

Recent Economic Developments 122

May - August 2008

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Part 1: Review of Recent Economic Developments, May to August 2008¹

Main developments

The economic data relating to the period under review, May to August 2008, show that Israel's economic growth continued, albeit at a slower pace than in the last few years. The slowdown was expected, in light of the high rate of growth in the last few years, the closing of the output gap, and the full employment environment. Inflationary pressure and continued real appreciation, which halted in the period reviewed, are consistent with the assessment that the growth slowdown to a great extent expresses the convergence to full utilization of production capacity.

In the four months covered by this review, the financial crisis in the US became more severe, but there were no signs of any direct effect on Israel's economy, i.e., of any undermining of the stability of financial institutions. In light of the further slowdown in global growth, the pace of expansion of Israel's exports moderated, although electronics exports continued growing at a good rate, due to the sound situation of the US electronics industry. As a result of the continued rise in world input and commodity prices, albeit with many fluctuations, the terms of trade worsened, with an adverse effect on the economy.

Although in the period reviewed, as stated, no significant direct effect of the global crisis was felt in Israel, there were signs of concern that it could spread, including a decline in private consumption following persistent drops in consumer confidence indices. The continued crisis in the US in the period reviewed and its spread to the eurozone and other countries increased expectations that the global crisis would also affect Israel. The sharp fall in price indices of bank and high-tech shares in Israel reflected these expectations.

GDP increased by 4.2 percent in the second quarter of 2008, following its 5.6 percent increase in the first quarter, and the Bank of Israel's composite state-of-the-economy index rose only minimally in the four months reviewed. The slowdown in expansion was evident in most industries: although the index of manufacturing production rose, the rise was focused in the petrochemicals industry. The long upward trend in the trade and services revenue index also halted. The slowdown

was also reflected in a decline in the government's tax revenues towards the end of the period reviewed, but the deficit is not expected to exceed the ceiling. Despite all the above, the slowdown was not reflected in the labor market: the unemployment rate was very low compared with its past levels, and the nominal wage rose.

The slowdown world wide and in Israel is likely to ease inflationary pressures, but over the last twelve months the CPI has risen by 5 percent, far above the upper limit of the inflation target. Inflation in May–August was caused mainly by the increase in world input and commodity prices, which was reflected in increases in energy and food prices. At the same time there were indications of domestic inflationary pressures, which is consistent with the economy being in the environment of potential GDP. In light of all the above developments, the Bank of Israel increased the interest rate four times in the period reviewed, by a total of one percentage point, in order to return inflation and inflation expectations to around the middle of the target range within about a year.

Aggregate real activity

In May–August 2008 Israel's economic growth continued, but at a slower pace than in the last three years. **National Accounts** data show that in the second quarter GDP increased by 4.2 percent (Table 1.1), and business sector product by 4.9 percent (annual rates). An analysis of sources and uses shows, however, that while GDP increased, goods and services imports fell steeply, so that the total sources available to the economy and total uses hardly changed. The change in the composition of sources compared with the previous quarter, although surprising in light of the persistent real appreciation, occurred after a marked and continuous increase in imports in the last two years, much above the increase in GDP, and is likely to indicate the end of the process of the increase in imports.

Private consumption dropped at an annual rate of 3.6 percent in the second quarter, after rising steeply in the first quarter. It is reasonable to assume that the decline resulted in part from the fall in the value of public's asset portfolio since the beginning of the year. This is supported by the fact that the decline was most marked in the consumption of consumer durables, the demand for which is very sensitive to changes

¹ Since January 2008 Recent Economic Developments covers a four-month period. Until then it covered a quarterly period.

in current income.¹ Another reason for the fall in purchases of durables was the surge in vehicle purchases in the first quarter following a cut in the purchase tax on them.² Current consumption continued to rise, but more slowly than in the previous quarter. This moderation followed a continuous decline in consumer confidence indices that started in the second half of 2007.

Fixed investment fell back a little in the second quarter, the result of no change in investment in the principal industries and a small drop in housing investment. This trend had started in the last quarter of 2007, when the increase in fixed investment halted, especially in the principal industries, to some extent reflecting the uncertainty in the business sector regarding the economic situation. Also contributing to the reduction in investment in the second quarter was the decline in investment in vehicles, following the surge in purchases in the first quarter, although investment in machinery and equipment rose by a steep 9.8 percent.

Public consumption dropped at an annual rate of 3.3 percent in the second quarter, after rising sharply by 10 percent (annually) in the first quarter. The decline derived from a sharp drop in domestic defense consumption, whereas public civilian consumption increased by 5.2 percent, further to its increases in previous quarters.

The rise in **goods and services exports** moderated in the second quarter. This was due to the global slowdown in growth, the six percent deterioration in the terms of trade since the beginning of the year, and the continued real appreciation calculated via export prices in the period reviewed: the relative price of exports (relative to GDP prices) fell by about 4.2 percent, following its 5 percent fall in the previous quarter. The modest increase in exports reflects a reduction in services exports, following their sharp increase in the first quarter, and a rise in goods exports.

The various categories of goods exports did not increase uniformly: exports of electronics grew, as a result of the continued expansion of that industry in the US, as reflected in the Tech-Pulse index that measures the activity of the US high-tech industries. The petrochemicals industry, whose exports account for about 30 percent of manufacturing exports, and most of whose product is exported, grew rapidly.

¹ See Yaacov Lavi, "Do Changes in Current Income Help to Explain Changes in Consumption in Israel?, An Empirical Study of the Permanent Income Theory with Rational Expectations," Bank of Israel Research Department Discussion Paper Series, 1995 (Hebrew).

² In the first quarter vehicle purchases increased as a result of a reduction as planned of 6 percentage points in purchase tax, and a smaller than expected increase in the imputed tax value of company cars.

Exports of most of the other manufacturing industries, on the other hand, were sluggish.

Imports fell at an annual rate of 8.6 percent in the second quarter, after rising at about that rate in the first quarter, and civilian imports, excluding ships, aircraft and diamonds, dropped by 15.4 percent. The decline in imports reflected a steep fall in imports of durables and services, following two quarters of significant increases in these categories. The reduction in imports resulted from the cumulative real appreciation, derived from import prices, which stopped in the period reviewed.

GDP prices (in quarterly terms) remained unchanged in the second quarter, and prices of business sector product dipped by 1.2 percent. In contrast, prices of private consumption, excluding durables, most of which are imported, increased by 3.4 percent, further to their 1.6 percent increase in the first quarter. This is an expression of the high level of domestic activity, and is consistent with the rise in the CPI. After a long period, the real appreciation calculated using the weighted purchasing power method halted (Figure 1.13)

By-industry real activity

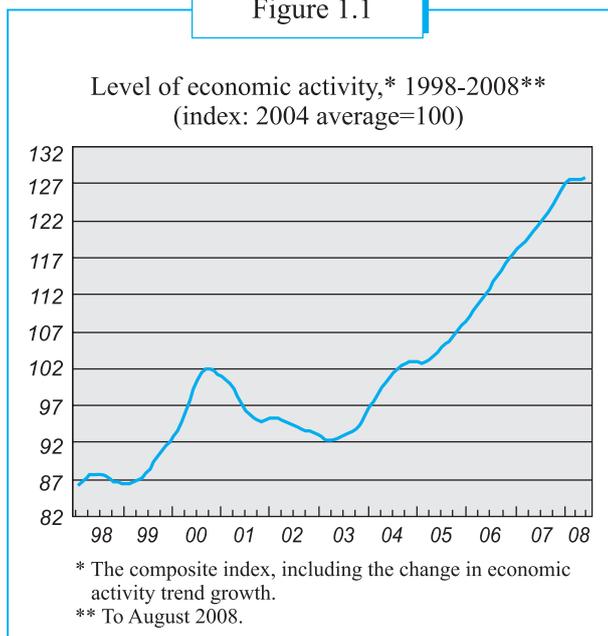
According to available data for the period May–July, the **manufacturing output index** rose by 2 percent (seasonally adjusted) on the heels of an increase in the previous period. However, not all industries participated in the expansion: manufacturing output excluding petrochemicals did not increase relative to the previous period (Figure 1.2). The significant contribution of the petrochemical industry to the overall growth rate is also evident from the fact that the growth rate excluding petrochemicals was much lower.

The trend in manufacturing output also differed perceptibly by degrees of technology intensity; most of the upturn occurred in high-tech industries, whereas output was stagnant in other industries and actually contracted in traditional industries. The gentle increases in output that were found in most industries are compatible with the findings of the Bank of Israel Companies Survey, which pointed to a significant slowdown in Q2 pursuant to that reflected in the previous survey.

The trend in **manufacturing factor inputs** also points to a slowdown. According to the manufacturing indices, manufacturing employment failed to increase for the first time since Q2:2005 and labor hours contracted³ (Figure

³ These indicators of labor in manufacturing, originating in the manufacturing survey, are not fully compatible with the data of the CBS labor force survey.

Figure 1.1



1.2). The manufacturing expectations survey for Q3, which reflects the continuation of the review period, foresees a decrease in manufacturing headcount. Nonresidential investment declined and, according to the survey, the growth of manufacturing fixed investment slowed perceptibly amid a decrease in utilization of manufacturing machinery and equipment. The Bank of Israel Companies Survey also indicates that manufacturing headcount fell in Q2 and that utilization has fallen since the beginning of the year.

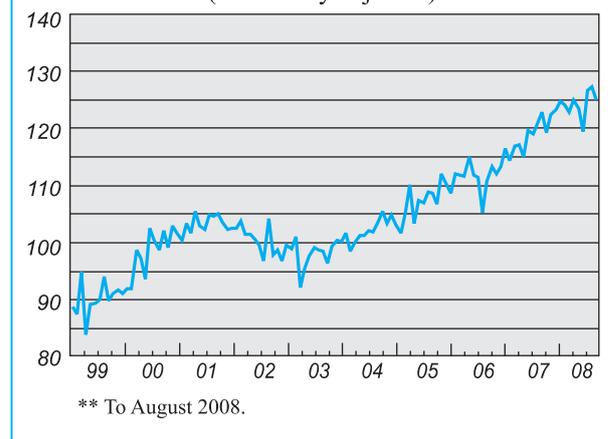
In **commerce**, the protracted upward trend in sales stopped in Q2 (Table 1.2); sales rose negligibly and the data for the review period suggest that they declined. **Services** also faced a slowdown: according to available data for the review period, sales of business services and hospitality and restaurant services slumped. **Commerce and services** turnover decreased during the review period, but at the end of the period there were indications that the upward trend that typified this sector in recent years resumed. Thus, increases were observed in turnover and in total credit-card sales, which predate the turnover data by one month and serve them as an advance proxy.

After continuous expansion since the late-2006 trough, **tourism** was basically unchanged during the review period but remained at the high plateau established earlier in the year. For example, average room occupancy was 72 percent in July 2008 as against 67 percent in the year-earlier month. Room occupancy and tourist arrivals increased in all districts but did so with special vigor in the Jerusalem District due to an upturn in inbound tourism. Inbound tourism also

Figure 1.2



Large-scale retail trade
(Seasonally adjusted)

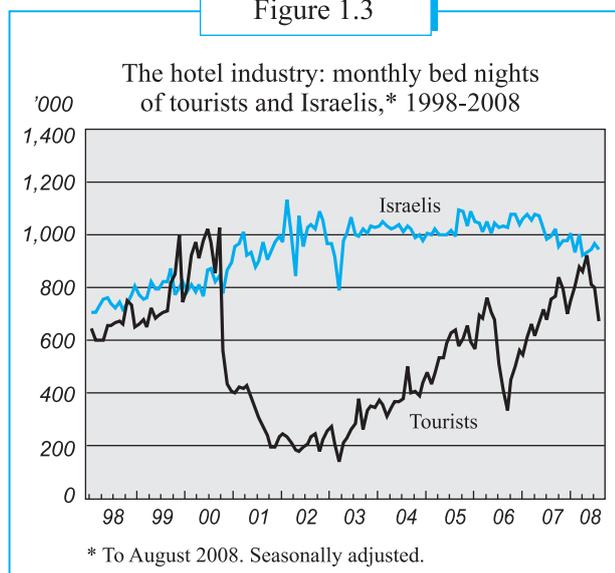


increased in the other districts and compensated for the continuing decline in domestic tourist person-nights (Figure 1.3, seasonally adjusted data), which originated in higher prices for domestic hospitality services and relatively lower prices of alternatives abroad due to protracted currency appreciation. The hotels that take part in the Companies Survey reported in Q2:2008, for the first time in a long while, that the demand constraint in domestic tourism was more severe than that in inbound tourism.

According to most indicators, **construction** showed no signs of recovering from the slump that has afflicted it in recent years (Figure 1.4). During the review period, construction starts decreased, sales of new dwellings built at private

initiative declined, and housing transactions fell. However, housing completions and area of construction starts at private initiative did turn upward.

Figure 1.3

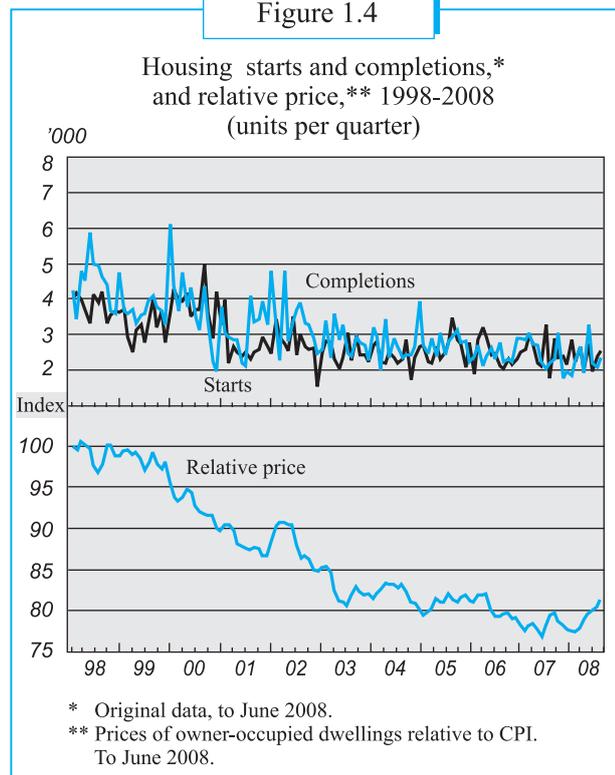


Since late 2007, the economy has offered expedient terms for an increase in construction activity: strong economic growth, low mortgage rates, real-estate purchase-tax benefits, and a lowered rate of VAT. Just the same, industry activity has not improved, as noted above. During the review period, the terms worsened slightly relative to those available at the beginning of the year: economic growth slowed, prices of intermediates picked up at a faster rate, and interest began to rise. Consequently, there is concern about a further deterioration in the condition of this industry. However, a steep increase in residential real-estate transactions in Q1:2008 augurs well for the future of construction activity.

The labor market

According to the CBS Labor Force Survey for Q2:2008, the **unemployment rate** fell from 6.2 percent to 5.9 percent during the quarter, following a decrease in the previous quarter, the **participation rate** declined, in contrast to its rise in the previous quarter, and the **employment rate** rose slightly (Table 1.3 and Figure 1.5). Among those in the main working-age cohort (25–64) the unemployment rate fell somewhat more significantly, from 5.3 percent in Q1 to 4.9 percent in Q2, as the participation rate held stable and the employment rate climbed.

