it from other emerging economies. This year there were many relatively small transactions, in contrast with the limited number of extremely large transactions in 2006. This indicates that the extent of large investments is sustainable, as it reflects wider characteristics of the economy, and does not derive solely from the specific success of one Israeli company or another. The extent of investment this year also indicates that the war in 2006 did not have a long-term effect on foreign investors, and that the security situation is perceived as being reasonable. Large investments by nonresidents—most of them diaspora Jews—in real-estate continued, and their effect was felt in the housing market. These investments, in common with foreign investment in other areas, are also affected by global prosperity and Israel's positive economic fundamentals, alongside other motives which may not necessarily be economic.

Investment in real estate abroad by Israelis rose.

The decline this year, in comparison with 2006, in the extent of investment abroad by residents does not attest to a trend shift away from the increase in these investments in the last few years. The trend is explained by structural changes in the domestic

[7] Box 7.3 presents several indices of the attractiveness of the Israeli economy for foreign direct investment.

capital market,[8] by excess saving over investment, which is diverted abroad, by the development of Israeli companies into multi-nationals through the acquisition of foreign companies, and by the global trends mentioned earlier. In effect, adjusting for one exceptional transaction in 2006, the rise in direct investment abroad by residents continued this year, too. There was a marked increase in 2007 in real-estate investment abroad, which is characterized by a high degree of leverage and unique risk factors.

## 6. INFLATION AND MONETARY POLICY

### a. Inflation

The inflation rate changed notably during the year.

The CPI rose by 3.4 percent in 2007, so that the annual inflation rate exceeded the upper limit of the inflation target. The inflation rate changed clearly in the course of the year: in the first half it was below the lower limit of the target and in the second half it overshot the upper limit (for further discussion, see Chapter 3).

The acceleration of inflation was due to a great extent to the rise in world prices of fuel and food.

The acceleration of inflation, despite the marked local-currency appreciation against the dollar, derived largely from forces exogenous to the economy, although endogenous forces also contributed to it. The exogenous forces were the rise in world prices of fuel, raw materials, and food. One way in which this was expressed was the price of food—accounting for a large proportion of the CPI—which rose by an exceptional rate compared with previous years. Domestic forces, such as the expansion of demand and the continued contraction of the output gap, served to raise domestic prices in two ways: first, they exerted upward pressure on prices in industries in which

**Table 1.3**
**The Consumer Price Index and Certain of its Components, Israel and Abroad, 2006 and 2007**

(rates of change during the year)

| | Israel | | US | | Europe | |
|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 |
| Consumer price index (CPI) | -0.1 | 3.4 | 2.5 | 4.1 | 2.2 | 3.2 |
| Food (excluding fruit and vegetables) | 3.5 | 6.3 | 2.2 | 4.7 | 0.9 | 5.9 |
| Energy | -1.6 | 13.2 | 2.9 | 17.4 | 4.6 | 8.2 |
| CPI excluding energy, food and fruit and vegetables | -1.1 | 1.6 | 2.6 | 2.4 | 3.0 | 1.9 |

SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

[8] Among them the reduction of the restrictions on capital outflow, such as the equalization between tax rates on income from investments in Israel and abroad, and the change in the regulations regarding investment by institutional investors, and the reduction of the public debt. For further discussion, see the 2005 and 2006 issues of this publication.

the domestic production component is high, particularly housing. Apart from the expansion of demand, the rise in housing prices despite local-currency appreciation also reflected a marked reduction in the dollar indexation of contracts in the housing market, which in turn contributed to the looser connection between the exchange rate and the CPI in 2007 (Box 3.2). Second, the effect of domestic forces caused producers to pass the rise in prices of imported inputs on to consumers, in contrast with periods of recession, when producers are generally prepared to absorb these price increases to a greater extent. In contrast with these channels, the moderation of wage increases acted to dampen the effect of the expansion of demand on prices.

The increase in prices was also affected by the development of demand pressures in Israel.

The effect of the rise in global prices and the existence of upward domestic pressure on prices can be seen in Table 1.3. The increase in inflation was not confined to Israel in 2007; in the US and Europe, too (as well as in many emerging economies), consumer price indices accelerated. They were also affected by the increase in world prices of food and energy, as is reflected by the faster rise in the price of these components in price indices. The outstanding difference between Israel and the US and Europe was in the development of the CPI adjusted for energy, food, fruit, and vegetables; the rate at which that index, which more than the other indices in the table expresses the internal forces in each economy, accelerated in Israel but slowed in the US and in Europe in particular, attesting to the emergence of demand pressures in Israel. Nonetheless, the level of the adjusted CPI shows that the effect of these pressures on prices is still moderate.

**b. Monetary policy**

Monetary policy operated to restore inflation to the target range, and in 2007 this was expressed by a switch in the interest-rate path between the two halves of the year. In the first half of the year the process of interest-rate reduction that had begun in 2006: IV continued, concluding with a 2 percentage-point reduction. This approach was adopted because both actual and expected inflation had fallen below the lower limit of the target range. In the second half of 2007, however, the Bank of Israel began to raise the interest rate gradually, though not continuously, because actual and expected inflation had risen and exceeded the upper limit of the target (for further discussion, see Chapter 3).

In 2007 it was difficult to predict the extent to which the various forces would affect inflation.

