

# RECENT ECONOMIC DEVELOPMENTS\*

## Main developments

In the first half of 2003 (henceforth “the period reviewed”) the rate of decline of economic activity moderated, with some indications of stabilization at a low level. The continued recession in real activity in the period reviewed was expressed by a further decline in the composite state-of-the-economy index, reflecting mainly a fall in the number of employee posts and in the index of manufacturing production, and the stabilization of the index of revenue in commerce and services at a low level. On the other hand, business-sector product increased in 2003:I, and the Bank of Israel’s Companies Survey for 2003:II indicates an easing of the rate of reduction of activity, and even a rise in the activity in the commerce, tourism and transport and communications industries. In the financial area improvement was evident during the period reviewed, expressed in a decline in the inflation environment and in long-term yields, and a sharp rise in share prices and the volume of stock-exchange transactions.

Developments in the various areas of economic activity were not uniform over the period reviewed, and the period can be divided into two sub-periods, with distinctly different characteristics in each. In the first few months of the year uncertainty rose and so did the inflation environment, with the exchange rate of the dollar and the CPI rising. This occurred despite the slowdown of economic activity, against the background of the continued Intifada and the worldwide recession in the high-tech industries, which were the main causes of the slump in the last two years. The firmer expectations regarding the outbreak of war in Iraq also contributed to uncertainty worldwide, and concern about its effects on Israel had an additional effect on uncertainty in Israel’s economy. From March several events took place and processes started that served to lower economic, security-related, and political uncertainty, including the formation of a new government, the publication of the economic package and its speedy approval by the government, the ending of the war in Iraq, the formation of a new government by the Palestinians and the renewal of the peace process, and the approval of the guarantees by the US government for loans to Israel. All the above led

to appreciation of the NIS, a rise in share prices, and a fall in long-term nominal and real yields. Reduced uncertainty and the resultant changes in the money and capital markets were also reflected in a decline in the inflation environment, a fall in the CPI, and the first indications of stabilization of the real economic activity.

Real activity developed very differently in the various industries during the period reviewed: while in some industries the rate of decline of activity slowed, even showing stability at a low level (in commerce, tourism and some manufacturing industries), in others, particularly construction, the downward trend intensified. The slack in the labor market continued, reflected by a sharp rise in unemployment in 2003:I, with a reduction in labor input in the business sector and in the number of employees in the public sector. In April and May the unemployment rate was steady at the high level it had reached in the first quarter.

Despite the economic package confirmed by the government in March 2003, the budget deficit is expected to deviate significantly from its target of 3 percent of GDP, and is expected to reach 6 percent of GDP. Most of the deviation derives from the large difference between actual tax revenue and that forecast in the budget. It seems that the effect of the economic package on the deficit in 2003 and 2004 will be modest, but is expected to be cumulative over the next few years and to contribute to the gradual reduction of the deficit and public debt in the medium term. Despite the relatively small effect of the package on the deficit in the short term, its approval by the government and quick passage through the Knesset transmitted positive signals of increased stability, and thus helped reduce uncertainty in 2003:II. Figures released recently by the Ministry of Finance regarding performance of the budget in 2002 show that even if all expenses in 2003 are carried out, investment in the transport infrastructure is expected to decline.

In the period reviewed the CPI went down at an annual rate of one percent, reflecting a constant decline since March 2003 after having risen in the January and February. Price changes during the period reviewed reflected mainly changes in the exchange rate against the background of the sluggish real economic environment: after devaluing in January and February, the NIS appreciated from March onwards, and at the same time inflation expectations declined. The latter, together with the persistent recession

\* For diagrams (bilingual) please turn to Hebrew section.

in real activity, acted to lower the CPI and the inflation environment in March–June. The Bank of Israel therefore renewed the process of reducing the interest rate, initially lowering it by 0.2 percentage points in April, and then gradually increasing the amount of the cuts, to 0.3, 0.4 and 0.5 percentage points in May, June and July respectively. In spite of these reductions, the real expected rate of interest remained relatively high.