Figure 1.4



The mild increase in the employment rate was composed of an upturn in the number of full-time employees, although not as steeply as in Q1, and a slight decline in the number of part-time workers. The number of unwilling part-time workers contracted by an especially precipitous 10.7 percent. Increases in employment were noted in both the business and the public sectors. However, the trend among industries in the business sector was uneven as manufacturing, commerce, and motor-vehicle repair took in workers whereas banking, finance, and transport and communications shed them.

Despite the generally favorable indicators in the Labor Force Survey, different sources report several troubling signs. According to National Insurance data, the number of jobseekers actually increased in Q1 for the first quarter-on-quarter upturn since Q1:2006. Jobless claims rose in Q2 and climbed further in July. The number of employee posts in the business sector began to fall during the review period. The Ministry of Industry, Trade, and Labor employers' survey for Q2 also delivered the worrisome news that the positive employment balance (hiring vs. firing) has declined and employers' personnel expectations for the rest of the year were more pessimistic than before. Finally, the Manpower company's want-ad index, accepted as a proxy for demand for labor, declined on average during the review period, although it edged upward in July.

Figure 1.5

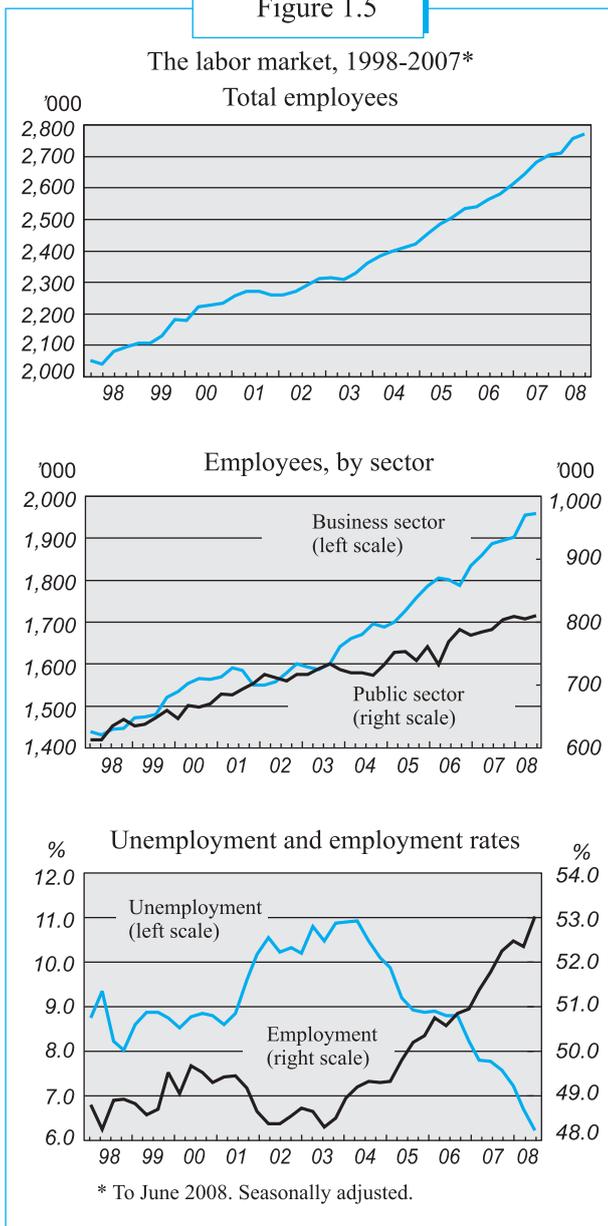


Figure 1.6

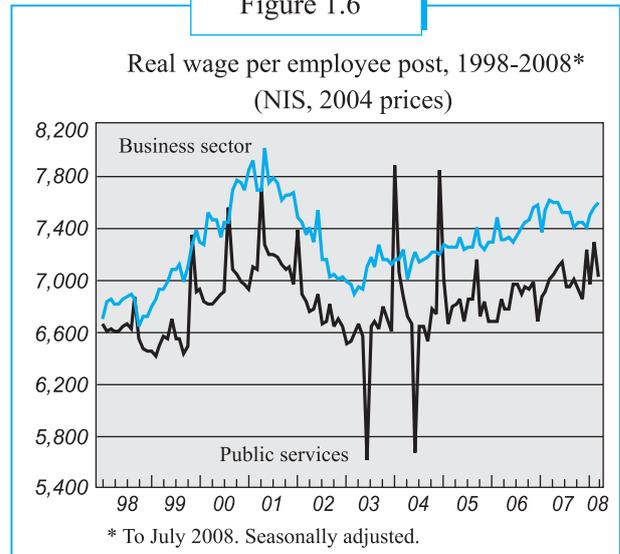
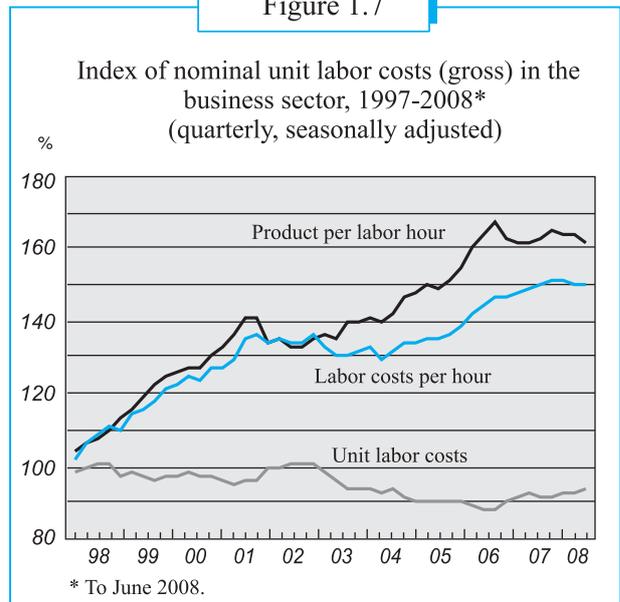


Figure 1.7



The rate of increase in the nominal wage per Israeli employee post increased in May and June, due to the high level of activity, which exerted upward pressure on wages in the business sector, and due to a similar rise in public sector wages following the signing a wage agreement in April. This trend reversed in July, but in that month the nominal wage was still 4.3 percent higher than in July 2007. The real wage was 0.4 percent lower in July 2008 than in July 2007. The erosion was due to an unexpected rise in prices, as well as the increase in world input prices, which cut into manufacturers' profits and made it difficult for them to increase wages.

The government

The slowdown in economic activity was manifested in a decline in tax revenues during the review period. Nevertheless, the deficit ceiling is not expected to be breached this year and, by all appearances, fiscal credibility will persist. The government's approval of the 2009 budget also enhanced credibility, especially since the programmed increase in expenditure is compatible with the expenditure increase target to which the government is committed—1.7 percent.

From the beginning of the year to the end of the review period (August), government activity excluding net issue of credit showed a total surplus of NIS 2.2 billion (Table 1.4 and Figure 1.8). The domestic surplus to that time, NIS 4.6 billion, surpassed the seasonal trajectory that corresponds to the budget because tax revenues exceeded the budget outlook and expenditure was underperformed. Toward the end of the review period, the economic downturn began to express itself in the form of sluggish revenues.

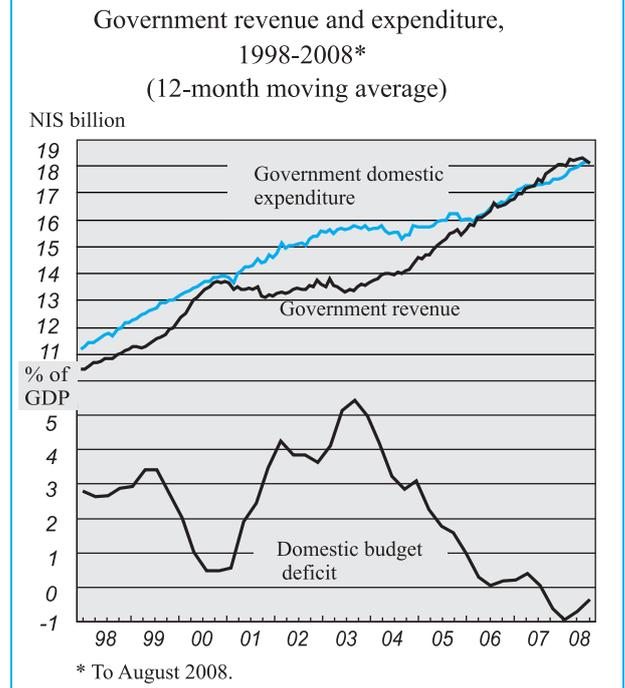
Direct and indirect tax revenue slowed during the review period and fell below the seasonal trajectory, growing by a paltry 0.8 percent relative to the year-earlier period (net of legislative changes and adjustments). Most of the decrease is explained by a decline in direct-tax revenues, at 2.4 percent for the period all told and at an especially steep pace toward the end of the period (August). Indirect-tax revenues increased more gently during the review period than at the beginning of the year—by 4.4 percent—and slipped by 3.3 percent in August.

The looming downturn in economic activity is expected to cause the slump in tax revenues—which began back in the second half of 2007 due to a decline in revenues on account of corporate and capital-gains taxes—to continue. Even if such a continuation comes to pass, however, it is unlikely to cause the deficit ceiling to be overshot this year.

Government expenditure fell short of the full budget-performance level but budget performance during the review period was bumpy. After strong performance in May–July, expenditure was very weak in August for reasons including a technical move-up of Ministry of Education expenditure to July. Since the beginning of the year, government ministries' outlays increased by 4.2 percent, much as the budget had intended. At the end of the review period, the rate of performance of the (original) annual budget stood at 62 percent, more or less matching the previous year's level.

During the review period and since the beginning of the year, there were no notable divergences in the government's financing activity, and it is still difficult to determine whether its financing revenues this year will correspond to the outlooks. One of the decisions made with regard to the 2008 budget was to raise NIS 4 billion through privatization. To date no significant privatization has been undertaken, and the government is still dealing with the privatization of Bank Leumi and the Bezeq phone company, which could bring in considerable capital.

Figure 1.8



The balance of payments

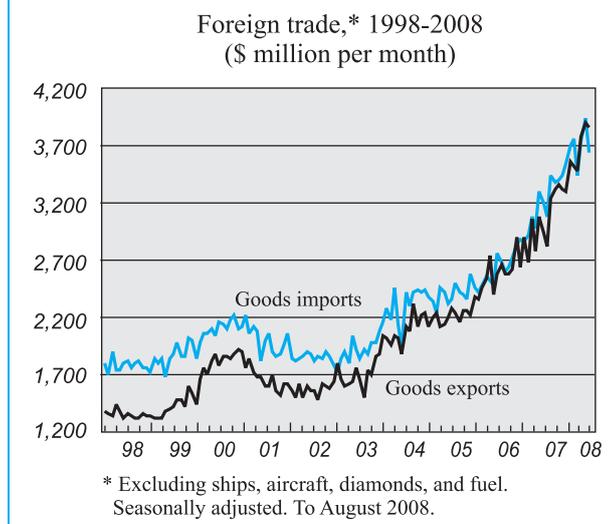
Data on the balance of payments in the second quarter of 2008 showed a surplus of about \$1 billion in the current account, following a surplus of \$1.1 billion in the first quarter. This stability in the current account reflects relative stability in all its components. The surplus in the first half of 2008 was about 20 percent lower than that in the first half of 2007, but it exceeded expectations that took into account the economic crisis in the US and the rise in energy prices.

The trade deficit increased slightly to \$900 million, with changes in its components: the deficit in the goods account contracted to \$1.9 billion in the second quarter, while the surplus in the services account reduced to about \$1 billion.

Global developments

The effects of the global economic crisis continued to be felt during the period under review and the concern regarding its underlying causes has yet to dissipate. Thus, although many of the problems that have arisen in the financial sector as a result of the sub-prime mortgage crisis have been identified and dealt with, there is still significant uncertainty as to the scope of the crisis and its effects in the future. In addition, the price of housing is still falling in many countries, particularly

Figure 1.9



the developed ones, and the slowdown in real estate activity continues. Finally, although the prices of oil and other inputs have fallen, they continue to fluctuate and commodity prices have stabilized at high levels.

The combination of factors that are acting to slow global economic activity and are creating upward pressure on prices has led to fears of stagflation. On the one hand, the slowdown in global growth is expected to continue due to the crisis in the financial sector and therefore policy decisions are called for that will support financial activity and relieve the liquidity crisis. On the other hand, the rise in the prices of inputs and commodities dictates against an expansionary policy, which is liable to increase the pressure on prices, and some developing countries are already in the midst of an inflationary episode.

The continuing global slowdown during the period under review was manifested in a drop in the global growth rate (particularly in the euro bloc where growth came to a standstill), an additional weakening in manufacturing production in the developed countries (and in some of the developing countries as well) and a decline in the indicators of consumer confidence and business stability in the developed countries. In view of the situation, the forecasts of the IMF call for a continuation of the slowdown during the second half of the year. The forecasted global rate of growth is 4.1 percent, as compared to 5 percent in 2007, and an even greater decline is expected in the developed countries, from 2.7 percent last year to 1.7 percent this year. The global slowdown is expected to continue in 2009 although it will attenuate towards the end of the year.

The national accounts data for the **US** were surprisingly favorable with GDP growing by 2.8 percent during the second quarter of 2008 relative to the previous quarter. This was a result of the growth in manufacturing exports, particularly petroleum products. Investment in the business sector grew at a moderate rate, primarily as a result of the increase in the purchase of computer equipment and software. In general, there was still no noticeable drop in hi-tech activity, as evidenced by the continuing rise in the Tech Pulse index and the continuing growth in the import of hi-tech products. The rate of unemployment rose to 5.7 percent although the rate of job loss was lower than expected. During the last 12 months, inflation in the US has risen to 5.6 percent and core inflation—the target indicator of monetary policy—reached 2.5 percent. During the period under review, the Fed rate remained unchanged at 2 percent.

The macroeconomic data, which were positive relative to forecasts, did not affect the pessimistic expectations for the US economy and the concern over the financial situation continued to play a leading role in the markets. The real estate crisis is in full swing and in contrast to the consistent growth in non-residential construction activity, residential construction is in a recession and its sharp decline continued during the period under review. The banks' credit spreads, which reflect the risk premium, remained high during the period under review and the quantity of loans remained low despite the measures taken by the Fed to alleviate the liquidity crisis. The difficult situations of the two large mortgage companies, Fannie Mae and Freddie Mac, exacerbated the already pessimistic outlook and the federal authorities were forced to nationalize them. On the other hand, the authorities chose not to come to the aid of the Lehman Brothers investment bank.

The slowdown in the rate of expansion was also reflected in the macroeconomic data of the **euro bloc**. Thus, its GDP fell during the second quarter at an annual rate of 0.8 percent, following growth of more than 2 percent during the first quarter, and unemployment rose to 7.3 percent. Alongside these developments, manufacturing production weakened, the credit rating of many European companies was reevaluated downward and indicators of consumer confidence were at particularly low levels. The situation in the **UK** also worsened significantly and the British housing market experienced a particularly severe crisis. The European Central Bank raised interest rates during the period under review by 0.25 percent to 4.25 percent though the financial markets are expecting the possibility of lower interest rates in the coming year, which can be explained by reduced expectations of inflation due to the economic slowdown.