The fact that inflation overshot the upper limit of the target towards the end of the year raises the question whether monetary policy during the year was appropriate, and especially whether the interest rate should have been reduced more moderately in the first half of the year, or whether the process of raising it should have been begun earlier and more vigorously. Note that monetary policy influences prices both immediately and with a lag. The immediate effect derives from the response of the exchange rate to interest-rate shifts, as is illustrated by the local-currency depreciation that occurred in the middle of the year. By contrast, the effect of policy on the level of economic activity—and through it on inflation—is slower. Consequently, monetary policy is required to assess the intensity of the forces acting on prices in advance, i.e., before

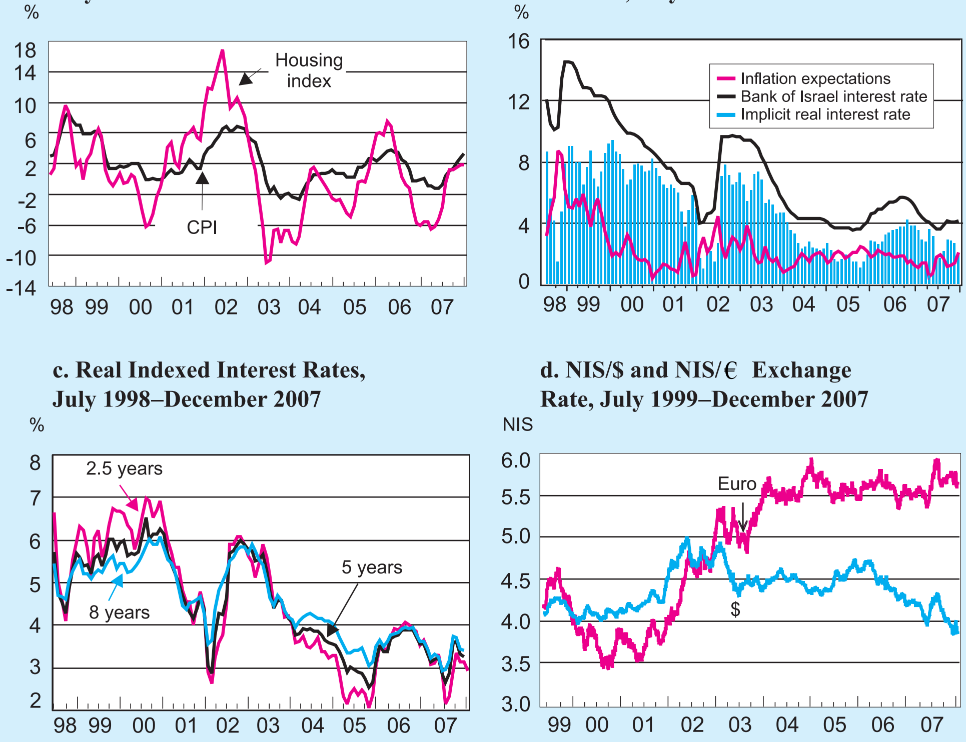
**Figure 1.6**

**a. Rates of Change of Selected Price Indices in the Last 12 Months, July 1998–December 2007**

**b. Bank of Israel Interest Rate, Inflation Expectations, and Implicit Real Interest, July 1998–December 2007**

**c. Real Indexed Interest Rates, July 1998–December 2007**

**d. NIS/$ and NIS/€ Exchange Rate, July 1999–December 2007**




SOURCE: Central Bureau of Statistics and Bank of Israel calculations.

they are expressed in actual inflation. This year it was difficult to predict the extent of their effect on inflation because there were significant forces acting in opposite directions. Local-currency appreciation, which contributed to the low inflation rate during the first half of the year and supported the reduction of the interest rate at that time, offset the effect of other forces—internal pressures and primarily the rise in world prices—impairing the ability to assess their magnitude, which was expressed more prominently in the second half of the year. It was also difficult to assess the extent to which the link between the exchange rate and housing prices had been weakened, and hence what was the contribution of appreciation—which turned out to be less than originally thought—to offsetting price increases. Although the Bank of Israel began to raise the interest rate in the second half of the year, it will take some time for inflation to return to the midpoint of the target range. Earlier identification of the intensity and persistence of these forces would have made it possible to start raising the interest rate earlier, and thus to attain the target earlier. However, much of the rise in world prices occurred in the last few months of the year, and this was difficult to forecast in the short run. Furthermore, conducting monetary policy in the face of pressures due to world price rises is more complex than contending with demand-side pressures.

The negative interest-rate differential vis-à-vis the US grew to unprecedented proportions this year. While the downward trend of the (positive) interest-rate spread vis-à-vis the US has persisted for several years, and since mid-2005 it had been particularly low, until the end of 2006 it remained positive almost all the time. In 2007, by contrast, it remained negative throughout the year, and even widened in the first half. The ability to widen the negative spread is explained by the ongoing reduction of Israel's risk premium (until the middle of the year), in the context of its economic performance and the macroeconomic policy of the last few years, as well as by other factors which were at work this year—local-currency appreciation due to the weakening of the dollar worldwide, and the low levels of actual and expected inflation in the first half of the year. The narrowing of the interest-rate spread towards the end of the year derived from the interest-rate hike made by the Bank of Israel in view of the acceleration of inflation and the need to restore it to the target range.