The short-term import of capital into Israel by nonresidents expanded markedly in the first half of 2003, whereas the long-term import of capital rose only moderately. Although the former helped to boost foreign-currency trading and to improve market discipline, it also increased the volatility of the exchange rate, which also increases the volatility of the monthly price indices

### The principal industries

The various indicators of activity in the principal industries present a mixed picture, apparently pointing to a slowdown in the rate of reduction in activity towards the end of the period reviewed, and even stabilization at a low level of activity. National Accounts data for 2003:I indicate that GDP, exports and current consumption rose, while consumption of durables and imports fell. Data from the Companies Survey for 2003:II show that activity in most industries continued to decline throughout the period reviewed, but after an acceleration in the rate of decline in the 2003:I there were indications of more moderate falls in the second quarter, with some industries actually showed a rise in activity. The composite index continued to go down during the period reviewed (Figure 2). This decline reflected mainly a deterioration in the labor market, with a sharp fall in the number of employee posts, and a drop in revenue in the commerce and services industry. The index of manufacturing output stabilized at a low level (Figure 1).

Business-sector product rose by 4.2 percent in 2003:I from its level in 2002:IV (annual rates, seasonally adjusted), after two years of constant decline (Table 2). The slowdown on the demand side continued, with a steep fall in total uses and in domestic uses. The latter reflected a contraction of private consumption, in contrast to a considerable increase in public consumption (excluding defense imports). Exports of goods and services (excluding diamonds and start-ups) grew in 2003:I, while imports fell sharply. The decline in imports explains most of the gap between output, which expanded, and uses, which fell, as most of the reduction in total uses derived from imported consumption (vehicle imports and consumption by Israelis abroad). Since the

data on foreign trade indicate a fall in goods exports and a rise in goods imports from March, the reduction in imports recorded in the National Accounts may have been temporary.

Investment in capital assets (excluding ships and aircraft) rose, reflecting a rise in investment in construction and in machinery and equipment (despite a low rate of capital utilization indicated by the Companies Survey), and a marked decline in investment in overland transport vehicles. The rise in total construction investment, following reductions in previous quarters, expresses a rise in private residential and nonresidential construction, while public investment in residential construction continued to decline.

The contraction of private consumption in 2003:I covered nearly all categories of consumption, and in particular expenditure by Israelis abroad that fell by 22 percent, consumption of durables that fell by 10 percent, and clothing and footwear that declined at a similar rate. The reduction in consumption in 2003:I reflects the effect of a contraction in individuals' disposable income resulting from the fall in the real wage and from the rise in unemployment. Although the decline in the real wage slowed towards the end of the period reviewed, due to the drop in the CPI that slowed the erosion of the wage, it is expected to accelerate again when the economic package comes into effect, because of the reduction of public-sector wages. On the other hand, the implementation of the tax reform starting from July 2003 is expected to act in the opposite direction and increase disposable income.

Other indicators of private consumption in the period reviewed suggest that it stabilized at a low level: indices of revenue in the commerce and service industries indicated stability in January to April 2003, following their decline in previous months. The stability in the revenue index reflects an increase in wholesale and retail trade, health services and hotels and catering services, while revenue fell in the business services and real estate industries, personal services, financial institutions and education. These findings are consistent with those of the Companies Survey for 2003:II (Table 1), that showed an increase in sales of trading companies and expectations of further increases in the third quarter, on the one hand, and the persistent decline (albeit at a slower rate) in the activities of companies in the business services industry on the other. Reports from trading companies also indicated that the severe demand restraint on the extent of orders reported in previous years eased somewhat in 2003:II, but the economic and security situation continues to constitute a serious and focal restraint on carrying out their activity.

Table 1. Indicators of Business Activity, 2001–2003

(all data excluding construction are seasonally adjusted)