In **Japan**, GDP continued to decline during the second quarter at an annual rate of 2.4 percent relative to the

previous quarter. The influence of energy and food prices was strongly felt in Japan as well, though core inflation rose only slightly and the central bank left the interest rate at 0.5 percent during the period under review.

The **emerging markets** are facing increasing rates of inflation and as a result interest rates were raised in India, South Korea and Russia during the period under review. At the same time, there are signs that the crisis is spreading from the developed countries to these markets. Thus, the rate of growth in manufacturing production declined sharply in China and it is expected that the central bank and the government will take measures to encourage exports and growth. Despite weakening growth, China's credit rating was raised as a result of its stability during the first half of the year and it is expected that the large surplus in its balance of payments will provide it with some protection from the global crisis.

Oil prices reached a record level of \$147 per barrel during the period under review but as a result of the global strengthening of the dollar and the expansion of oil production, prices then dropped by more than 20 percent from that peak.

Prices, monetary policy and the money and capital markets

The **CPI** rose by 2.8 percent from May to August and by 4.4 percent since the beginning of the year. During the previous 12 months, inflation reached 5 percent, which is well above the upper bound of the target range (Table 1.7 and Figure 1.11). Although the CPI rose by a surprisingly low amount in June, in July it was again outside the target range. As a result, its total increase during the period under review was higher than its forecast and the seasonally-adjusted path towards the inflation target.

Inflation during the period under review was primarily the result of the increase in the global prices of inputs and commodities, which was reflected in the energy and food components. However, as a result, the CPI discounted for energy and food and fruits and vegetables rose by only 2.1 percent during the past 12 months, though in July it rose by 0.9 percent and in August by 1.1 percent. This increase, which among other things reflected the increase in the housing component, is evidence that—in addition to external factors—there exists domestic inflationary pressure as a result of the high level of economic activity. These effects would be even more pronounced if there had not been an ongoing appreciation in the exchange rate that worked to moderate price increases.

Figure 1.10

Israel's high-tech manufactured exports to the US and US high-tech manufactured imports, 1998 to June 2008

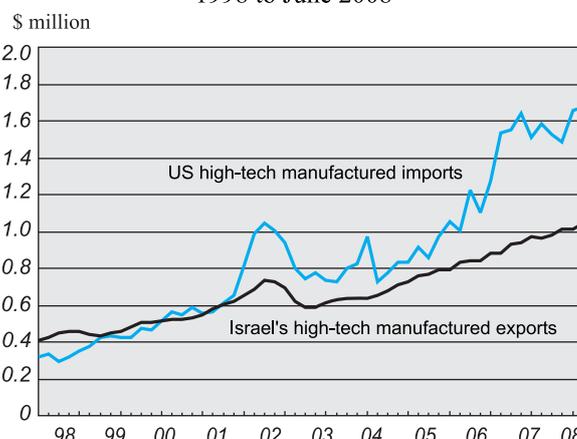
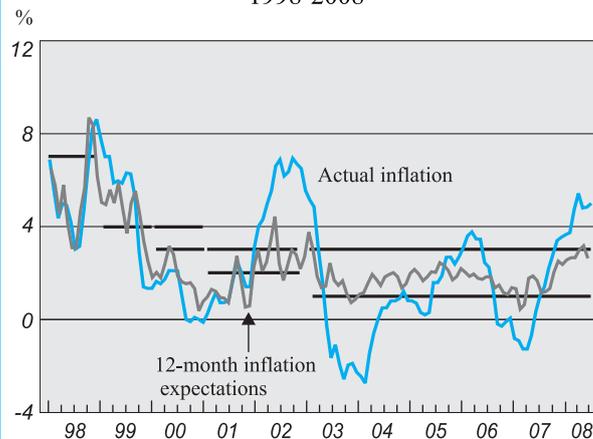


Figure 1.11

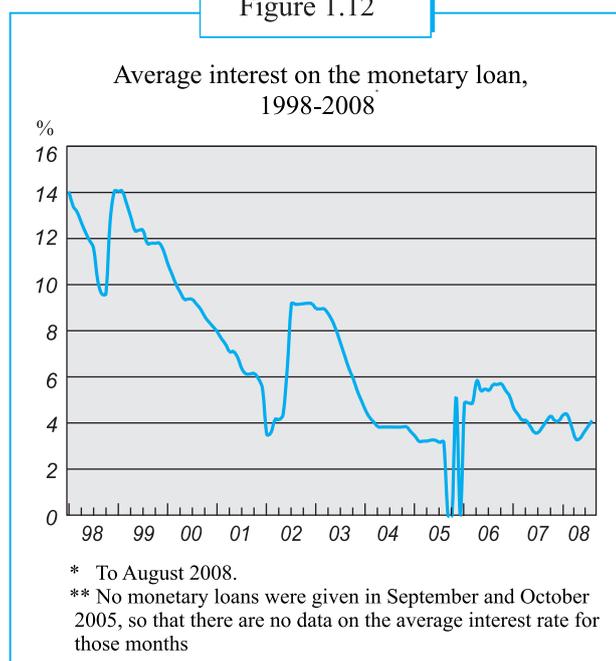
Inflation in previous 12 months, inflation expectations, and the inflation target, 1998-2008*



* 12-month inflation expectations as calculated by the Bank of Israel Monetary Department. To August 2008.

At the beginning of the period under review (i.e. in May), it appeared that the slowdown in economic activity would constrain the rise in prices and therefore it was decided to leave the interest rate unchanged. The slowdown later in the period was less than expected and there was no noticeable reduction in inflationary pressure. As a result, the **Bank of Israel interest rate** was raised during the subsequent four months (June-September) by one percentage point in four stages and stood at 4.25 percent at the end of the period

Figure 1.12

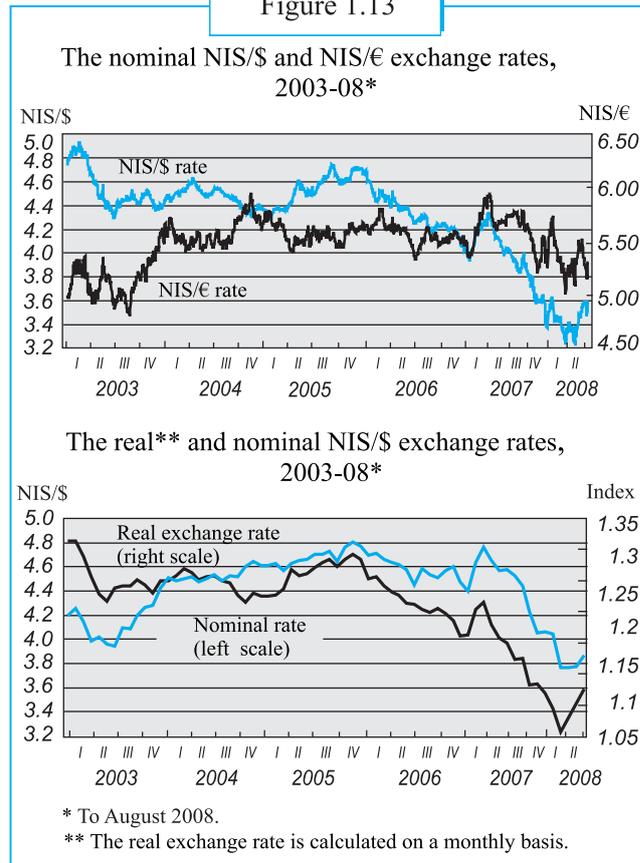


under review. In September (after the period covered by this review), in light of the signs of an easing of demand in Israel and world wide and the fall in commodity and oil prices, it was decided not to change the interest rate. In October, with the further deterioration in the global crisis, the interest rate was reduced by half a percentage point.

Overall, there was no significant change in the nominal NIS/\$ **exchange rate** during the period under review though there were sharp fluctuations during the period. The exchange rate fell from NIS/\$ 3.43 at the beginning of the period to 3.25 at the beginning of July. It then began to rise and reached 3.60 by the end of the period. The change in trend was a result of the strengthening of the dollar against other currencies and the announcement of the Bank of Israel that it is increasing its purchase of dollars from \$25 million to \$100 million per day. During the period under review, the Bank of Israel bought \$4.2 billion as part of its plan to increase foreign exchange reserves and against the background of the rapid changes in the exchange rate. During the period, the shekel strengthened against the euro, primarily due to the weakening of the euro against other currencies which was the result of worrying signs in the performance of the euro bloc economy. The exchange rate of the shekel against the effective currency basket was on average 3.9 percent lower in the period reviewed than in the previous period, but in July it started rising.

Expectations of inflation for the coming 12 months fell somewhat during the period under review but were still very close to the upper bound of the target range. The expectations

Figure 1.13

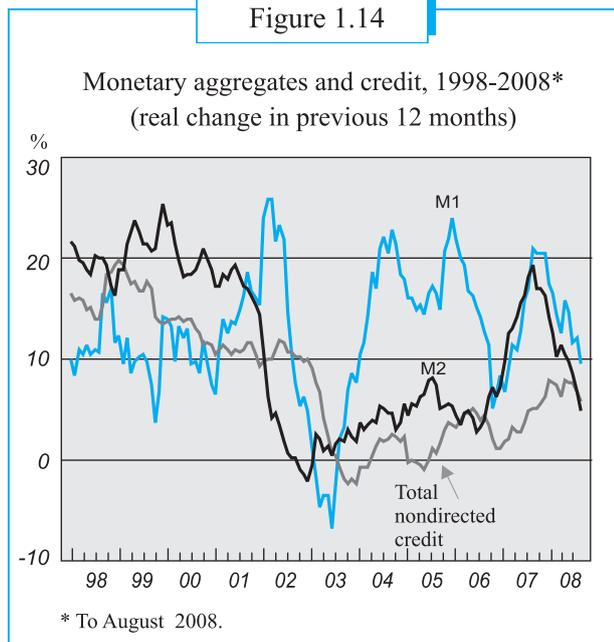


derived from the capital market stood at 2.7 percent at the end of the period under review as compared to 3 percent at the beginning of the period. At the same time, local forecasters expect that inflation over the next 12 months will be 2.9 percent and will total 4.7 percent for 2008. Meanwhile, they expect inflation to return to the center of the target range of price stability during 2009.

In view of the high expectations of inflation, the *makam* yield curve reflected **expectations of a rise in the interest rate** at the beginning of the period under review. By the end of the period, following a cumulative increase of one percentage point in the interest rate, the slope of the curve flattened significantly and reflected expectations of stability in the interest rate in the short and medium terms.

Growth in the **money supply**, including the liquid monetary aggregates, continued at a high rate, which exceeded both the expected rate of growth in the economy and the rate of inflation (Table 1.8 and Figure 1.14). This was due, at least in part, to the growth in the money base. Nevertheless, the slowdown in the rate of growth in **non-directed bank credit** since the beginning of the year continued as a result of the dampening of economic growth and the cautious approach adopted by the banks in the granting of credit.

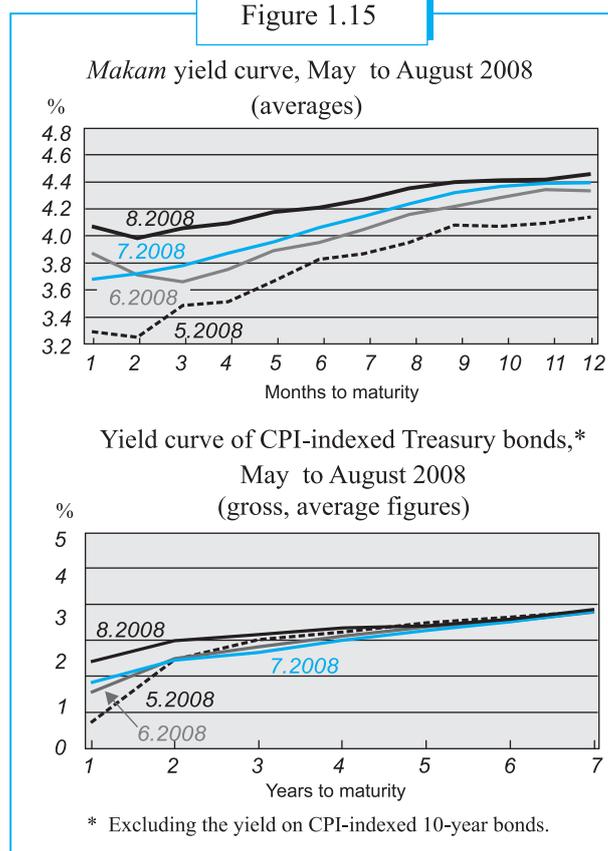
Figure 1.14



The value of the **public's asset portfolio** declined during the period under review, thus resulting in a cumulative real decline of 4.6 percent since the beginning of the year.⁴ Due to the growing concern over a global financial crisis, the component of shares fell from 24.3 percent at the beginning of 2007 to 20.8 percent in June of this year. The proportion of foreign investments held by Israeli residents was 8.8 percent in June of this year, as compared to 11.3 percent in the same month last year. The decline was the result of liquidation of investments, the drop in share prices on exchanges around the world and the weakening of the dollar. In contrast, the proportion of CPI-indexed assets grew considerably as a result of the increased risk of inflation and increased risk in general.

During the period under review, there was an uninterrupted decline in the General Share Index of the **Tel Aviv Stock Exchange**, which was 1.7 percent lower than the average for the previous period and which had fallen by about 20 percent since the beginning of the year. The share indexes of the banks and hi-tech companies led the decline while the share indexes for manufacturing, commerce and services declined only moderately. This reflects the assessments of investors regarding the sources of the slowdown, i.e. the financial crisis in the US and a possible slowdown in global hi-tech activity as a result, although these factors have yet to affect real activity.

Figure 1.15



⁴ Not including government obligations to the veteran pension funds.

Table 1. National Accounts,^a 2007-08

	Change from previous quarter						
	2007				2008	2008/II	
	2007 ^b	II	III	IV	I	Change from previous quarter	Year on year change ^{b,c}
GDP	5.4	6.1	5.8	5.8	5.6	4.2	5.3
Business-sector product	6.2	7.0	7.2	7.3	6.5	4.9	6.5
Private consumption	6.7	3.8	8.2	3.7	9.3	-3.6	4.3
Gross domestic investment	12.0	54.8	0.6	19.5	-20.4	4.7	0.1
Fixed investment	15.5	16.3	48.2	-10.3	7.5	-0.5	9.2
Goods and services exports							
excl. diamonds	9.0	7.2	11.6	24.4	-3.1	13.1	11.1
Goods exports ^d	7.5	19.3	3.4	0.6	60.1	-18.1	8.1
Services exports ^d	9.5	12.8	12.4	12.3	24.1	4.6	13.1
Goods and services imports							
excl. diamonds	11.1	23.0	26.8	-2.3	3.7	-2.6	5.7
Goods importse	16.4	23.2	-6.0	16.3	22.5	-17.7	2.5
Services imports ^e	13.5	21.8	9.2	18.9	14.2	-15.4	5.8
Public sector consumption	2.9	7.5	0.4	-3.0	10.0	-3.3	0.9
Public sector consumption							
excl. defense imports	3.5	1.8	4.2	1.7	2.1	-3.7	1.0
Domestic use of resources	6.5	11.6	3.4	9.3	1.1	-2.0	2.8

^a Percentage change in annual terms, at constant prices, seasonally adjusted.