The negative interest-rate differential vis-à-vis the US widened during the year to an unprecedented level.

## 7. THE CAPITAL MARKETS AND THE FINANCIAL SYSTEM

The boom in the capital markets persisted in 2007, expressed inter alia in rising share prices and growing turnover, the extensive capital raised by the business sector, the continued extensive inflow of capital from abroad, and a further increase in the public's asset portfolio.

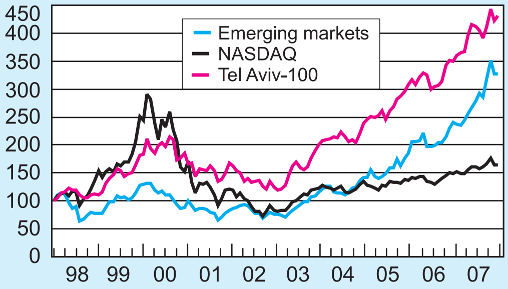
Despite the global financial crisis the financial system remained stable and the resilience of the banks and the institutional investors was maintained. The limited effect of the crisis until the end of 2007 was due in part to the fact that Israel's financial system was exposed only slightly to the subprime market in the US, as well as to other characteristics of the system (for further discussion, see section 2 of Chapter 4). Broader factors are also partly responsible for the steadiness of the system in Israel. One indication of this is the stability that has been maintained for several years despite significant shocks. In 2006 it held firm despite the war in the north of the country, and in 2005 it remained so irrespective of a series of political shocks. This stability is also confirmed by the continuing reduction of Israel's risk premium, as reflected amongst other things by the negative interest-rate differential mentioned earlier, as well as by the improvement in the country's credit rating and the persistence of extensive foreign direct investment in Israel in 2007. Nevertheless, the capital and foreign-currency markets displayed greater volatility this year, and since the global financial crisis has not yet ended its effect on Israel's financial system may yet grow.

The financial system remained stable, but the effect of the world financial crisis on Israel's financial system might increase.

A major question is to what extent do the prosperity and stability of the capital market reflect favorable cyclical conditions—rapid growth that has persisted for several years, against the backdrop of a global boom and the stability of the security situation—and how far do they depend on structural fundamentals. This question is important because by their very nature suitable cyclical conditions act to ameliorate many of

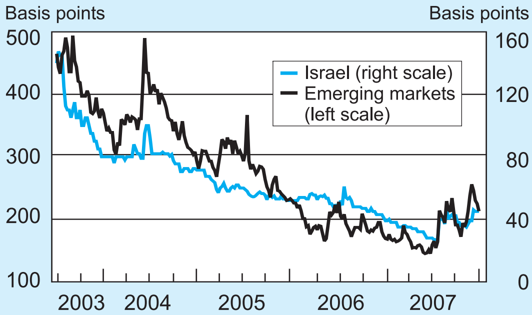
**Figure 1.7**

**a. Share Index Developments in Israel and Abroad,[a] 1998–2007**



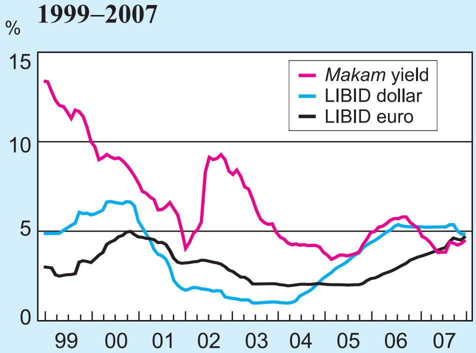

[a] Index of shares in emerging markets, Morgan Stanley.

**b. Risk Premium, Israel[a] and the Emerging Markets,[b] May 2003 to December 2007**




[a] Premium on Israel government 10-year bonds relative to the US.
[b] Emerging markets premium (excluding Argentina) calculated by J.P. Morgan.

**c. Yields on Three-Month *Makam* and Three-month LIBID Dollar and Euro, 1999–2007**




SOURCE: Bank of Israel.

The structural changes in the financial system have considerable advantages, but they also embody certain dangers.

the indices, but structural lacunae could exacerbate the damage to the capital market and stability when a shock occurs or when the growth rate slows—inter alia because of developments in this market just at a time of prosperity. In other words, although the system remained stable, and its resilience—in terms of its ability to absorb shocks—rose, the risks also increased, so that the overall balance for the future is unclear.

Macroeconomic policy supported the positive developments in the capital market: fiscal discipline, including the reduction of the deficit and the public sector debt, helped to reduce Israel's risk premium and lessen government intervention in the capital market, diverting sources to the business sector. This is also expressed in the extent of corporate bond issues. Thus, fiscal policy together with monetary policy, aimed at maintaining price stability, continued to make a structural contribution in 2007 to capital market activity and stability. However, the amount by which the debt was reduced also reflects a cyclical component due to the rise in tax receipts.