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	115.7	111.9	-3.4	-3.5	-2.9	-2.8	-4.5	-3.5	-3.3	6
Large-scale retail trade	4.0	-2.5	-4.8	-7.6	-2.7	-4.0	10.1	-0.2	-3.0	6
Manufacturing production (excl. diamonds)	-4.1	-2.4	4.2	-5.8	1.6	0.3	-4.1	-5.4	-0.9	5
Business-sector consumption of electricity	2.3	3.4	11.8	12.3	-1.2	-0.5	-2.2	0.9	4.6	4
Index of revenue in commerce	-0.5	-2.6	-1.5	3.1	-3.0	4.9	-0.5	-4.1	1.0	5
Index of total revenue	1.6	-1.2	-3.7	-3.2	1.7	-6.2	-6.3	-2.1	-3.0	5
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	-50.3	-28.1	-19.4	15.6	10.8	-24.7	38.9	-41.0	2.9	6
Immigrant arrivals	-27.6	-23.0	-1.7	27.0	-0.8	-50.6	-6.3	-27.6	-39.9	5
Residential starts	-31.3	0.6	-5.9	-3.3	-17.4	8.2		-0.3	-21.1	4
of which:										
Government-initiated	-50.9	0.5	31.1	-39.1	-0.5	24.9		-5.8	-14.1	4
Residential completions	-10.1	-1.8	-8.6	5.2	-21.5	9.8		13.1	-13.3	4
of which:										
Government-initiated	-17.7	21.6	-13.1	44.8	-35.6	9.0		44.1	-12.0	4
Survey of companies (percent) <sup>a</sup>										
Output of manufacturing firms (not adjusted)	-15	-10 <sup>b</sup>	0 <sup>b</sup>	-13	-16	-22	-6 <sup>b</sup>			6
Output of manufacturing firms (adjusted)	-14	-10 <sup>b</sup>	-4 <sup>b</sup>	-15	-16	-15	-11			6
Sales by commercial firms (not adjusted)	-24	-32 <sup>b</sup>	-40	-19 <sup>b</sup>	-20	-32	32			6
Sales by commercial firms (adjusted)	-24	-32 <sup>b</sup>	-40	-26	-22	-24	35			6

\* Last month for which data available.

<sup>a</sup> 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.<sup>b</sup> Denotes non-significant result at 5 percent level.

In 2003:II manufacturing companies reported a flattening of the decline in their output, inventories and orders for the next quarter, and a standstill in exports. However, they continued to report on demand restraints on carrying out their activities, with no real improvement in 2003:II. The findings of the Companies Survey are at one with the stabilization of the index of manufacturing output at a relatively low level in the period reviewed (Figure 3). The upward trend of the production index in high-tech industries intensified, the downward trend in the index in the traditional and medium-low-tech industries eased, while the downward trend in the medium-high-tech industry strengthened.

All the construction industry indicators show a further deterioration. Reports from construction companies to the Companies Survey show a steeper decline in all aspects of their activity and a continued downward price trend in dollar terms. The most serious restraints reported remained the demand restraint and the shortage of skilled workers (against the background of the security situation that restricted the entry of Palestinian workers, and the government's efforts to reduce the number of foreign workers). There has also been a steady rise since the beginning of 2002 in the number of companies reporting financing difficulties as a significant restraint on their activity. Building starts and completions fell markedly

Table 2. National Accounts, 2001–2003  
(seasonally adjusted)

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	-0.9	-0.8	-0.1	1.5	-0.6	3.6		-3.0	1.1	3
Business-sector product	-2.6	-2.8	-1.6	1.3	-1.2	4.2		-5.9	0.6	3
Business-sector product excl. start-ups	-1.3	-1.8	-1.6	2.1	-0.9	6.1		-3.7	1.4	3
Private consumption	3.2	0.1	-1.0	-1.6	-0.2	-7.0		0.2	-2.5	3
Gross domestic investment	-4.9	-13.1	-0.1	9.9	-13.5	-45.6		-24.4	-20.0	3
Gross domestic investment excl. start-ups	-7.4	-10.2	-4.6	5.7	-27.3	-40.8		-16.6	-18.8	3
Goods and services exports	-11.5	-2.6	10.6	-4.8	15.1	18.5		-11.3	9.5	3
Goods and services exports excl. start-ups and diamonds	-6.7	-6.3	-1.0	4.9	20.8	10.3		-14.2	8.5	3
Goods and services imports	-4.5	-2.3	8.3	-4.3	3.3	-21.6		-9.6	-4.3	3
Public-sector consumption	3.4	5.7	5.1	2.1	-1.5	6.6		5.6	3.0	3
excl. defense imports	2.5	5.1	3.9	4.6	3.7	2.0		4.6	3.6	3

\* Last month for which data available.

from their levels in the equivalent period in 2002, in both the private and the public sectors (Table 1 And Figure 4), and relative housing prices fell steeply. The number of apartments sold also fell steeply, as did the number of transactions involving the Land Betterment Tax. The rapid reduction in the supply of apartments of the last few years continued, the result of the large reduction in the number of starts and completions, the effect of which was not offset even by the slower rate of sales.