^b Unadjusted data.

^c In quarterly terms

^d New calculation - excluding subsidies.

^e New calculation - excluding taxes.

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,^a 2007-08

	Change from previous quarter					May - Aug 08		
	2007 ^b	2007		2008		Change from previous period	Year on year change ^{b,c}	Last month for which data available*
		III	IV	I	II			
Composite state-of-the-economy index	-0.1	6.8	7.2	9.2	4.6	2.9	6.2	Jul
Large-scale retail trade	6.7	10.9	8.4	1.9	-2.4	1.8	3.3	Jul
Manufacturing production								
(excl. diamonds)	4.9	10.8	10.0	17.9	9.5	4.4	10.7	Jun
Index of trade revenue	7.6	4.9	0.6	7.5	-2.6	-8.9	0.7	Jun
Index of trade and services revenue	9.0	5.1	2.4	2.8	-3.6	-5.5	0.6	Jun
Index of export - services	11.8	-14.4	71.0	26.4	-4.1	-10.1	12.8	Jul
Tourist arrivals	24.7	84.7	80.4	15.2	24.5	3.8	33.1	Aug
Residential construction ^b								
Starts	0.2	17.5	-2.1	-6.4	-4.5		-2.9	Jun
Completions	-7.0	4.9	-29.4	-7.2	2.1		4.6	Jun
Nonresidential construction ^b								
Area of starts		0.0	15.2	15.2	24.2			Jun
Survey of companies (net balance, percent) ^d								
Weighted balance of the business sector	33	40	40	34	13			Jun
Output of manufacturing firms	27	34	34	23	3 **			Jun
Sales by trading firms	37	46	46	36	-5 **			Jun

* When the last month is August, the comparisons are of four-month periods; when the last month is June, the comparisons are quarterly; and when the last month is July, the comparisons are monthly.

** Not significant at 5% level.

^a Percentage change, in annual terms, seasonally adjusted.

^b Unadjusted data.

^c In quarterly terms.

^d The net balance is defined as the difference between the number of firms reporting a rise and those reporting a decline, as a proportion of all reporting firms.

SOURCE: Based on Central Bureau of Statistics and Ministry of Construction and Housing data.

Table 3. Indicators of Labor Market Developments, 2007-08

	2007		2008		May - Aug 08			
	II ('000s)	III percent change from previous quarter	IV percent change from previous quarter	I percent change from previous quarter	II percent change from previous quarter	Change from previous period	Year on year change*	Last month for which data available*
Civilian labor force	2,945.3	0.5	-0.3	1.2	0.2	0.2	1.7	Jun
Israeli employees	2,771.0	0.9	0.2	1.7	0.5	0.5	3.6	Jun
<i>of which:</i> in general government	810.1	2.1	0.5	-0.4	0.6	0.6	2.7	Jun
in business sector	1,959.4	0.4	0.5	2.7	0.2	0.2	3.9	Jun
Foreign workers and Palestinians (unadjusted)	396.6	4.7	4.2	2.5	-0.6	-0.6	11.1	Jun
Average hours worked weekly per employee	37.1	0.5	0.5	-0.5	1.4	1.4	1.7	Jun
Labor input in business sector (incl. foreign workers and Palestinians)	96,875.0	1.5	1.5	2.0	1.1	1.1	6.1	Jun
<i>of which:</i> Israelis	85,054.0	1.1	1.3	1.5	1.5	1.5	5.5	Jun
Labor input in general government (Israelis)	17,629.0	3.8	-0.7	2.7	0.9	0.9	5.0	Jun
Unemployed	174.3	-4.4	-7.5	-5.8	-4.9	-4.9	-21.6	Jun
Work seekers	191.1	-3.4	-3.1	-2.3	2.8	0.0	NA	Jun
Claims for unemployment benefit	57.7	-4.2	-7.0	-2.8	2.3	20.2	-6.0	Aug
Real wage per employee post ^b	7,406.6	-1.2	0.3	1.7	-0.8	-4.6	-0.1	Jun
In general government	7,152.4	-1.5	0.6	1.0	-0.9	-3.4	-0.1	Jun
In business sector	7,526.1	-0.9	-0.7	1.5	0.3	-0.9	-0.1	Jun
Nominal wage per employee post ^b	8,018.0	0.1	1.5	2.8	0.5	0.7	4.9	Jun
In general government	7,744.2	-0.2	1.6	2.3	0.4	2.2	4.9	Jun
In business sector	8,146.7	0.3	0.5	2.7	1.7	4.6	5.0	Jun
Participation rate	56.4	56.5	56.1	56.6	56.4			Jun
Employment rate	53.1	52.5	52.4	53.0	53.1			Jun
Unemployment rate	5.9	7.2	6.7	6.2	5.9			Jun
Depth of unemployment ^c	36.2	30.4	30.1	34.0	36.2			Jun

* When the last month is August, the comparisons are of four-month periods; and when the last month is June, the comparisons are quarterly.

^a Unadjusted data.

^b Including foreign workers and Palestinians.

^c Percent of unemployed seeking work for more than six months (unadjusted).

SOURCE: Central Bureau of Statistics, Labor Force Survey, except for data on Israelis, non-Israelis, and labor input in the business sector, and total Israelis employed, which are the Central Bureau of Statistics' National Accounts estimates.

Table 4. Government Budget Performance, 2007-2008

	2007		2008		May - Aug 08			
	2007	III	IV	I	II	Change from previous period	Year on year change	Last month for which data available*
Domestic deficit as percent of GDP	1.4	2.1	-2.6	4.6	0.1	0.1**	2.1	Aug
Deviation from domestic budget path, excl. credit extended ^a								NIS billion, ^b nominal prices
Revenue		4.1	3.2	2.5	0.4	-4.5	-5.5	Aug
Expenditure		-0.7	-0.6	-0.3	-0.9	-2.9	0.8	Aug
Deficit		-4.8	-3.8	2.8	1.3	-2.6	-7.3	Aug
Total deficit (excluding credit)		2.2	-7.9	5.5	-2.8	-8.9	-3.7	Aug
		Real percentage change, year on year						
Government tax revenue	6.1	6.8	3.4	-1.9	-2.8	-1.4	-5.3	Jul
<i>of which:</i> income tax, net	3.3	-3.1	-0.8	-11.6	-7.5	-9.4	-10.2	Jul
VAT, gross	5.8	10.5	9.6	9.5	3.4	-2.1	0.7	Aug
Government expenditure	3.4	0.8	1.0	4.1	1.1	-2.7	-0.9	Aug
National insurance allowances	2.8	1.5	0.4	2.9	1.7	1.0	1.5	Jul
<i>of which:</i> Unemployment benefit	-10.6	-8.5	-18.9	-12.1	-3.0	4.1	0.6	Jul
Income support	-8.0	-9.3	-10.6	-6.5	-6.6	-1.8	-5.7	Jul
National insurance contributions received from the public	4.7	7.7	2.1	5.9	3.2	3.4	0.0	Jul

* When the last month is August, the comparisons are of four-month periods; and when the last month is June, the comparisons are quarterly.

** The deficit in 2008:II.

^a The path was determined on the basis of a deficit of 3.0 percent of GDP.

^b Year on year change. Does not refer to the seasonal path.

SOURCE: Based on Ministry of Finance and National Insurance Institute data.

Table 5. Foreign Trade, Balance of Payments, and the Reserves, 2007-2008
 (Seasonally adjusted)

	2007 ^a	2007		2008		May - Aug 08		
		III	IV	I	II	Change from previous period	Year on year change ^a	Last month for which data available*
	percent change from previous period ^b							
Trade in goods ^c								
Goods imports	20.8	6.7	6.5	4.6	2.5	2.2	17.5	Aug
<i>of which:</i> Consumer goods	29.1	6.4	4.6	15.6	-5.7	-5.6	14.2	Aug
Capital goods	24.0	11.3	7.0	8.5	1.1	-4.2	19.4	Aug
Intermediates	17.1	5.1	7.0	-0.8	6.3	8.1	18.0	Aug
Goods exports	18.6	3.4	12.5	2.7	5.9	9.6	26.7	Aug
<i>of which:</i> Manufacturing	18.3	3.8	12.2	3.0	6.6	9.9	27.5	Aug
<i>of which:</i> High-tech	13.1	-0.1	11.1	-3.0	9.0	9.7	15.7	Aug
Balance of payments		\$ million						
Goods and services exports	70,904	17,798	19,261	20,893	20,993			Jun
Goods and services imports	73,634	19,221	20,205	21,676	21,868			Jun
Balance of trade in goods and services ^a	-2,730	-1,424	-944	-783	-875			Jun
Current account surplus	4,524	561	858	1,156	988			Jun
Financial account (excl. foreign exchange reserves) ^a	-1,013	317	-3,479	13	-288		317	Jun
<i>of which:</i> Nonresidents' direct investment ^a	2,416	2,887	1,733	2,190	1,470		2,887	Jun
Nonresidents' portfolio investment ^a	540	-421	-533	334	687		-421	
Residents' direct and portfolio investment abroad ^a	2,475	1,588	1,207	1,357	2,469		1,588	Jun
Net foreign debt (percent of GDP) ^a	-25.5	-24	-25	-24	-23		-24	Jun
Bank of Israel reserves, end-period ^d	28,460	29,130	28,480	29,475	31,276			Aug

* When the last month is August, the comparisons are of four-month periods; and when the last month is June, the comparisons are quarterly.

^a Unadjusted data.

^b The change relates to the dollar values of imports and exports.

^c Not including ships, aircraft, diamonds, and fuel.

SOURCE: Central Bureau of Statistics.

Table 6. Indicators of Economic Development in Advanced and Developing Countries^a
(annual rate of change, percent)^b

	2005	2006	2007	Projection 2008	Projection 2009
World GDP	4.4	5.1	5.0	4.1	3.9
Advanced countries	2.5	3.0	2.7	1.7	1.4
Developing countries	7.0	7.9	8.0	6.9	6.7
World trade	7.5	9.2	6.8	5.6	5.8
Advanced countries					
Imports	6.1	7.4	4.2	3.1	3.7
Exports	5.8	8.2	5.8	4.5	4.2
Developing countries					
Imports	12.1	14.4	12.8	11.8	10.7
Exports	11.1	10.9	8.9	7.1	8.7
Commodity prices (US\$)					
Oil ^c	41.3	20.5	10.7	63.8	7.3
Nonfuel	10.3	23.2	14.1	14.6	-5.2
Inflation (CPI) in advanced countries	2.3	2.4	2.2	3.4	2.3
Short-term interest ^d (%)					
Dollar deposits	3.8	5.3	5.3	2.8	3.6
Euro deposits	2.2	3.1	4.3	5.0	5.3
Unemployment rate in advanced countries	6.0	5.7	5.4	5.6	5.9

^a According to World Economic Outlook, Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

^b Except for unemployment and interest rates.

^c Average price per barrel in 2006 was \$64.27

^d Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), July 2008.

Table 7. Selected Price Indices,^a 2007-08
 (percent change)

	2007	2007		2008		May - Aug 08		
		III	IV	I	II	Change from previous period ^a	Year on year change	
		Change during the quarter						
CPI	3.4	1.3	1.1	0.1	2.2	2.8	5.0	
CPI excl. housing, fruit and vegetables	3.7	0.1	2.0	0.4	3.0	2.2	5.5	
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	3.8	0.6	1.3	1.2	2.3	2.2	5.3	
Index of housing prices	1.9	4.7	-2.3	-2.3	1.0	6.1	1.6	
Wholesale price index	11.4	1.9	5.0	1.0	6.2	5.6	13.1	
NIS/\$ exchange rate	-7.1	-2.3	-4.5	-10.1	-4.2	1.1	-15.8	
NIS/currency-basket rate	2.4	1.0	0.3	-4.1	-4.1	-3.9	-7.4	
		During previous twelve months ^c						
CPI	0.5	0.9	2.8	3.6	5.0	2.7	5.0	
CPI excluding housing, fruit and vegetables, price controlled goods, clothing and footwear	1.1	0.7	3.1	4.2	5.3	2.9	4.4	

^a Last month of each quarter compared with last month of previous quarter.

^b August 2008 compared with April 2008.

^c Year on year change, average of quarter (or four months).

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2007-08
(annual terms, percent)

	2007	2007		2008		May - Aug 08 Change during period	
		III	IV	I	II	Compared with change during previous period ^d	Year on year change
Rates of change		from previous quarter					
M1 ^a	15.3	38.4	38.4	2.3	21.5	12.2	20.2
M2 ^b	15.3	21.1	21.1	4.9	12.2	7.6	9.0
M3 ^c	12.9	22.2	22.2	3.1	6.7	6.0	3.6
Nondirected bank credit	4.3	10.1	10.1	5.9	9.4	6.8	7.1
Unindexed local-currency credit	15.7	3.3	3.3	24.0	23.9	16.8	16.2
CPI-indexed credit	-0.9	14.0	14.0	2.4	3.3	5.4	4.7
Credit in and indexed to foreign currency	-10.9	22.3	22.3	0.0	-19.7	-17.1	-15.5

^a January to April 2008.

^b Narrow money supply (demand deposits and cash in the hands of the public).

^c M1 plus short-term local-currency unindexed deposits.

^d M2 plus short-term CPI-indexed demand deposits.

SOURCE: Bank of Israel.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2007-08
(quarterly average, percent)

	2007	2007		2008		May - Aug 08	
		III	IV	I	II	Change from previous period ^a	Year on year change
Nominal interest							
SRO deposits	3.0	2.8	3.0	3.0	2.4	2.6 **	2.7
Nondirected local-currency credit	7.5	7.9	7.4	8.1	7.4	7.8	7.1
Effective interest on daily deposit auctions	3.9	3.7	4.1	4.1	3.3	4.1	3.6
LIBID 3-month dollar interest	5.2	5.3	4.9	3.1	2.6	2.6	5.3
Yield to maturity on:							
<i>Makam</i> (short-term Bank of Israel bills)	4.3	4.5	4.5	4.3	4.1	4.3	4.1
Yield on 5-year bonds	3.2	3.4	3.3	2.7	2.6	2.6	3.0
Risk premium ^c		0.3	0.3	0.7	0.6	1.1	3.6
Expected inflation, twelve months forward	1.3	1.6	1.5	2.5	2.8	2.9	1.5
General Share-Price Index (change from previous period)	23.3	-0.7	1.7	-16.8	5.5	-7.8	-1.7
General Share-Price Index (change)							

** 2008:II compared with 2008:I

^a January to April 2008.

^b As measured by the 5-year credit-default-swap (CDS) market

^c Derived from the yield gap between indexed and unindexed bonds held by tax exempt institutional investors, minus the x-day effect on the price of the bond.

SOURCE: Bank of Israel.