The deep structural changes in the financial system in the last few years persisted in 2007, contributing to the prosperity and stability of the capital market as well as to many positive developments in the economy in general, although they also embody risks. One of the most prominent changes was the ongoing reduction of the role played by the banks and the increased share of institutional investors, headed by the insurance firms, in managing the public's assets and extending credit to the business sector.[9] This process served to make the financial markets deeper and more efficient, to increase competition in them, and to disperse credit risks. However, in the course of this process several significant problems emerge: institutional investors displayed greater readiness to take on credit risks and market risks, and in 2007 this contributed to the continued rapid expansion of credit to the business sector; hence, the risks inherent in the financial instruments offered by these investors rose; the rise in competition also impels the banks to increase risks in order to maintain profitability. These problems are intensifying because the system is in a stage of transition in which the various players are not yet fully acclimatized to the many and rapid changes, and also because the regulatory and supervisory mechanisms have not yet been fully adapted to cope with these changes, chief among them the marked increase in the importance of the supervision of the institutional entities.

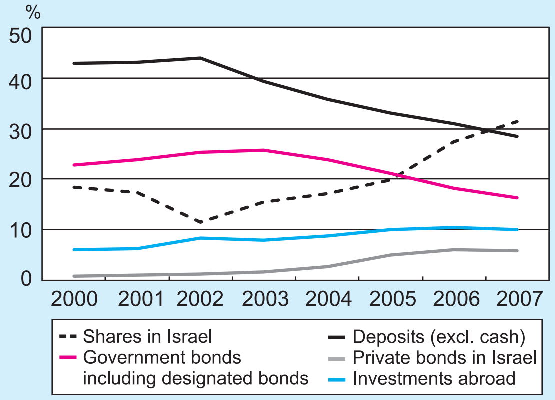
Credit to the business sector expanded notably.

The accelerated expansion of credit to the business sector in 2007, at an even faster rate than in the last two years, illustrates the contribution of the various factors mentioned above to developments in the capital market, but also underlines how developments of this kind can simultaneously reflect both positive and problematic trends. A significant part of the increase is cyclical, i.e., it stems from the continued expansion of economic activity, and may even reflect expectations of further growth in the future. Part of it is nourished by the reduction of government intervention in the capital market which, as stated, frees sources for the private sector. The structural changes in the capital market also expand sources of finance for the private sector and reduce borrowing costs. However, part of the increase in credit stems from problematic features, among them a rise in the risks taken by institutional entities and the problematic distribution of the ranking of bonds.

The extent of corporate bonds increased greatly.

The development of corporate bonds, which have expanded rapidly in recent years, emphasizes some of the aforementioned processes regarding credit to the business sector. Their development is connected inter alia with the structural changes: for the business sector they constitute an important substitute for bank credit, and for investors they are a partial replacement for government bonds, the supply of which has decreased as a

**Figure 1.8**
**Components of Asset Portfolio,[a] 2000–07**




[a] Total assets include also *Makam*, cash held by the public and other assets.

[9] In 2007 the implementation of the 'Bechar Reform' was almost complete, in which banks were required to sell their provident and mutual funds. For further discussion, see section 3 in Chapter 4.

result of the reduction of the public sector debt. However, there is a knotty problem in this market: the high proportion of unranked series and the lack of series at the intermediate rank appear to indicate that there is a low level of transparency in the issuing companies, increasing the danger that risks will be underpriced. The reaction of the markets at the time of the global financial crisis attests to this danger (for further discussion, see section 5 of Chapter 4).

There were significant improvements in the composition of the public's asset portfolio, but its volatility and risk level also rose.

The various effects of cyclical and structural developments were also expressed in the public's asset portfolio. The value of the portfolio soared, primarily because of the rise in share prices. Significant shifts in the composition and management of the portfolio have been in evidence for several years and derive from macroeconomic policy (the reduction of the public sector debt and the maintenance of price stability) as well as from the structural changes in the capital market: the cancellation of tax distortions between various investment channels, the pensions reform, the change of the rules regarding investment by institutional entities, the decline in the importance of the banks, etc. These served, inter alia, to increase the share of investment in corporate bonds, with a slight rise in investment abroad (which remained unchanged in 2007), and a decline in the share of government bonds, bank deposits, and assets managed by the banks. The various reforms annulled distortions in the public's investment decisions, enabling it to increase diversification, returns, and the tradable and liquid component in its asset portfolio. However, the changes in the composition of the portfolio also involve a rise in its volatility and risk level, reflecting only in part the households' decisions, as a considerable part of these changes derive from the investment decisions of the institutional entities which manage the portfolio. Furthermore, the various reforms have not yet led to increased competition in providing financial services to households between nonbanks and the banking system, or within the banking system itself, which is still controlled by two major groups. The low level of competition could have an adverse effect on the quality of the management of the portfolio, as well as making it more expensive, and this is expressed inter alia by high bank fees (for further discussion, see section 3 of Chapter 4).

The structural changes also affected pension savings.

The effect of the structural changes on the public's asset portfolio is worthy of particular attention in the context of long-term savings, particularly pension savings. In recent years there has been a rapid rise in the exposure of these savings to financial risks. The effect of the structural changes on this trend is augmented by the ongoing reduction of the government's guarantees of pensions, expressed in the transfer of the general government to contributory pensions and the contraction of earmarked bond issues. On the other hand, increased competition within the system could improve the quality of the pension savings offered to the public and increase its ability to choose. Apart from this, completing the process of detaching the mutual and provident funds from the banks in 2007 has made it possible for the banks to begin serving as financial advisors, a process which is expected to improve the quality of advice, reduce conflicts of interest, and make it more accessible to the public.