Activity in the tourist industry reached its trough in 2003:I, mainly due to the shaky security situation and the war in Iraq (Table 1 and Figure 5). Tourism picked up slightly following the conclusion of the war in Iraq, as seen from an increase in tourist entries and hotel bednights of tourists and Israelis. This improvement was also reflected in replies from companies in the hotel industry to the Companies Survey, in which for the first time they reported an increase in activity. Despite the improvement, the level of activity in the industry is far below that prevailing prior to the outbreak of the Intifada.

### The labor market

After six months with hints of improvement, the labor market again deteriorated in 2003:I. Total labor input in the business sector went down by 0.8 percent, and the number of employees increased by only 0.2 percent. The number of employees in the public sector fell by half a

percent.<sup>1</sup> These changes, together with a considerable rise in the participation rate, contributed to a sharp rise in the rate of unemployment, which reached 10.8 percent of the labor force in 2003:I (Figure 6 and Table 3). At the same time the real wage fell steeply in nearly all the principal industries. The rate of unemployment remained unchanged in April and May from the level in the first quarter, 10.8 percent (trend data based on partial data from the Labor Force Survey), and real wages continued to fall. Although the number of job-seekers and the number of claims for unemployment benefit went down a little, this might have derived from the lengthening of the period of unemployment, the stricter criteria imposed to obtain unemployment benefit, or stricter application of the willingness-to-work criterion, that contributed to the reduction in the number of those applying to the labor exchanges.

The average participation rate rose significantly from 54.2 percent in 2002:IV to 54.6 percent in 2003:I. The rates for women and men, for new immigrants and for the established population all rose. The government's policy in general, and the economic package approved at the beginning of the year in particular, could be expected to

<sup>1</sup> These figures are seasonally adjusted, so that the change in the total number of employees, an increase of 0.5 percent, does not equal the sum of the changes in the business and public sectors.

Table 3. Indicators of Labor Market Developments, 2001–2003  
(seasonally adjusted)

	2001	2002	2002			2003		Jan-Jun*		**
			II	III	IV	I	II	2002	2003	
			('000s)					*	*	
Civilian labor force	2,500	2,546	2,531	2,547	2,573	2,605		2.4	2.8	3
Israelis employed	2,266	2,284	2,271	2,284	2,312	2,323		0.3	2.4	3
Business sector	1,574	1,572	1,556	1,575	1,603	1,607		-1.2	3.5	3
General government	692	713	714	708	714	710		4.5	-0.8	3
Average weekly hours worked per employee	37.0	37.2	37.1	37.5	37.4	38		-1.1	1.9	3
Business sector	39.8	40.2	39.9	40.2	40.5	40		0.6	-0.4	3
General government	30.6	31.1	31.2	31.2	30.9	31		0.2	-0.9	3
Labor input of employed Israelis	83,830	85,016	84,258	85,650	86,458	87,360		-0.8	4.4	3
Business sector	62,611	63,148	62,092	63,237	64,857	64,289		-0.6	3.0	3
General government	21,146	22,155	22,315	22,068	22,025	21,832		4.7	-1.7	3
Claims for unemployment benefit	117	118	130	114	99	91	86	18.2	-31.9	6
Work seekers	187	197	203	197	184	194	191	16.7	-5.5	5
Real wage per employee post (NIS) <sup>a, b</sup>	7,078	6,509	6,568	6,416	6,348	6,357	6,298	-6.5	-4.9	4
of which: Business sector	7,269	6,570	6,714	6,463	6,376	6,430	6,366	-8.3	-4.7	4
General government	6,678	6,386	6,341	6,272	6,271	6,232	6,245	-2.4	-5.3	4
Unemployment rate (%)	9.4	10.3	10.3	10.3	10.2	10.8				3

\* Percent change compared with same period in preceding year.

\*\* Last month for which data available.

<sup>a</sup> At 2001 prices.

<sup>b</sup> Real wage per employee post relates to Israelis and to foreign workers with work permits, and does not include Palestinians.

have a marked effect on the rate of participation<sup>2</sup> as the severe cuts in unemployment benefits and allowances made individuals join the labor force, in other words, made them start looking for jobs or start working under conditions that previously would not have seemed worthwhile to them.

The moderate rise in the number of Israelis employed in the business sector in 2003:I encompasses great variation between the different industries: in business services,

construction, electricity, water, banking and finances employment of Israelis increased considerably, offsetting the rise in unemployment, while in other industries, headed by trade and vehicle repairs, in which employment rose rapidly in the second half of 2002, there was a significant cutback in the number of Israelis employed. In the public sector, the number of employees in education in 2003:I rose (and reached the same level as at the beginning of 2002, after declining steeply in the second half of 2002), while the number of employees in the health and welfare services contracted.