Part 2: Broader Review of Selected Issues

Earned income tax credit from an international perspective

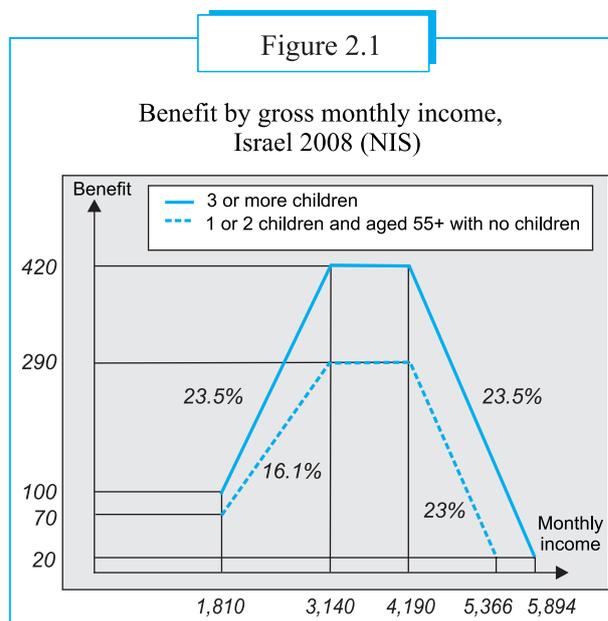
Earned income tax credit (EITC) confers low-income workers with a financial benefit in order to raise their disposable income above the poverty line, and to provide an incentive to work. This study reviews the generosity of EITC in Israel compared with the USA, Ireland and the UK—countries with an EITC system similar to Israel’s. Since EITC is part of the income tax system, the analysis is based on net income—exclusive of all compulsory payments (income tax, national insurance, health insurance and mandatory pension).¹ The comparison refers to the year 2008. The comparison shows that in the case of families with a single breadwinner (male or female), the net financial benefit in Israel is the lowest of all the countries examined at all income levels while in families where both spouses work,² the net financial benefit in Israel is the most generous. The proportion of families with two employed persons, as defined in accordance with the legal eligibility for the benefit, is low.

The EITC Law went into effect in September 2008.³ The level of the benefit and the determinant wage levels for eligibility purposes vary according to the number of breadwinners in the home and the number of children: A worker aged 23 and above with 1-2 children is eligible to an increment of up to NIS 290 a month; a worker with 3 children and more is entitled to a larger increment, of up to NIS 420 a month (Fig. 2.1). Workers aged 55 and above are also eligible to EITC even if they have no children or their children are older than 19. In their case, the level of the benefit is the same as that of a person with 1-2 children. The benefit is paid quarterly on the basis of income in the previous year.

¹ In Israel, an order went into effect in January 2008 which extended the collective agreement signed between the Histadrut and the Economic Organizations’ Liaison Office to all work places in the economy and to all workers who are not insured in a beneficiary pension arrangement. Employee provisions for 2008 amount to 0.833 percent and will reach 5 percent in 2013.

² With families where both spouses work, we therefore assumed that the woman’s income is 30 percent less than the man’s. See: Navon, Guy and Tojerow, Ilan (2006). “The Effects of Rent-Sharing on the Gender Wage Gap in the Israeli Manufacturing Sector”, IZA Discussion Paper No. 2361.

³ The Law for Increasing the Rate of Participation in the Labor Force and Reducing Social Gaps (Earned Income Tax Credit) was enacted in December 2007. The Law was changed in August 2008 and the analysis refers to the version following the change, and does not refer to unearned income.



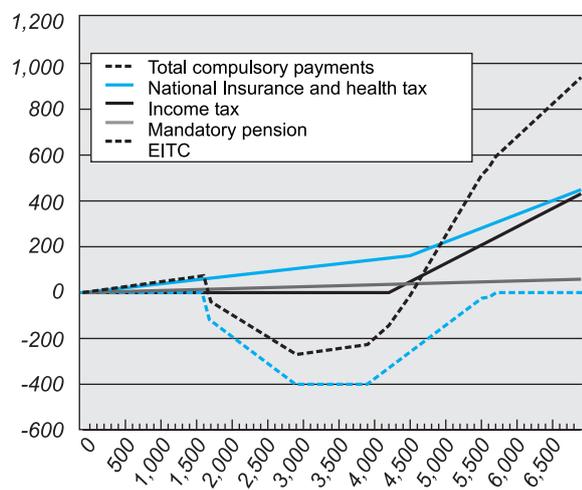
Exclusive of compulsory payments in wages, a single breadwinner with 3 or more children receives a net financial benefit if his average gross monthly income ranges between NIS 1,810 and NIS 4,750. The maximum net benefit obtained on a gross monthly wage of NIS 3,140 amounts to NIS 284, 9 percent of the gross monthly income. Women receive a net financial benefit on higher income levels because of the credit points which obtain for each child.⁴ In families where both spouses work, the maximum financial benefit obtained on a gross monthly family income of NIS 7,100 amounts to NIS 473, 6.7 percent of that income. A family with two working spouses and three children will receive a net financial benefit up to a monthly family income of NIS 8,900.

In 2008, EITC has been applied on a trial basis to salaried employees living in 19 “integration areas” where the MEHALEV (“From Income Assurance to Assured Employment”) program has been implemented (the Hadera-Netanya area, the Jerusalem area, the Nazareth and Upper Nazareth area, and the Ashkelon-Sderot area), and covers only 60 thousand entitled persons. From 2009, the self-employed will also be eligible for the benefit and from 2010,

⁴ A working woman receives half a credit point more than a man. She is also entitled to one credit point worth NIS 189 for each child up to the age of 18, in addition to the basic 2.75 credit points. As a result, a woman with two children does not pay income tax on a wage of less than NIS 6,670 a months while her husband already pays income tax on a wage of NIS 4,200.

Figure 2.2

Compulsory payments on labor, salaried male with 3 or more children, excluding beneficiary pension,^{1,2,3} Israel 2008 (NIS)



- ¹ A salaried male is entitled to 2.25 income tax credit points worth NIS 425.25 a month
² Assuming that all the income is from salaried labor with no other income from capital or allowances
³ A salaried employee not insured by beneficiary pension (provident arrangement or pension) pays 0.833 percent of his income towards compulsory pension.

the coverage is to be extended to the entire country. When full coverage is applied, 400 thousand workers are expected to receive a net financial benefit in the form of EITC; 85 percent of them will be single breadwinners as defined for legal eligibility purposes (Table 2.1).⁵ Among families with 3 or more children, the proportion of families with two breadwinners is particularly low, at only 9 percent.

Table 2.1
Distribution of number of breadwinners in household, according to number of children

No. of breadwinners (according to legal eligibility)	Aged 55+			Total
	with no children	1-2 children	3+ children	
1	88	82	91	86
2	12	18	9	14

⁵ The estimate is based on the 2007 Income Survey and population estimates for Israel in 2010.

EITC worldwide

Benefits for low-wage employees are also provided in Australia, Ireland, the UK, the USA, Belgium, Denmark, Holland, New Zealand, Finland, France and Canada. However, a net financial benefit for labor, as in Israel's case, is not granted in respect of earned income in every country. Programs of this type are only operated in the USA, the UK and Ireland. In those countries, the tax unit is the family.⁶ In order to compare the generosity of EITC, the net financial benefit deriving from it is examined as a percentage of per-capita GDP in 2008.⁷

Earned income tax credit in **Ireland** (where it is called "Family Income Supplement," FIS) is the most generous among the countries reviewed for families with a single, low-income earning breadwinner, in terms of both the level of the benefit and the maximum income at which the financial benefit is obtained. The benefit amounts to 60 percent of the difference between net income and a threshold determined according to the number of children. Eligibility is conditional on at least 19 hours of work a month. In the case of two breadwinners, the work hours of each of them can be added together. The income for means test purposes includes all net income of both spouses. As a result, a family with two or three children is entitled to a subsidy up to an income at the rate of 60 and 67 percent of per-capita GDP respectively. The benefit to those eligible is sent by post on a weekly basis.

Earned income tax credit in the **United Kingdom** (where it is called "Working Tax Credit," WTC) is part of the means-tested benefits system. The level of the benefit is dependent not on the number of children, but on the marital status of the head of the household and the household income: The benefit is inversely proportional to the income. In the UK as in Ireland, eligibility to FIS is dependent on the number of hours worked: The minimum number of work hours for FIS eligibility is 30 work hours a week. Exclusive of all taxes and compulsory payments on wages, a family with two or three children is entitled to a net financial benefit up to an income at the rate of 65 percent of per-capita GDP. An individual is entitled to a net financial benefit up to an income at the rate of 55 percent of per-capita GDP.

In the USA, the EITC program is the principal mechanism employed in combating poverty. The family is considered

⁶ In the USA, a couple can choose whether to submit tax reports separately or together, as a couple. We have assumed that a couple submit the reports together.

⁷ Source of the per-capita GDP estimates: World Economic Outlook (WEO), April 2008, IMF, and World Economic Outlook UPDATE, July 2008.

as a single tax unit and the benefit is provided once a year, following the submission of the annual report. The program is operated on a federal and an individual-state basis. On the level of the federal program, EITC increases with wages, in a manner whereby at a wage of 26 and 34 percent of per-capita GDP the financial benefit amounts to 10.4 percent of per-capita GDP, after which it decreases and ceases at a gross wage of 83 percent of per-capita GDP. Apart from the federal program, 23 states run additional programs. As an example, New York State augments the EITC benefit by a rate of 30 percent of the federal payment, while Wisconsin provides an increment that is dependent on the number of children (4 percent for one child, 14 percent for two children and 43 percent for three children and more). In Texas however, no increment to the federal program is provided. Exclusive of all taxes and compulsory payments on wages, a single-breadwinner family with two or more children and an increase of less than 60 percent of per-capita GDP is eligible to a subsidy on labor. In New York State, the maximum net benefit reaches 11.4 percent and in Texas amounts to 8.2 percent. In a family where both husband and wife work, the maximum net financial benefit is slightly more, at 8.3 and 11.5 percent of GDP respectively. This is because the tax-deductible amount is larger.⁸

A global comparison shows that in families with a single breadwinner (a male), the net financial benefit in Israel is the lowest among all the countries examined, for all income levels (Figures 2.3 and 2.4). The financial benefit in Israel is obtained at a lower wage level as well: The maximum financial benefit (NIS 284 a month) is obtained on an average monthly wage of NIS 3,140, and the benefit ceases at a wage of NIS 4,750.⁹

In families where both husband and wife work,¹⁰ the net financial benefit in Israel is obtained on a family income that is slightly higher than in the other countries (Figures 2.5 and 2.6): In the case of income of over 65 percent of per-capita GDP, the EITC system in Israel is the most generous. This is because in Israel the tax unit is the individual and not the family—with the result that both spouses benefit from EITC—and due to the high tax threshold in Israel (especially for women). In the case of a family with two

⁸ Apart from standard deduction, an exemption of \$ 3,500 a year can be deducted from taxable income for each family member. In New York State, an additional \$ 1,000 can be deducted for each child.

⁹ In a family with three children. In a family with two children at the qualifying age, the maximum benefit is NIS 144 a month, and the benefit ceases at an average monthly wage of NIS 4,300.

¹⁰ Assuming that the woman's income is 30 percent less than that of the man. See: Navon, Guy and Tojerow, Ilan (2006). "The Effects of Rent-Sharing on the Gender Wage Gap in the Israeli Manufacturing Sector", IZA Discussion Paper No. 2361.

working spouses and three children, the net financial benefit in Israel ceases at a gross monthly wage of NIS 8,900.

Figure 2.3

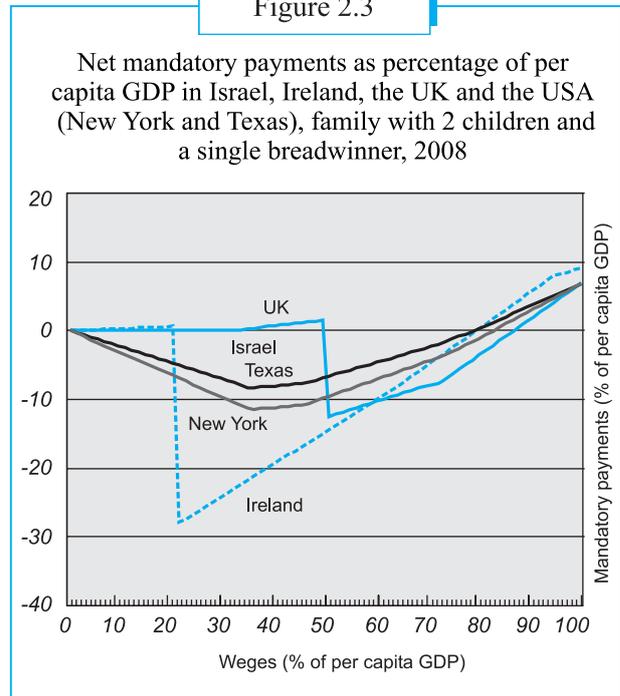


Figure 2.4

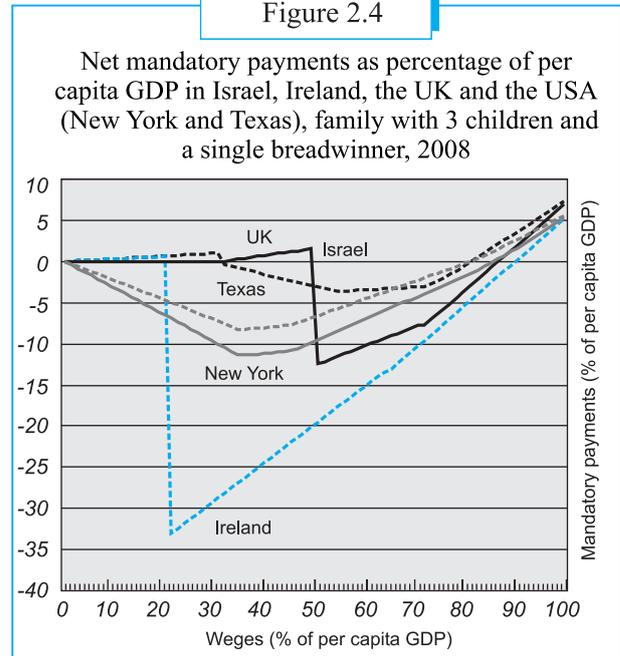


Figure 2.5

Net mandatory payments as percentage of per capita GDP in Israel, Ireland, the UK and the USA (New York and Texas), family with 2 children and 2 breadwinners, 2008

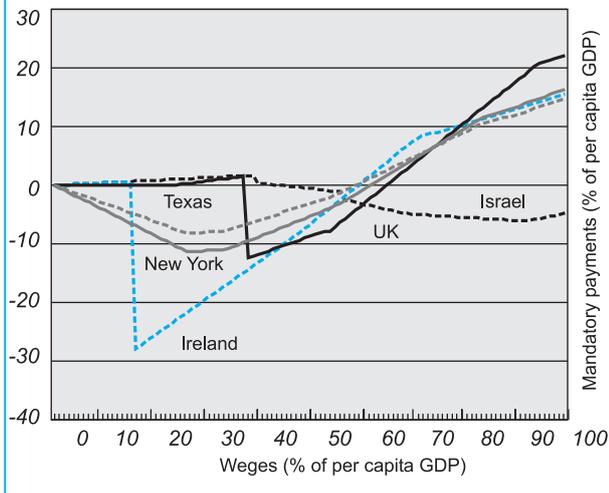
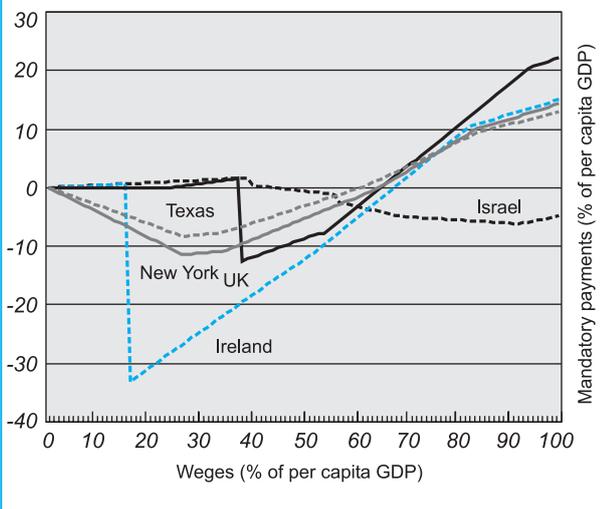


Figure 2.6

Net mandatory payments as percentage of per capita GDP in Israel, Ireland, the UK and the USA (New York and Texas), family with 3 children and 2 breadwinners, 2008



Mandatory pension agreement—initial assessment

The mandatory pension agreement for employees who are not covered by any pension arrangement was implemented at the beginning of 2008. The agreement requires every employee and his employer to set aside during his period of employment a certain rate of his earnings as savings, which will be used for the payment of an annuity after he retires from work. The agreement was signed between the Histadrut and the economic organizations,¹¹ as the government prepared to enact the Mandatory Pension Law.