Special attention should be paid to the extension of pension arrangements to additional segments of the public in 2007. On the one hand, it expands coverage to weaker segments of the population which did not benefit from it untill now; on the other, it is reasonable to assume that this section of the public is less well-informed, and hence there is an even greater need to improve the regulatory and supervisory mechanisms with regard to the entities which manage pension funds.

## 8. FUTURE TARGETS AND POLICY

The positive economic developments of the last few years—rapid growth, stability, and improvements in many other spheres—present economic policy with several main challenges.

The positive developments were based in part on cyclical factors and in part on structural ones, and the latter should be augmented.

1. These developments rely partly on cyclical factors—the global boom and favorable background conditions—and partly on structural factors: macroeconomic policy which supports growth and the structural changes of the last few years. A clear distinction should be made between the two kinds of factors, and a policy delineated which will support sustainable growth and stability even in the face of a possible slowdown in the global economy and deterioration in the other background factors. Note, in this context, the importance of continuing to reduce the public sector debt, exercising caution regarding further tax cuts, anchoring in law the independence of the central bank and its ability to act to maintain price stability, improving the mechanisms designed to ensure the stability of the financial system, and making sustainable improvements in integrating various segments of the population in the labor market.

Problematic processes, especially in the financial system, should be identified in timely fashion.

2. Policy must identify problematic processes in timely fashion, whether in the economy, certain markets, or policy; some of these tend to develop during a cyclical boom or at a time of rapid structural changes. Their negative implications are almost imperceptible during a boom, but in the future they are liable to exacerbate the effect of a slowdown or a shock to the economy. These processes involve the financial system and its risks in particular, against the backdrop of the reforms and the surge in the capital markets, but also concern budgetary policy, which creates long-term commitments for a high level of expenditure.

The government should act to improve matters in those spheres where the contribution of economic growth is not enough.

3. Policy must act to improve those areas in which the contribution of growth is not sufficient, or in which there has been a deterioration in the last few years—inter alia, because of the intensity of the fiscal adjustment, which underscored the preference for macroeconomic targets over other needs. Tackling poverty and the level of the public services are among these spheres.

As is always the case, economic policy will have to find the right balance between conflicting needs. The main issues that will have to be balanced in the next few years are reducing public sector spending, thereby making tax cuts possible in order to bolster growth and increase the sources available to the economy in the long run, and increasing expenditure, inter alia in order to contend with poverty in the short run; allocating funds to growth-sustaining activity such as infrastructure investment, and assigning them to deal with income distribution; reducing the debt/GDP ratio, and providing funds to improve the level of the public services and for security requirements; reaping the benefits of adopting long-term targets—for the public sector debt, total expenditure and its composition, tax rates, employment, poverty, and price stability—and keeping policy flexible in view of changing circumstances and ensuring that the various targets are in line with one another in the long term; taking advantage of market forces and the private sector, and maintaining an adequate degree of government responsibility for the welfare of its citizens in the areas of income, education, health, pension savings, and public order; stimulating competition, and preventing the rise in risks and other negative outcomes which could accompany it, especially in the financial system.

**a. Fiscal policy**

The public debt/GDP ratio should be reduced.

Policy should ensure that the public debt/GDP ratio continues to decline until it reaches the level accepted in other countries, since even though it has been reduced in recent years it is still high. This is necessary in order to continue supporting the important achievements of the last few years, among them the reduction of Israel's risk premium and the maintenance of stability in the financial markets, sustaining price stability, reducing the government's debt-servicing payments, freeing capital market sources, and supporting the important changes occurring in it. A lower level of debt is also required in view of the unique risks confronting Israel's economy, and will make it possible in the future to conduct a counter-cyclical fiscal policy during a slowdown, which is not the case at present.

The expenditure target—the limit of the annual increase in government spending––in the next few years should strike a balance between two main considerations: the need to ensure the continued reduction of the debt/GDP ratio without increasing tax rates or harming fiscal discipline, and the need to increase public spending in view of several developments. The share of government expenditure in GDP has fallen significantly in recent years, reaching its lowest level since the 1960s, which is on a par with the average in the developed countries (Figure 6.5). This reduction played a crucial role in reducing the deficit and the debt, as well as in the ability to reduce tax rates, and hence made a signal contribution to bringing the economy out of the doldrums in which it found itself at the beginning of the decade, as well as to persistent improvement in various spheres. However, it also involved reducing expenditure on welfare and the public services. In addition, it was helped by the reduced share of defense expenditure, after the marked increase in this item in 2002. Looking ahead, the possibility of reducing benefits in their present format has been utilized to the full, and what is required now is some expansion of expenditure on public services, such as education; defense expenditure is also likely to rise. Moreover, within a few years adherence to the present expenditure target will bring the share of public expenditure in GDP to a level that is significantly lower than the average in the developed countries, so that the extent of the public services and government involvement in income distribution will also be far below the average in those countries (for a long-term analysis, see section 4 of Chapter 6). These considerations support a cautious increase of the expenditure target, provided it is consistent with the debt reduction target and the economy's long-term growth rate.