The reduction in the number of foreign workers in the business sector accelerated in 2003:I, apparently due to the establishment of the Immigration Police that speeded up the process of deporting foreign workers without work permits. The number of Palestinian workers rose in the quarter and reached the same number as at the beginning of 2002, prior to the closures which became more frequent in 2002:II and 2002:III. The rise in the number of Palestinian workers (about 4,000), however, did not

<sup>2</sup> The reported rate of participation is the ratio of the civilian labor force (individuals reported in the Labor Force Survey as working or actively seeking work) to the total working-age population (i.e., aged 15 and over). It may be that due to the intention to impose greater severity in the criteria for obtaining government support, individuals who are not actively seeking work, and who are therefore not included in the labor force, do not report their true situation (out of concern over losing their support), and report that they are seeking work. If some individuals do act in this way, the estimated rate of participation and rate of unemployment will be higher than their actual rates.



nearly offset the sharp decrease in the number of foreign workers (about 30,000), so that the total of non-Israeli workers fell by about 10 percent. This reduction may have affected construction companies, among others, and throughout the first half of 2003 those companies continued reporting a severe restraint caused by the shortage of skilled workers. Concurrently, the number of Israeli employees in construction rose by about 6 percent (about 7,000), and at least some of them may have been taken on as replacements for foreign workers. Nevertheless, it is too soon to be able to prove this claim, or in fact to know whether this is a long-term change.

Together with the rise in the rate of unemployment in 2003:I, data from the Labor Force Survey indicate also greater depth of unemployment: the share of those looking for work for more than half a year continued to rise, and reached an unprecedented level—a third of unemployed persons. The share of those looking for work for less than two months was at the same low level in 2003:I as in 2002:IV.

The findings of the survey of employers undertaken by the Manpower Planning Authority of the Ministry of Labor and Social Affairs support those of the Labor Force Survey regarding the slack in the labor market: it found that in 2003:I the number of vacant positions fell considerably,<sup>3</sup> the share of business looking for workers to fill positions fell, as did the share of businesses reporting difficulties in filling vacant positions. At the same time the number of workers leaving their jobs increased, mainly those leaving due to cutbacks. As in previous quarters, the number of positions filled was smaller than the number of workers losing their jobs.

The real wage continued to decline in the period reviewed (Table 3 and Figure 7). In January to April 2003 the overall average real wage in Israel went down by 5.8 percent—5.9 percent in the business sector and 5.4 percent in the public sector. The reduction reflected a decline in the nominal wage after years of rises even at times of troughs in activity, and is mainly an indication of the degree of slack in the labor market. In addition, the reduction in the real wage reflected unexpected inflation in 2002. The reduction in the wage does not yet reflect the cut in the public-sector wage approved as part of the economic package (the Economic Arrangements Law). The decline

in the wage was particularly marked in banking, insurance and financial institutions, construction, and business services, in all of which employment rose. Nevertheless, a calculation performed by the Bank of Israel Research Department shows that the change in the industry composition in 2003:I acted to raise the average wage in most industries, meaning that were it not for the change in composition, the real wage in these industries would have fallen even faster. The only industry in which the change in industry composition acted to reduce the average wage was business services.

Disquiet in industrial relations was expressed in local and partial strikes throughout the period reviewed. At the end of April and the beginning of May the Histadrut (Labour Federation) called a general strike, in protest against the budget cuts and the adverse changes to retirement and pension rights in the framework of the economic package. Following negotiations between the Histadrut and the representatives of public sector employers, a collective agreement for the period from 22.5.03 to 30.6.05 was signed, according to which the salaries of all public-sector employees<sup>4</sup> would be cut at specified rates. The cuts are temporary, and will be effective from 1.7.03 to 30.6.05, and will apply to all components of the employee's salary, excluding imputed benefits (e.g., imputed value of use of vehicle or of mobile telephone) and grossing up of tax. It was also agreed that the cost-of-living allowance will be deferred to 1.7.05, and that the vacation supplement and the Jubilee bonus would be deferred to the January or February of the year following the year to which the payment relates (e.g., the Jubilee bonus for 2003 will be paid in January or February 2004). The signatories to the agreement also undertook to observe industrial calm until 30.6.05, i.e., not to strike or institute sanctions because of wage claims or benefits in the period of the agreement or prior periods. No agreement was reached between the Histadrut and the employers concerning the change in legislation regarding pension funds.