The economic justification for enacting the Mandatory Pension Law derives from a market failure that is expressed by young peoples' attitude to retirement: Experience shows that in the absence of pension saving during the initial years of employment, the savings actually accrued are inadequate to maintain a proper standard of living after retirement. Retrospectively, they would have benefited from acting otherwise, because their wellbeing over their life cycle would have increased had they begun to save earlier.¹² In addition, support for the low-income elderly population is a burden on the State budget and necessitates the imposition of taxes, thereby distorting the allocation of resources in the economy. Government intervention, by compelling workers to save for a pension from the beginning of their employment, is therefore preferable. According to socio-economic theory, saving during the period of employment is intended to provide a suitable pension, which will enable the pensioner to maintain the standard of living enjoyed before retirement. At a later stage, we will present the main elements of the mandatory pension agreement and will examine its implications on the changes in the income of retirees

¹¹ The agreement has been applied to all workers in the economy by means of an extension order enforced by the Ministry of Industry and Trade. In principle, the agreement is to apply to all workers, including those employed in situations where the opportunity for enforcement is limited, such as cleaners, care-gives and waitresses.

¹² See for example: L.J. Kotlikoff (1987) who claims that due to their nature, errors occur in the assessment and calculation of future requirements, which lead to an ongoing shortfall in the amount of saving for the period of retirement. Under another economic approach to income and expenditure over the life cycle, it is found that the application of a compulsory pension worsens the worker's position particularly during his initial years in the labor market. This is because in that period, the worker is in the situation of a borrower, with the result that his current requirements exceed his current income. As he is shouldered with loan and mortgage repayments on a current basis, additional compulsory saving is not optimal from the worker's aspect, since it requires him to borrow more in order to pay the necessary provisions for the pension.

compared with their income before retirement, taking due account of taxation and other mandatory payments

Within the area between the minimum wage level and the level of the average wage in the economy, the income replacement ratio (the ratio of post- to pre-retirement income) for workers saving for pension throughout all their years of employment are reasonable. It should however be noted that this conclusion derives from the high proportion of income from the National Insurance Institute's old-age allowance in overall income, an allowance whose rate is not guaranteed. Moreover, actual income replacement ratios will be much lower for those utilizing severance payments during their period of work and for those who worked for less than the maximum number of years. This applies particularly in the case of women, whose participation rate in the labor force in full-time payrolls is less than that of men.

Consideration can be given to increasing the rates of provision, and to ensuring that the agreement is applied to populations that are not covered by pension insurance. This should be concurrent with action by the taxation system to enhance enforcement on employers—for example, by means of non-recognition for tax purposes of the salary expenses of an employee for whom pension provisions have not been paid.

Main elements of the agreement

1. The agreement applies to all employees whose employers are not obliged to insure them in collective pension agreements that already existed before the mandatory pension agreement was signed (under which the rates of provision from earnings are 17.5 percent and more).

2. The agreement will apply immediately to employees who had worked for over 6 months as at the beginning of 2008. Thereafter, it will be applied to employees who are members of a pension fund. For workers without a pension fund, provision will be required only after 6 months of employment (in 2008—after 9 months).

3. The age for joining the agreement is 21 for men and 20 for women.

4. The agreement requires insurance coverage in the event of death and disability. As a result, it is preferable to implement the arrangement via the pension funds rather than by other means of pension saving. If the employee does not express a preference for the form of saving, the default choice will be saving in a pension fund.

5. The rates of provision will be gradually increased in order to take into account the additional costs for employers, according to the following table:

From (date) onwards	Employer's provisions	Employee's provisions	Employer's provisions for severance pay	Total
1.1.2008	0.833	0.833	0.834	2.5
1.1.2009	1.66	1.66	1.68	5
1.1.2010	2.5	2.5	2.5	7.5
1.1.2011	3.33	3.33	3.34	10
1.1.2012	4.16	4.16	4.18	12.5
1.1.2013	5	5	5	15

6. The wage ceiling is the average wage in the economy, and the wage forming the basis for the provisions is as defined in the Severance Payment Law (excluding the vehicle expense component and similar components).

7. The employer's payments to a severance pay fund, at a rate of 5 percent of earnings, will be set aside to the fund and will serve as an annuity for the employee on retirement. The employer will not be permitted to withdraw the money set aside on behalf of the employee. In the case of dismissal, the employer will have to pay severance payment eligibility up to a rate of 8.33 percent. The employer can supplement a current provision at a rate of 3.33 percent or pay the balance of his severance pay liabilities from own sources. The advantage for the employee of the new method is that in the event of dismissal, the provisions for severance payment can still be withdrawn as part of the annuity. In the past, these provisions reverted to the employer.

The suitable level of pension is measured according to the **income replacement ratio** (the ratio of post- to pre-retirement income). The amount accrued is calculated according to the current provisions accrued during the period of employment, after deducting fund management payments and expenses for assuring a disability and survivors' pension.¹³ Due to taxation benefits, it is usual practice to monitor the net income replacement ratio, which takes account of changes in

¹³ It was assumed that management expenses are 4 percent of current provisions and 20 percent of the provisions are paid as a premium for disability and survivors' insurance. It was assumed that real wages increase by 2 percent a year and that the interest rate is 3.74 percent, in accordance with the Finance Ministry's guidelines for calculating the funds' actuarial position. (In international comparisons, the assumption was an interest rate of 3.5 percent—similar to that assumed in OECD publications.) The annuity was calculated by means of a conversion table which the Finance Ministry has approved for the pension funds, in accordance with mortality rates updated to the beginning of 2008. The annuity calculation method is a simplification to some extent, which emulates the approved adopted in an OECD comparative publication. The approach is suitable for analysis at the level of principal criteria, but not at the individual member level.

the tax burden, in employee payments for national insurance and health insurance before and after retirement, and in pension contributions.

Life expectancy is an important element in determining the amount of annuity accrued to the employee's benefit in pension fund during his period of work.¹⁴ As can be seen from Figure 2.9 and the tables below, life expectancy in Israel and especially that of men is high relative to OECD countries.

Income after retirement includes an allowance that is paid by the National Insurance Institute, which contains an increment in respect of seniority at a rate of 2 percent a year of the annuity for years of work over and above the first 10 years, up to a ceiling of 50 percent. The rate of the allowance varies between 17 and 24 percent of the average wage in the economy. This allowance is not dependent on the rate of income and raises the effective income replacement ratios, especially among pensioners with a low income (see below).¹⁵ Although it is assumed that the individual does not withdraw the provisions for severance payment (amounting to 5 percent of earnings as stated), it may happen that a worker withdraws part of the severance pay fund during the period of employment, with the result that the income replacement ratios presented with the framework of the mandatory pension are merely the maximum rates.

The findings are presented separately for women and men due to the difference in retirement age (64 for women and 67 for men and the difference in their life expectancy on retirement (87 for women and 84 for men). In order to examine the sensitivity to the level of wages, 3 wage levels are presented in the findings: at the level of the average wage; at 50 percent of it, which is in the region of the minimum wage; and 1.5 times the average wage in the economy.

The gross income replacement ratio is the ratio between the amount of the annuity and the worker's gross income prior to retirement. The net income replacement ratio is defined as the income from the annuity exclusive of tax and provision for health insurance, and net income—gross income minus payments for income tax, national insurance and health insurance, and the employee's provisions for the pension

fund. The tax rates and the brackets used for calculating them are those prevailing in the first half of 2008.

Main findings

The income replacement ratios in the new agreement:
The gross income replacement ratio for a man who starts to work at the age of 21, retires at 67 (the current legal retirement age) and lives till 84 (the male life expectancy as at the age of 67 in 2040) will be 40 percent of his earnings before retirement. **The gross income replacement ratio for a woman** who starts to work at the age of 20, retires at 64 and lives till 87 (the female life expectancy at retirement) will be only 35 percent of her earnings before retirement. Accordingly, the income replacement ratios for women are significantly lower than those for men because they work for fewer years (44 compared with 46 years) and mainly as a result of women's higher life expectancy, which increases the number of years for which they are paid the allowance.¹⁶

Income replacement ratios by income level: Since the taxation system in Israel is progressive, the differences between the gross and net income replacement ratios increase as income rises. Apart from that, pension recipients' tax status is preferential to that of wage recipients. The calculations show that for those earning 1.5 times the average wage in the economy the net income replacement ratio increases by approximately 18 percentage points to 58 percent. A similar result is obtained for women: the net income replacement ratio increases by 4 percentage points to 40 percent at the minimum wage level, and by 16 percentage points to 52 percent at the level of 1.5 times the average wage. (See Table 1—column 3 as compared to column 1.)

The overall income replacement ratios: Since citizens' overall income after retirement from work includes the **old-age allowance from the National Insurance Institute** which is paid to every citizen, it is important to examine the standard of living when old-age allowance payments as well as the annuity from pension are included in disposable income. (We have referred only to the universal allowance

¹⁴ Since the first of those covered by the agreement to retire will do so in 2040, an extrapolation of life expectancy in Israel was made in accordance with forecast estimates for the increase in life expectancy in the OECD countries (Pensions at a Glance, OECD 2007).

¹⁵ It was assumed in the estimates that the seniority increment is maximal, in line with the assumption that the individual starts to work at the age of 21 and works continually until retirement.

¹⁶ The resulting higher pension for men than women derives directly from the move from a DB pension to a DC pension. Under the DB method that was practiced in the past, a "subsidy" was actually transferred from men to women because the pension terms were uniform even though the life expectancy of women exceeded that of men. Under the present method, in which the annuity for an employee is determined according to the savings which he accrued, this indirect subsidiary has been effectively abolished.

and not to income supplement, because annuity recipients are unlikely to be eligible for it.¹⁷)

Table 1 shows that the **net overall income replacement ratio at the level of the average wage** amounts to 80 percent among men and 75 percent among women. Due to the high proportion of the national insurance allowance at the minimum wage level, the net overall income replacement ratio reaches 93 percent for men and 88 percent for women. The diagram shows that since the old-age allowance is progressive in that its amount is the same for every citizen while the tax benefits on pension annuities are regressive, they together initially create a descending slope at the net income replacement rate at wage levels below the average wage in the economy and then produce a rising slope due to the structure of the tax system.

Withdrawal of severance payment during the period of employment considerably reduces the income replacement ratios: The gross replacement ratio for men falls from nearly 40 percent to only 26 percent (Table 2) and the net income replacement ratio at the level of the average wage drops from 51 percent to 35 percent. The trends among women are similar.

The calculation assumes that employees paid the full provision for pension, and this is the situation that will prevail in the long term when 15 percent is paid at the very commencement of employment. For the short term, the provisions for mandatory pension start from a low rate (2.5 percent) in 2008 and gradually increase to 15 percent in 2013. The gradual introduction of the arrangement implies a loss of annuity of 2-4 percentage points at the gross income replacement ratio.¹⁸ For those joining the arrangement at a later age the loss deriving from the gradual introduction of the arrangement is greater.¹⁹

Assessment of the agreement

The mandatory pension agreement signed between the Histadrut and the economic organizations is an important achievement, which permits a higher standard of living after retirement for workers, mostly low paid, who had not

¹⁷ We assumed that the amount of the annuity remains at its present real level and that it increased at a fixed real rate of 2 percent, like the average wage in the economy.

¹⁸ We also calculated the implications of the extension in 2004 of the period of employment from 65 to 67 for men and 60 to 64 for women. This increases the gross income replacement ratio by 2.5 percentage points among men and by 4.5 percentage points among women.

¹⁹ Special arrangements have therefore been prescribed for employees over the age of 45.

been covered been covered by pension arrangements at all. The existence of a pension arrangement for all workers in the economy is an important means for the more equitable distribution of income and for reducing the extent of poverty. However, an enforcement problem exists and experience to date shows that actual enforcement of the labor laws has been limited. Although the law stipulates penalties and even criminal indictment for those failing to make provisions in accordance with the law, in most cases these are not put into

Figure 2.7

Gross replacement ratios including old-age pension, by country, 1998-2008 (percent of average wage, interest accumulation rate 3.5 percent)