The government should ensure that its long-term spending plans are in line with the overall expenditure target. During 2007 the government adopted long-term plans in the areas of defense, the public services, welfare, and the infrastructure, which involve considerable budgetary outlay in the coming years. There are several advantages to making long-term plans, but an analysis of the expenditure involved indicates that their full implementation is not consistent with the current spending target. Note that an analysis of the actuarial indebtedness of the unfunded pensions shows that even though the debt is large, the extent of the expected payment flows is smaller than it is generally thought to be, so that at their peak their burden will not be significantly greater than it is at present (Box 6.2, Chapter 6).

The government should ensure that long-term spending plans are in line with the overall expenditure target.

Tax rates have been substantially reduced in the last few years, and are expected to continue to be cut in accordance with the long-term path adopted by the government. The reduction of tax rates supports growth and is in line with the policy of reducing the share of public expenditure in GDP over time. The tax burden in Israel at present is similar to the average in the developed countries (Figure 6.6), and its further reduction in accordance with the path will bring it to a level that is even lower than that.

The tax burden in Israel is similar to the average in the developed countries.

**b. Public civilian and defense consumption**

The public services should be improved both by making them more efficient and by moderately increasing expenditure, subject to the fiscal targets. Expenditure on the public services has been eroded in recent years, and the gap between Israel and the developed countries as regards the extent of the public services has widened (see Figure 6.4 and the detailed discussion in Chapter 6). It is true that because of its high defense expenditure, debt-servicing payments, and additional factors Israel is unable today to provide services at a level equivalent to those in more developed countries, but an effort must be made to avoid widening the gap. This is required for improving the quality of life as well as fostering economic growth and Israel's long-term competitiveness, all of which are influenced by the quality of the public services. An improvement is also required in the budgetary process and the implementation of budgets approved under the budget law. The problem of the under-spending of civilian ministerial budgets, which has been in evidence for several years, is discussed in Box 6.1.

The public services and the budgeting process should be improved.

The two main components of civilian public consumption are education and health. The need to improve the functioning of the education system—both by increasing resources and by making structural changes—is intensified by the marked gaps in achievement between pupils from different socio-economic backgrounds.[10] It is

[10] See section 3.2 of Chapter 6. For the development of the socio-economic composition of pupils and its effect on their achievements in their Bagrut (school-leaving) examinations, see section 4 of Chapter 8.

important to maintain an adequate level of public health services, inter alia in order to ensure a high level of accessibility to health services by weaker segments of the population. Although the public health package in Israel is generous in comparison with the developed countries,[11] spending on supplementary health insurance, and with it private spending on health, has soared in recent years, and this could have an adverse effect on the weaker segments of the population (section 5 of Chapter 8).

There was a switch in the perception of defense needs; changes are expected in defense spending.

The development of defense expenditure in the next few years is expected to undergo major changes, both in extent and in their budgeting process. Since 2003, in the context of the waning of the second Intifada and regional developments, the rise in the defense budget was curtailed drastically. Although in terms of the number of terrorist attacks the security situation has improved considerably since 2003, in the last two years there has been a turnaround in the perception of security needs, inter alia in view of the development of the Iranian threat and the deficiencies in the IDF that were exposed in the course of the Second Lebanon War. Consequently, in contrast to the fluctuations in defense expenditure since the beginning of the decade and which were connected to a great extent with the actual security situation, the increase in it that is expected in the coming years reflects a long-term policy that is associated with a change in the perception of needs and the potential threats.

The government adopted the recommendations of the committee set up to review the defense budget.

Extending the budget horizon of defense expenditure and increasing its extent found expression in the government's decision this year to adopt the recommendations of the committee appointed to examine the defense budget. The committee recommended, amongst other things, that a long-term budget covering ten years should be introduced for the military in order to utilize the advantages embodied in long-term planning and budgeting. The introduction of a long-term budget was intended not only to increase the military's confidence that its budget would not be cut at short notice, but also to ensure, provided there were no exceptional situations, that it would not increase beyond the path set. Accordingly, adherence to the long-term path would also help in the management of the civilian budget: in the last few years the civilian ministries have suffered on more than one occasion from extensive budget cuts during the year (across-the-board cuts) in order to finance the increase in the defense budget due to unexpected events. The committee recommended that a special reserve be allocated within the defense budget each year for such events (up to a certain scale), so that they would not constitute a reason to increase the total defense budget. In the next few years defense aid from the US will also rise, in accordance with the new agreement reached in 2007.

### c. Welfare, poverty, and the labor market

Israel's policy aimed at reducing poverty must take several of its main features into account. The poverty level in Israel is one of the highest in the developed world;

[11] For an international comparison of the health package, see section 4 of Chapter 8 in the 2006 edition of this publication.

it is concentrated in specific sectors of the population—particularly Arabs and the ultra-orthodox,[12] who are characterized by low employment rates and high birth rates—even though there is also considerable poverty among households with only one bread-winner. For several years the incidence of poverty rose sharply, inter alia because of government policy. The increase in the poverty rate was checked in 2005 and 2006, and the improvement was concentrated in those segments of the population which were connected with the labor market—evidence of the infiltration of growth to some of the weaker segments of the population via this market.

Poverty is concentrated among the Arabs and the ultra-orthodox.