<sup>3</sup> In most industries the number of vacant positions fell to unprecedented lows. The only industries in which demand was relatively high in the first quarter were construction and agriculture, in which most demand is for foreign workers and Palestinians. In the other industries the number of vacant positions was more than 22 percent lower than the average in the previous quarters.

<sup>4</sup> The agreement applies to all employees employed by the entities that signed it, including those employed on personal contracts (including senior managers' contracts) and those "holding offices" as defined in the Economic Arrangements Law. The agreement also applies to those workers whose employers did not sign, if the latter add their signatures to it or if they confirm in writing to the head of labor relations that they wish to be included. For those workers whose employers did not sign and who have not indicated their wish to be included, the provisions of the Economic Arrangements Law will apply (The Program to Revive Israel's Economy Law—Amendments to Achieve the Budget Deficit Targets and Economic Policy for 2003 and 2004).

Table 4. Balance of Payments, Foreign Trade,<sup>a</sup> and the Reserves, 2001–2003  
(\$ million, current prices)

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
<b>Monthly averages</b>										
Trade deficit	313	296	288	318	205	48	333	331	190	6
Goods imports	1,986	1,870	1,873	1,858	1,825	1,780	1,887	1,898	1,834	6
Consumer goods	387	363	357	355	341	324	349	377	336	6
Capital goods	499	455	458	432	477	433	463	456	448	6
Intermediates	1,098	1,050	1,057	1,069	1,005	1,020	1,073	1,064	1,047	6
Goods exports	1,672	1,574	1,585	1,541	1,620	1,732	1,555	1,567	1,643	6
Manufacturing	1,616	1,520	1,529	1,484	1,564	1,662	1,496	1,515	1,579	6
High-tech	832	741	742	695	768	810	643	750	726	6
<b>Quarterly averages</b>										
Net current account	-444	-307	-698	-1,101	729	591		-427		3
Financial account (excl. foreign-currency balances)	49	-435	560	-224	-1,952	-986		219		3
Nonresidents' direct and portfolio investment	880	412	813	528	391	684		365		3
Nonresidents' portfolio investment	30	193	-42	395	-323	-272		351		3
Residents' direct and portfolio investment	566	993	1,487	190	462	-40		1,659		3
Net foreign debt (% of GDP)	0.55	-2.68	-1.60	-1.77	-2.62	-5.22		-1.34		3
End-period Bank of Israel reserves	23,181	23,670	24,790	24,229	23,670	23,486	24,088	24,790	24,088	6

\* Last month for which data available.

<sup>a</sup> Foreign trade data are seasonally adjusted and do not include ships, aircraft, diamonds, and fuel.

## The balance of payments

In 2003:I the current account showed a surplus of \$ 0.6 billion, compared with a deficit of \$ 0.2 billion in 2002:I (Table 4). The surplus reflects a surplus in current transfers and in the services account and deficits in the goods account and income from production inputs. The trade deficit (excluding ships, airplanes, diamonds and fuel) has followed a rising trend since the beginning of the year as a result of a rising trend in goods imports<sup>5</sup> and a downwards trend in exports (Figure 8). Although foreign-trade data for January and February indicate opposing trends (a sharp decline in the trade deficit, with a steep rise in exports and a fall in imports), the direction changed as early as March, and the improvement in the trade account was seen to be temporary. The development if

foreign trade in 2003:I was accompanied by an improvement in the terms of trade, as export prices rose faster than did import prices. The terms of trade improved despite the relative strengthening of the euro which acted in the opposite direction, as the share of imports from Europe outweighs the share of exports to Europe.

All components of goods imports rose significantly: consumer goods, raw materials (excluding diamonds and fuel), and capital goods. In the consumer goods category, imports of both consumer durables and current consumer goods rose. Among capital goods, the upward trend in the imports of machinery and equipment that had started in 2002:IV continued, although the rate of utilization of machinery and equipment declined throughout the period reviewed. Imports of vehicles as capital goods increased relatively rapidly in March–June, after falling at a similar rate from July 2002 to February 2003. The rise in imports, and in particular that of capital goods, probably reflects expectations that the economic situation will improve in the near future.