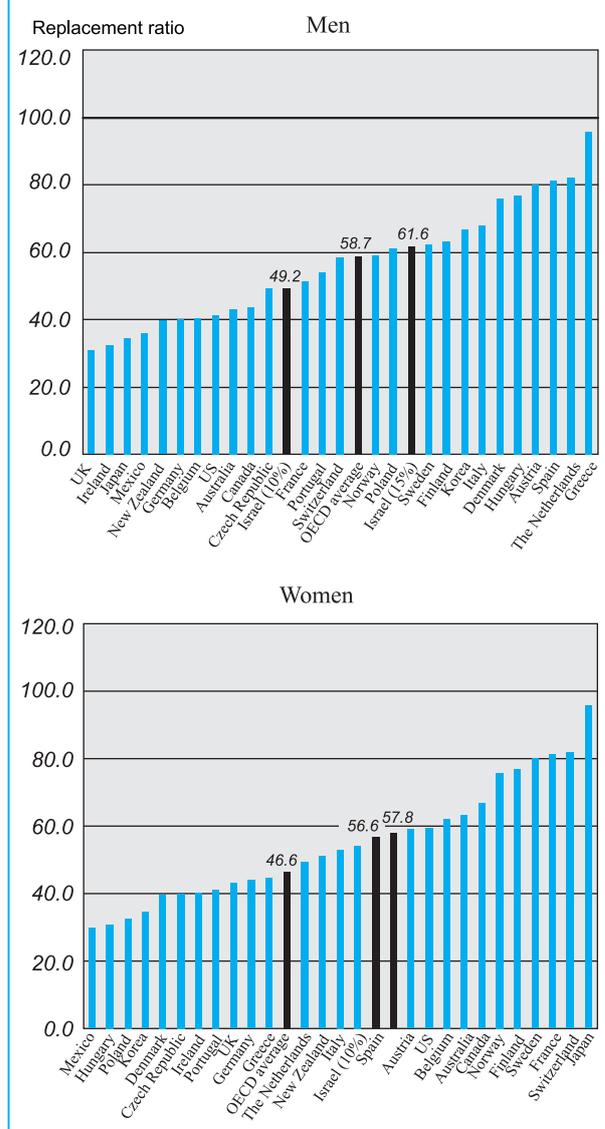
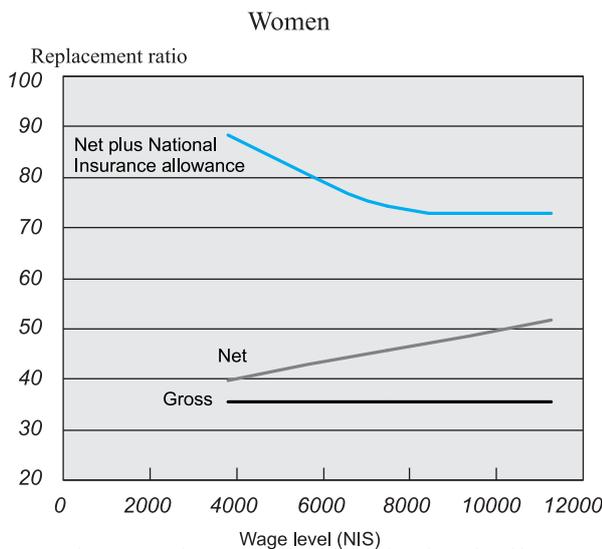
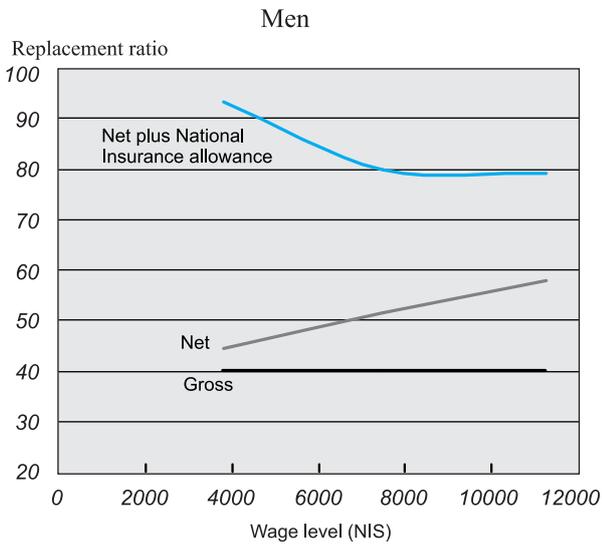


Figure 2.8

Replacement ratios in the mandatory pension agreement

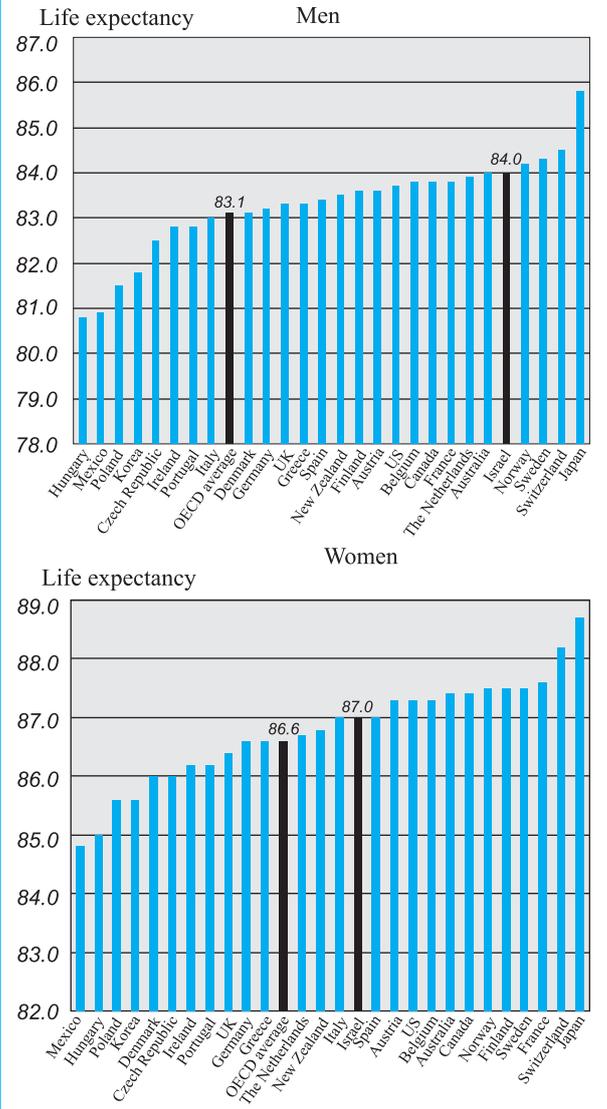


The gross replacement ratio is defined as the ratio of income after retirement to income prior to retirement. The net replacement ratio is calculated after deduction of income tax, national insurance, health insurance and provisions for pension before and after retirement.

practice. A possible solution for the enforcement problem might be a stipulation in the income tax regulations that an employer's salary expenses will not be recognized as an expense for the employer if the provisions for pension have not been made. This solution will ensure that the arrangement is implemented, and is effectively and firmly enforced by the existing tax system.

Figure 2.9

Forecast of life expectancy in Israel in 2040



Another problem is the revolving door stratagem, whereby employers dismiss employees after a short period of time and then re-employ them, in order to avoid paying social benefits. Under the agreement, for an employee who was not a member of a pension fund the payment of pension provisions will begin only after 6 months of employment. If the employee has a pension fund, his eligibility to provisions is immediate. In this situation, it could be in the employer's interest to dismiss employees before the end of 6 months in order to save salary costs, thereby leading to the loss of many months of accrual in a fund for the weakest employees. Moreover, if they are dismissed before a year has elapsed from the commencement of their employment, the employer will not have to pay vacation allowance, which amounts to 4

percent of annual earnings. The extent to which this problem will be solved under the new agreement is not clear. (As stated, non-recognition of salary expenses could help in this respect.) In the first quarter of 2008, 100 thousand workers joined the agreement out of an estimated one million who were not covered by any kind of pension arrangement. It is currently difficult to assess the rate at which workers will join the arrangement, because in 2008 it is permitted to bring in workers to the arrangement after 9 months as well.

The question arises as to whether the rates of provision are adequate in order to sustain a proper standard of living after retirement. Since the net income replacement ratios including an old-age allowance for workers who save for a pension during all their years of work are reasonable and similar to the ratios worldwide (Figure 2.7), the answer would appear to be affirmative. However, this ratio is achieved because of the relatively high proportion of the national insurance allowance at the low wage levels—an allowance whose rate is not guaranteed. Moreover, the income replacement ratios presented are based on the assumption that the worker paid into a pension during all his years of employment. But this does not usually happen, because of late participation in the work force, cases of the revolving door stratagem which do not confer the right to pension provisions, and due to the fact that workers fail to complete their entire period of (potential) employment. This applies particularly in the case of women, because of maternity leave and housework. The rates of provision specified may therefore be too low. This would indeed appear to be the case compared with other pension

saving arrangements in Israel and by international standards. (Abroad, the provision for severance payment is not usually used for paying an annuity after retirement from work.)

Table 2.2
Income replacement ratios in the mandatory pension agreement plus the National Insurance Institute old-age allowance^a
(percent)

Wage level	Gross		Net	
	Mandatory pension	Mandatory pension+Old-age allowance	Mandatory pension	Mandatory pension+Old-age allowance
Men				
3,800	39.7	87.6	44.4	93.1
7,500	39.7	63.9	51.4	79.9
11,250	39.7	55.8	57.8	79.1
Women				
3,800	35.5	83.3	39.7	88.3
7,500	35.5	59.7	45.9	74.4
11,250	35.5	51.6	51.6	73.0

^a The net income replacement ratio is calculated after deduction for income tax, national insurance, health insurance and provisions for pension before and after retirement from work. The National Insurance old-age allowance is calculated on the assumption of maximum entitlement (above 35 years of work), which increases the allowance by 50 percent.

Table 2.3
Gross and net income replacement ratios and including national insurance, by different rates of provision.* (percent)

	Overall rate of provision	Gross (percent)	Gross+N.I. allowance	Net (percent)	Net+N.I. allowance
Men:					
Mandatory pension ^b	10.0	26.4	50.7	34.2	62.8
Mandatory pension ^c	15.0	39.7	63.9	51.4	79.9
Existing arrangements ^d	17.5	46.3	70.5	60.3	89.1
Existing arrangements ^e	20.3	53.8	78.0	70.6	99.5
Women:					
Mandatory pension ^b	10.0	23.6	47.9	30.6	59.1
Mandatory pension ^c	15.0	35.5	59.7	45.9	74.4
Existing arrangements ^d	17.5	41.4	65.6	53.9	82.7
Existing arrangements ^e	20.3	48.1	72.3	63.1	92.0

* The national insurance old-age allowance is determined on the assumption of maximum seniority (over 35 years of employment), which increases the annuity by 50 percent.

^a Income replacement ratio relative to average wage in economy.

^b Assuming that the accrual in the severance payment fund is accrued entirely for pension (that is, the severance pay money was not withdrawn during the years of employment).

^c Assuming no pension accrual for severance payment.

^d In manufacturing and in other principal industries.

^e The current maximum rate.

Estimating the profitability of manufactured exports

The sharp drop in the exchange rate of the dollar and the worsening in the terms of trade during the last two years have created concern over a halt in the growth of exports. This concern has not been realized as yet but it is nonetheless important to examine the effect of these processes on the profitability of exports over time. The analysis requires a broad frame of reference in order to accurately estimate the reduction in profitability and to understand its causes. The findings indeed indicate a significant reduction in the profitability of exports during the last two years although this is relative to the high level of profitability over the long term. The findings also show that the drop in profitability is primarily the result of the worsening in the terms of trade while the influence of the exchange rate was relatively small. This is explained by the increase in the dollar price of exports and the fact that part of the losses were passed on to workers through the erosion of their wages relative to production for the local market. The worsening in the terms of trade, unlike the appreciation in the exchange rate, affects the economy as a whole and not just the export sector.

Studies abroad²⁰ show that changes in the nominal exchange rate have a relatively small effect on exports compared with the effects of other factors. The studies show that the high cost of breaking into the global market lowers the importance of the changes in the exchange rate, which are likely to be short term, and increases the importance of past performance and expectations of the future.

The method for calculating the profitability index for exports

The profitability of exports is defined here as the rate of profitability per unit of output (the return to capital) multiplied by the number of units of output.²¹ Since the quantity of exports grew rapidly in recent years, it is reasonable to assume that the drop in profitability was the result of a decline in the rate of profitability per unit of export output which, according to Equation (1), is the after-tax share of capital in output:

$$(1) \quad \pi = \left(1 - \frac{LW_L}{YP_y}\right)(1 - \tau)$$

²⁰ J. Campa (2004) "Exchange Rates and Trade: How Important is Hysteresis in Trade?" *European Economic Review* 48. S.M.S. Das, M.J. Roberts and J.R. Tybout (2007). "Market Entry Costs, Produce Heterogeneity and Export Dynamics," *Econometrica* 75.

²¹ The calculation is similar to that carried out from time to time by the Manufacturers Association.

capital in exports; however, its components are not directly measurable. In order to estimate these components, a method is proposed below for calculating the profitability of exports, which is composed of two components: the nominal cost of labor per unit of export output and the price of export output.

Production, wages and employment in manufacturing cannot be divided between local sales and exports since even on the level of the individual firm production is often destined for both and this is all the more so on the level of an industry or total production. However, assuming that on the industry level nominal labor costs per unit of output for both local sales and exports are similar, this ratio can be calculated for the export sector as a whole by assigning weights to industries according to their share in exports:²²

$$(2) \quad \frac{W}{(Y/L)} = \sum_1^n \omega_i \frac{W_i}{(Y_i/L_i)}$$

where $\frac{W}{(Y/L)}$ is the nominal cost of labor per unit of

output and ω_i is the weight of the industry in total

manufacturing exports. In order to achieve maximum accuracy in the calculation, the weighting was done for some 75 sub-industries in manufacturing, thus making Equation (2) a good approximation of the index for the nominal cost of labor per unit of export output.

The price of export output (3) is represented by the dollar exchange rate E multiplied by the term in parentheses, which is the price of exports P_x (the price of production) less P_m , the price of imported production inputs, weighted by s , the proportion of the input in production. Equation (3) therefore represents the shekel price of the value added in exports:

$$(3) \quad P_y^x = E(P_x - sP_m)$$

The share of an input in production changes over time and therefore it is calculated on an annual basis by dividing the total import of manufacturing inputs (apart from diamonds) in shekel terms by manufacturing sales income. In order to

²² The likelihood of this assumption increases to the extent that industries are smaller and more homogeneous.

neutralize the effect of changes in the terms of trade, the calculation was done in constant prices.²³

In order to attain the after-tax profitability of export output, the expression in Equation (1) is multiplied by $(1 - \tau)$,

where τ is the corporate tax rate.

Findings

Figure 2.10 presents the first component of the above expression, i.e. the nominal cost of labor per unit of output, in the manufacturing sector as a whole and for exports alone. It can be seen that in recent years there has been an improvement in this component since the rate of increase in wages was slower than that in labor productivity. This is especially true in the export industries, in which wages eroded relative to the rest of the manufacturing sector while labor productivity grew at a similar rate.

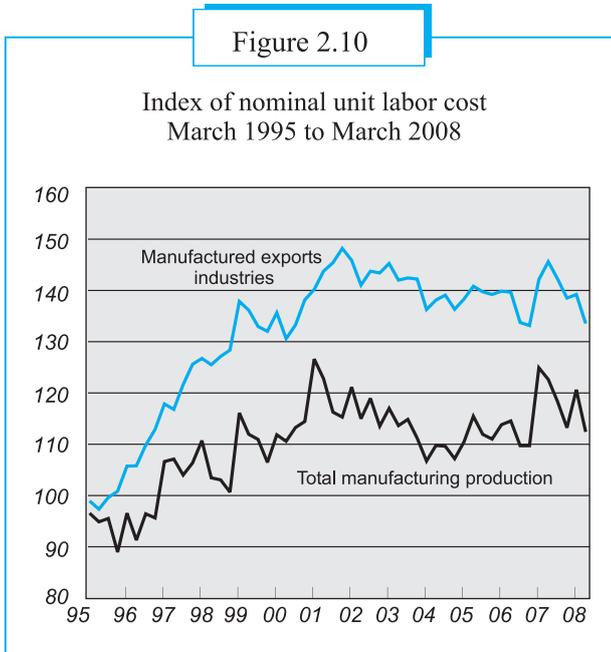
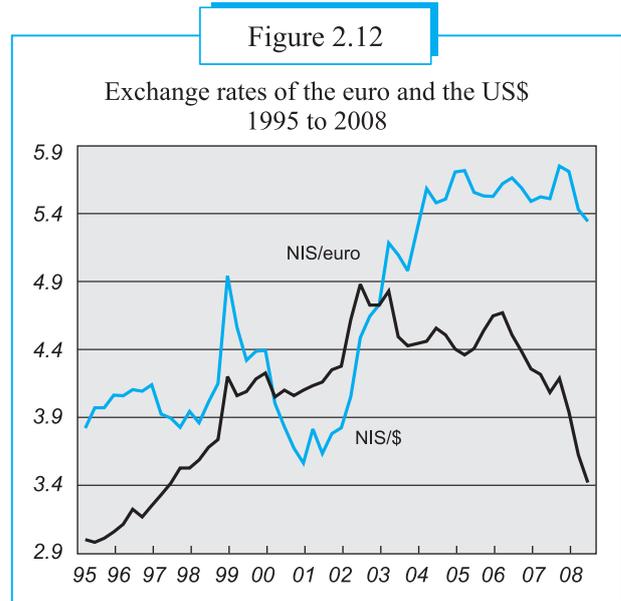
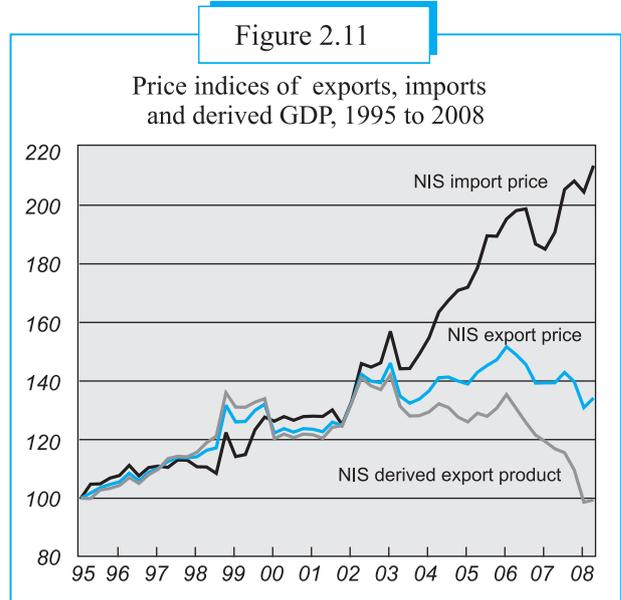


Figure 2.11 presents the shekel price of manufacturing exports and imports and the price of export output derived from them. It can be seen that the shekel price of exports has declined during the last two years as a result of the fall in the exchange rate; however, the decline was only moderate since it was offset by the increase in dollar prices that resulted from the weakening of the dollar against other world currencies

²³ The terms of trade are directly taken into account and thus double-counting of this effect is avoided.