These characteristics indicate that the policy aimed at reducing poverty should focus on boosting entry into the labor market and on defined segments of the population—especially Arabs and the ultra-orthodox. Acknowledgement of the importance of integration into the labor market as a means of reducing poverty was expressed in the adoption of the 'welfare to work' policy, but in effect a clear imbalance was created in this policy: enormous emphasis was placed on negative incentives, with a sharp cut in benefits, which played a crucial role in the fiscal adjustment of 2003. This was expressed inter alia in the reduction of transfer payments and in the policy's contribution to reducing the poverty rate (Table 8.1). Although this policy had some effect on the participation rate of persons with a low level of education (as described in Chapter 8), not enough was done to help develop positive incentives for integration into the labor market. This imbalance also contributed to the expansion of poverty among families with only one breadwinner, and even among those with more than one.

The policy of reducing poverty must focus on augmenting entry into the labor market.

Awareness of the imbalance created between the two kinds of incentives was expressed in several decisions made in 2007. The government adopted long-term targets regarding the extent of poverty and the employment rate, and a system of earned income tax credit was introduced (for details of the law, see section 7 of Chapter 5). Alongside the importance of determining these targets, they should be bolstered by specific policy measures which focus on the essential problems, without being content with measures intended to attain them that do not solve the underlying problem.[13] It should also be made clear how the attainment of these targets is consistent with the fiscal targets and other long-term expenditure plans.

The government adopted long-term targets regarding the extent of poverty and the employment rate; earned income tax credit was introduced.

Activity aimed at integrating the ultra-orthodox and Arabs in particular, and Israelis with a low level of education in general, into the labor market should be increased. It is especially important to act to raise the wages of persons who enter this market, especially in view of the expansion of poverty among families with a bread-winner. The introduction of earned income tax credit is an important step in this direction.

[12] This report discusses two segments of the population in which poverty is particularly prevalent: the ultra-orthodox and the elderly (sections 2 and 3 of Chapter 8). Poverty among the Beduin and the integration of immigrants from Ethiopia is discussed in Boxes 8.2 and 5.1 respectively in the 2006 edition of this publication. For a discussion of training programs for specific population groups, see part 2 of Bank of Israel, *Recent Economic Developments,* 118 (2007).

[13] For example, by slightly increasing the transfer payments to families which are close to the poverty line in order to bring them above the line. For further discussion, see Chapter 6.

Active policy in the labor market should be expanded, and the programs should be adapted to the unique characteristics of each population segment. Attention should be paid to the fact that an important part of the measures required do not involve significant budgetary outlay, and that in order to implement them what is required is mainly government determination. For an account of the steps that have been taken this year, see section 7 of Chapter 5.

The main measures that are recommended in order to attain these objectives are:

- **The significant and resolute reduction of the number of foreign workers.** It is proposed that the recommendations of the committee appointed to examine the subject of foreign workers, and which were recently adopted by the Minister of Finance, be implemented. According to these recommendations, the legal employment of foreign workers should cease completely by 2010 (other than those in agriculture and live-in carers of the disabled), and that all illegal foreign workers should be deported by 2012. The presence of foreign workers impacts on the wages and employment chances of Israelis with a low level of education, and has many other negative repercussions. There has been considerable slackness in the efforts to reduce the number of foreign workers of late, and their number actually rose in 2007.
- **Expansion of the 'Lights to Employment' program.** In 2007 some improvements were made in the Mehalev (Wisconsin) program, among them, in the criteria by which franchisees were rewarded. It is recommended that the program, which is currently in effect in several areas, be extended and aimed at additional segments of the population, including persons aged 45 or more.
- **Expansion of the vocational training programs.** The vocational training system has been greatly reduced in the last few years, and should be expanded in order to improve the chances of those individuals with low levels of skills of finding employment and earning a decent wage. This could be of particular help to persons who have been unable to find work for a long time and might therefore drop out of the labor force.[14]
- **Wider implementation of earned income tax credit.** The government decided to introduce earned income tax credit in areas where the 'Lights to Employment' program is in operation. It is recommended that the program be extended to the entire country, because of the importance of encouraging the integration into the labor market of those segments of the population with low earning potential and increasing the income of workers whose wage is low.
- **Improving labor market integration of those who do not receive income support payments.** This refers to unemployed persons and other segments of the population which do not receive income support payments, groups which do not get sufficient attention in the existing frameworks. The treatment of these groups should be improved in order to help them integrate into the labor market, using

[14] The discouraged worker effect is discussed in Bank of Israel, *Recent Economic Developments,* 120 (2008).

similar tools to those used in the 'Lights to Employment' program.

- **Stricter enforcement of the labor laws.** The enforcement of the labor laws should be augmented, in accordance with the government resolution on the subject passed this year. In addition, the negative aspects of employment by means of sub-contractors should be tackled more vigorously.
- **Amendment of the Capital Investments Law.** The contribution of the law in its present form to the encouragement of employment in the periphery is minimal. It should be amended to give greater weight to encouraging employment instead of stimulating investment in physical capital, and resources should be diverted from this law to alternative measures, such as vocational training.

Tackling welfare and poverty is not confined to welfare benefits and the labor market. An important role is played by the provision of public services, such as education and health. Education is particularly important for tackling the roots of poverty in the long run and for reducing its persistence from one generation to another. Old-age benefits were increased in 2007, but a large part of the treatment of the elderly—a segment of the population that is particularly vulnerable and prone to poverty—is connected with the public services, among them health, long-term care, and public order.

### d. Monetary policy

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

In common with other countries which have amended their central bank legislation of late, it is important that the introduction of the new Bank of Israel Law be completed. The new law must ensure the independence of the central bank and define its objectives clearly: the principal aim of the bank should be defined as preserving price stability in accordance with the target set by the government, while supporting other aims, including growth and employment, without impairing price stability and the orderly activity of the financial system. The bank should have complete independence in deploying the instruments required to attain its objectives. A monetary committee should be established which will make decisions in the sphere of monetary policy. The committee should be headed by the Governor of the Bank of Israel, and should also include external members with appropriate qualifications, who are devoid of conflicts of interest.

### e. The financial system

The reforms made in the financial system in the last few years increased competition within it, contributed to the greater dispersal of risks and the better allocation of capital, and supported several important economic processes. Nonetheless, the regulatory and supervisory mechanisms have not yet been sufficiently adapted to the extensive structural changes that have taken place in the system, chief among them the increased importance of institutional investors, especially insurance firms, at the expense of the banks. It is possible to discern new risks which are developing among both institutional investors and the banks. Until the end of 2007 the effect of the global financial crisis on Israel's financial system was moderate, but its effect may be more significant in the future.

The regulation and supervision of institutional investors, especially insurance firms, should be supplemented.

It is necessary to augment the regulation and supervision of institutional investors, especially insurance firms, and their management of risks and actual exposure. Special attention should be paid to the increased risks to pension schemes savers. It is recommended that improvements be made in the functioning of the markets and institutions in accordance with the lessons learned in Israel and abroad as a result of the global financial crisis. A combined effort should be made by the various supervisory authorities in preparation for dealing with financial crises. Action should be taken to increase competition and reduce concentration in the field of financial services to households. For a more detailed account, see Chapter 4.

**f. The infrastructure**

Public transport should be substantially improved, and an advanced system of mass transportation should be established in the Tel-Aviv metropolis.

The main challenge in the infrastructure sphere is to substantially improve public transport and get a significant number of commuters to shift from private to public transport. For this purpose it is necessary to persist in and extend the trend of diverting investment from roads to public transport; to establish an advanced system of mass transportation in the Tel Aviv metropolis, to invest the considerable resources required to achieve this, and to establish an appropriate authority for planning, executing, and operating this system;[15] to extend bus lanes; to increase the subsidies to public transport when this is justified; to accompany these vast investments with additional measures, such as congestion charges and higher parking fees, which will reduce car use and encourage the transition to public transport, especially by commuters. It is also recommended that wage distortions which encourage vehicle ownership be annulled, and that the incentives to use company cars be reduced further, beyond the recent moderate increase in the cost of using these vehicles. It is important to impose at least part of the marginal cost of travel on the user. These steps are in line with the recommendations of the recently published report of the Inter-Ministerial Committee on Ecological Taxation. For further discussion of the desired land transport policy, see Box 2.5.

There has been no improvement to date in the performance of the ports.

Three years after the introduction of the reform of the seaports there has still been no improvement in the indices of their performance, either relative to the period before the reform or in comparison with ports abroad. Accordingly, it is recommended that the operation of port infrastructures to be built in the future be transferred to operators not associated with the current port corporations.

It is recommended that airline competition (the 'Open Skies' policy) be increased by making changes in the bilateral aviation agreements between Israel and other countries. As a first step it is recommended that the code-sharing agreements between

[15] See the recommendations of the committee set up to examine the reform of public transport (the Sadan Committee), which were recently submitted to the Minister of Transport.

Israeli and foreign companies be limited, as they reduce the competition between them.

Action should be taken to restrain demand for electricity and in other infrastructure spheres.

The existing power-generating capacity is insufficient, in view of the present and expected level of future demand. Capacity build-up is a lengthy process which requires long-term planning and lengthy preparation. Capacity has not been expanded sufficiently in recent years, even though it was obvious that the problem would arise, and it will now take several years to put the matter right. As an immediate measure it is necessary to contain demand by means of a system of tariffs and incentives that will encourage people to save electricity and divert demand to off-peak hours. The policy of restraining demand must also become an integral part of long-term policy, together with the expansion of generating capacity, because of the negative environmental effects of electricity generation. Restraining demand must be an important component of policy also with regard to other infrastructures whose expansion has negative effects on the environment, such as roads, water, and the rezoning of land for construction.

Planning processes should be speeded up while maintaining an adequate level of planning.

Land policy is an extremely complex issue involving ethical, economic, legal and other considerations and involving many conflicting interests. Decisions in this sphere are characterized by a low degree of reversibility and by repercussions for the very long-term, so that great caution is required. One of the main questions in this context is the extent to which land should be privatized in Israel. It is recommended that public land in urban areas be privatized; if land is privatized in rural areas the continued public ownership of those areas intended to remain open should be ensured; land in areas intended for conservation should not be privatized (for further discussion, see Box 2.3). In a small, crowded country like Israel it is essential to avoid the wasteful use of land and to preserve open areas. Construction should be concentrated in towns, and high-rise construction should be encouraged, alongside plans for urban regeneration; the expansion of existing localities should be preferred over the establishment of new ones, and high-density construction should be preferred over low-density. It is important to speed up planning processes in regional and local planning committees while adhering to an adequate level of planning and protecting the public interest.