(Figure 2.12). Thus, the decline in the derived price of export output is primarily the result of the sharp climb in import prices, i.e. the worsening in the terms of trade, which has a negative effect on the economy as a whole.



Finally, the statutory corporate tax rate was reduced from 37 percent at the beginning of the period (i.e. 1995) to 27 percent in 2008. These reductions began previously (in 2003) and are expected to continue in coming years. It should be mentioned that the statutory corporate tax rate is likely to differ from the actual tax rate on corporate profits as a result of various exemptions and benefits. Furthermore, in many countries, reductions in the corporate tax rate

are accompanied by an expansion of the tax base through increased efforts at enforcement and the cancellation of exemptions and benefits, such that the actual tax rate remains unchanged. In contrast, the reduction of corporate tax rates in Israel indeed led to a similar reduction in the tax burden.

Figure 4 presents the gross and net (of tax) rate of return on capital in the export sector for the years 1995–2008. It can be seen that from a long-term perspective, there has been no real change in the index since 1995.

for the decline in profitability was therefore the worsening in the terms of trade, which was the result of the sharp increase in the prices of imported inputs. As can be seen in Figure 5, when the effect of the worsening in the terms of trade is neutralized, an increase in profitability is revealed during the last two years.²⁴ Therefore, the sharp drop in profitability that resulted from the worsening in the terms of trade was offset to some degree by the passing of losses onto workers, as can be seen in Figure 2.10.

Figure 2.13

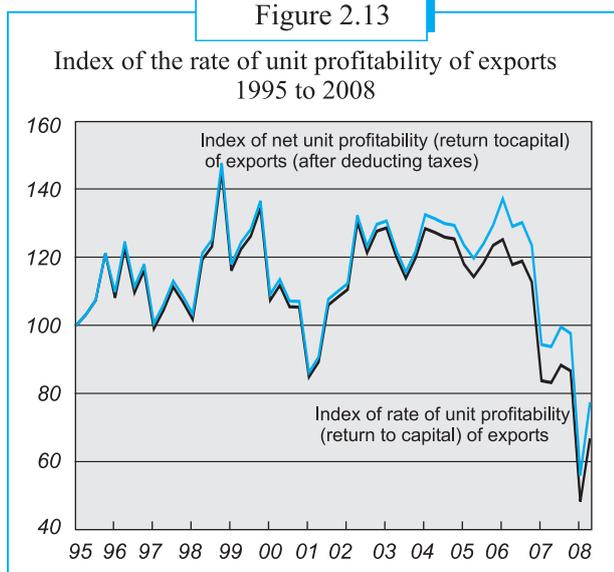
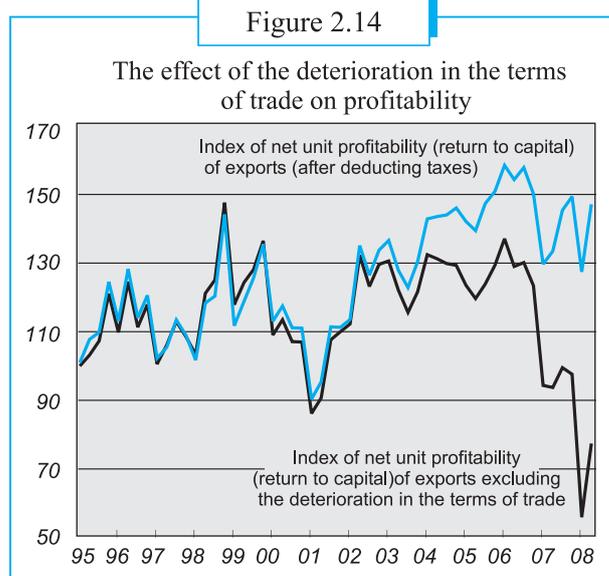


Figure 2.14



As explained above, the exchange rate played only a small role in the decline of profitability during the last two years since the main source of the appreciation was the global weakening of the dollar rather than the strengthening of the shekel. Thus, the price of dollar exports adjusted to the weakening of the dollar to a large extent. The main reason

²⁴ The neutralization was accomplished by setting the changes in the price of imported inputs equal to the changes in the price of exports.

Diary of Events from May to August 2008

Month	Date	Event	Details
May	20	The Knesset Finance Committee approves benefits for participants in Mehalev (the Israeli “Wisconsin Plan”).	According to the motion that was approved, people who move more than 60 km. away from the program’s pilot areas no longer have to remain with the program and may go over to the treatment of the labor exchange in their area of residence. Participants who move 40–60 km. away from the pilot areas will be bussed to the Mehalev center. Travel time exceeding one hour shall be considered part of their personal programs, or personal programs involving a location no more than 40 km. from their homes shall be set up for them.
	25	The NIS joins the CLS system.	It is now possible to settle conversion transactions between the NIS and 17 other currencies by means of the international CLS system, which each day settles some 500,000 transactions at a total value of around USD 4 trillion. This will do much to mitigate the settlement risk associated with currency-conversion transactions.
	25	A tax-relief program for recent immigrants and returning Israelis, instigated by the ministries of Finance and Immigrant Absorption, is approved.	Benefits include a tax and reporting exemption for up to 10 years on assets and income of foreign origin. Said benefits shall apply to all types of income, from interest, dividends, and rent, to occupation, supplemental labor, and a business, up to capital gains from the sale of assets abroad.
	28	The Knesset Finance Committee approves relief for employers of foreign workers in construction.	According to the amendment approved, employers shall pay a fee for each foreign worker whom they employ only on the basis of the number of days actually worked and not as an annual lump sum, as before. If an employer switches workers and a transition period occurs between the old employee’s departure and the new employee’s arrival, the employer shall not be charged for this period.
		The Bank of Israel raises its key rate for June by 0.25 percentage points, to 3.5 percent .	
June	2	The Knesset approves an amendment to the Securities Regulations requiring corporations to provide detailed disclosure of senior executives’ remuneration and transactions with controlling principals in public corporations.	The amendment requires companies to divulge details about their remuneration mechanisms and the remuneration transactions themselves, both in their periodic statements and in their current reporting. The periodic statements must provide disclosure in regard to the firm’s five best-paid individuals. Companies must also address themselves to the question of whether said remuneration is based on company performance or on the meeting of targets, and whether mechanisms for the review of this matter have been set up. Another amendment requires expanded disclosure in the annual financial statements and in the prospectus on all transactions with controlling principals.

BANK OF ISRAEL RESEARCH DEPARTMENT

Month	Date	Event	Details
June	16	The Knesset approves the Encouragement of Capital Investments Order.	The Order defines the “development areas” that the state wishes to assist by channeling private investments, encouraging employment, developing industrial areas, and awarding miscellaneous grants and benefits. As part of the Order, the adding of regional industrial areas within 7 km. of the Gaza Strip security fence to a Class A Development Area was also approved.
	22	The tariff on iron is abolished.	Israel’s iron industry has two domestic manufacturers that meet about two-thirds of demand; the other third is imported under a 10 percent tariff. Therefore, the elimination of the tariff may lower the price of iron by up to 10 percent . This will save the economy an estimated NIS 5 billion in the long run.
	22	Minister of Finance signs “accelerated depreciation” regulations.	Under the new regulations, the rates of depreciation on machinery and equipment investments in manufacturing, agriculture, construction, and hospitality will be raised in a uniform and across-the-board way, so as to stand at 50 percent for all establishments in these industries. Today, the income-tax regulations allow different rates of depreciation that range from 7 percent to 40 percent depending on the type of asset and the nature of the establishment’s activity.
		The Bank of Israel raises its key rate for July by 0.25 percentage point, to 3.75 percent .	
July	1	The bank-charge reform goes into effect.	The reform allows consumers to receive all relevant information about bank charges, to compare them from bank to bank, and to choose the bank where they will keep their account.
	1	The minimum wage is adjusted.	As of July 7, 2008, the minimum wage will be NIS 3,850.18 per month.
	8	The annual fee and the license fee that personnel contractors who import foreign workers for construction must pay are lowered	The Vice Premier and the Minister of Industry, Trade, and Labor, Eli Yishai, signs new regulations that will allow employers to pro-rate the annual fee and the license fee the actual amount of time that each foreign worker spends in their employ; the regulations also entitle them to a prorated refund of fees overpaid. The regulations are meant to prevent double payment by employers of foreign construction workers in the event that such workers switch employers or leave Israel and are not immediately replaced.
	10	The Bank of Israel steps up the pace of its foreign-currency purchases.	The Bank of Israel will accelerate its foreign-currency purchases from now on, buying \$100 million on daily average. This is part of its plan, announced on March 20, 2008, to increase the reserves to \$35 billion–\$40 billion.-

Month	Date	Event	Details
July	22	The Socioeconomic Cabinet decides to provide sewing workshops in the Druze and Circassian sectors with NIS 5.4 million in assistance.	The cabinet's decision follows a resolution that the Government adopted on Aug. 31, 2006, to the effect that existing jobs in sewing workshops in Israel's Druze and Circassian localities, especially for women, should be preserved. The aid will be forwarded to workshops in these localities for a three-year period, provided that several conditions are met including location (the shop must be situated in a Druze or Circassian locality), size (employing at least 70 workers), and gender (at least 75 percent of the workers must be women).
	26	The U.S. Senate approves legislation allowing the Administration to inject capital into Fannie Mae and Freddie Mac.	After the Administration expressed its willingness to help these companies in the event of a liquidity problem, their bonds became popular once again. According to Lehman Brothers data, the yield on the government mortgage companies' bonds is 1.56 percent higher than that on government bonds. The yield spread is verging on its highest level in 20 years.
	29	The Securities Authority lowers by 15 percent the fees that it charges companies, funds, and the Stock Exchange.	The Knesset Finance Committee recently approved a Securities Authority proposal to lower the annual fees that it charges corporations.
		The Bank of Israel raises its key rate for August 2008 by 0.25 percentage point, to 4 percent .	
August	1	Amendments to the Army Reservists' Compensation Law go into effect.	The amendments follow: a. The formula used to calculate compensation is amended—from call-ups of 7 days or longer, in which the term of service ends on a weekend. b. The minimum compensation is raised to NIS 166.65 per day and NIS 5,000 per month instead of NIS 123.67 and NIS 3,710, respectively. c. A half-day call-up also entitles reservists to compensation. d. Reserve-duty compensation shall be paid for each day of service irrespective of whether said service has harmed the reservist's income.
	1	The banking permit of Industrial Development Bank is revoked.	Pursuant to a decision of Governor of the Bank of Israel on January 29, 2006, this bank's banking license is revoked; accordingly, the bank ceases to be a banking corporation.
	5	The Knesset Economics Committee approves compulsory unit pricing as part of the Consumer Protection Regulations.	According to the Consumer Protection Regulations, shops that have more than 100 square meters in floorspace must mark each piece of merchandise not only with its total price of but also with the unit price. The regulations shall go into effect on Jan. 1, 2009.

BANK OF ISRAEL RESEARCH DEPARTMENT

Month	Date	Event	Details
August	8	Freddie Mac and Fannie Mae report unexpectedly large losses.	Fannie Mae, the American mortgage giant, reports losses of \$2.3 billion. The company announces that it will slash its dividend by more than 85 percent and take further measures to shore up its capital. In response to the publication of its financial statement, the Company's stock falls by 14 percent in pre-opening trading. Freddie Mac recorded a loss of \$821 million in the second quarter of 2008 and its revenues fell by 28 percent, to \$1.69 billion. Due to the second-quarter loss, on the heels of a \$151 million loss in the first quarter, Freddie Mac announces that it will cut its third-quarter dividend 25 cents per share to 5 cents. The shares of both government mortgage companies, which provide \$5.3 trillion in guarantees for mortgages and mortgage-backed securities—about half of the U.S. mortgage market—have lost more than 70 percent since February due to concerns about their financial strength.
	12	The Prime Minister and the Finance Minister agree to adopt the Dorner Report.	According to the agreement, the basic benefit for Holocaust survivors shall be raised to 75 percent of the benefit paid under German law. Payment shall be made retroactively to Jan. 1, 2008. Pursuant to the decision, the government is expected to increase its aid to Holocaust survivors by around NIS 250 million, in addition to the NIS 500 million increase that it decided to allocate for this purpose in Nov. 2007.
	25	The Government approves the 2009 state budget and economic policy.	The budget for the next working year will include significant increases for social services and internal security and the deferral of payment of some of the defense-budget supplements, without deviating from the Brodet outline. The Government also approves a Ministry of Finance plan to award national priority to the geographic periphery. Finally, it approves a 1 percent across-the-board cutback in the budgets of government ministries other than defense on behalf of higher-education institutes, internal security, municipal government, and culture.
	31	The Commissioner of the Capital Market authorizes Bank Leumi to engage in pension consulting.	Thus far, seven banks—Union, Mizrahi-Tefahot, First International, Israel Discount, Mercantile Discount, Otsar Hahayal, and Poalei Agudat Yisrael— have received licenses to provide pension-consulting services. The pension-consulting model was established by legislation in accordance with the Bachar Committee recommendations. Accordingly, banks may enter the field of pension consulting only after they sell off provident and mutual funds that they own. Several months ago, a model was set up that gives small and medium banks an advantage in entering the field of pension-consulting services for wage-earners by barring the large banks from this field until August 2010. However, the large banks may, after obtaining their licenses, provide pension-consulting services in peripheral localities.
		The Bank of Israel raises its key rate for September 2008 by 0.25 percentage point, to 4.25 percent .	