<sup>5</sup> The rising trend in goods imports was greatly affected by a marked jump in June. Until May imports were stable.

Goods exports were fairly stable in January and February, and actually showed a small rise, but in March this reversed into a rapid downward trend. The path followed by goods exports is mainly a reflection of that followed by exports of manufactured goods, particularly of high-tech industries that surged in the early months of 2003 and then contracted considerably, offsetting the earlier rise. Exports of other manufacturing industries were highly volatile, with a moderate upward trend in the traditional industries, stability at a relatively high level in the medium-high-tech industries, and a rapid upward trend in the medium-low-tech industries. The changes in manufacturing exports in the period reviewed apparently reflect the extent of the effect of the slowdown in world trade on exports of the high-tech industries, while the traditional industries were more affected by the real exchange rate, which rose rapidly in 2002. Moreover, because the fall in world demand for goods in which Israel's manufacturing industry specializes was faster than the fall in world trade overall, the effects on exports of high-tech industries was greater than the direct effect which the drop in world trade would have caused. Beyond the effect of the global slowdown, Israel's exports may also have been influenced by the prevailing security situation and political uncertainty. A comparison of Israel's high-tech exports with US imports of high-tech goods (Figure 9) highlights the great effect which the change in world demand for high-tech goods had on exports of high-tech industries, on the one hand, and the effect of factors specific to Israel due to which the rise in US imports in the second half of 2002 was not matched by a similar rise in Israel's exports, on the other. It is nevertheless difficult to assess the relative effect of risk factors specific to Israel, as most of the deterioration in exports and in the trade deficit occurred in 2003:II, a period when most indicators suggested a reduction in Israel's country risk premium.

The financial account (excluding the foreign exchange reserves) showed net capital outflow of \$ 1 billion in 2003:I, down from an outflow of \$ 1.9 billion in 2002:I. Nonresidents' direct investment in Israel rose by \$ 0.7 billion, while their portfolio investment showed net realizations of \$ 272 million. The contraction of nonresidents' investment in securities in the first quarter took place against the background of the high degree of uncertainty in the markets at that time: expectations of the outbreak of war in Iraq and uncertainty regarding its implications for Israel; uncertainty about the approval of the budget; and the rise in the inflation environment. Later in the period reviewed, nonresidents' short-term capital flows to Israel increased greatly, as detailed below. Direct and portfolio investment abroad by Israelis resulted in net realization of \$ 40 million. Israel's foreign exchange

reserves stood at \$ 24 billion at the end of the period reviewed, a rise of 1.8 percent in the period.

## Global developments<sup>6</sup>

Economic developments in Israel in the last few years, especially in the period reviewed, showed the considerable extent to which global developments affected Israel in general, and high-tech exports in particular (Figure 9). Israel's chances of emerging from the recession depend not only on security-political developments in the region but also to a great extent on future developments in global demand, especially for high-tech products.

According to most indicators of the global economic environment the slump will persist despite the continuation of expansionary monetary policy in most of the advanced economies. Nevertheless, the simultaneous and leading indicators in some of these countries rose moderately or stabilized in May.

In 2003:I the geopolitical situation had a notable effect on global developments: the uncertainty resulting from expectations of war in Iraq and the slow rate of recovery of the advanced economies led to a fall in prices of shares and bonds in those countries at the beginning of 2003, after they had appeared to be recovering in 2002:IV. In most of the advanced economies there was stagnation in manufacturing production alongside a slowdown in world trade. The labor markets remained slack, most leading indicators declined, and the dollar depreciated against most major currencies. In March assessments that the war in Iraq would be quick revived, leading to the reversal of all these trends: the stock markets rallied, bond yields rose, and the dollar appreciated against the major currencies. Developments regarding the war in Iraq also had a marked effect on the goods markets: the geopolitical uncertainty, together with the political crisis in Venezuela, caused oil prices to soar in January–February, despite the decision by OPEC to increase production quotas. Oil prices dipped again in March.

In 2002 and at the beginning of 2003 capital inflows to emerging economies soared (although remaining lower than in the past). Interest-rate spreads, representing the risk premium, contracted markedly, due to the decline in the level and price of risk. As of March 2003, as background conditions in Israel stabilized and both uncertainty and the inflation environment declined, short-term capital inflow to Israel picked up notably.

<sup>6</sup> This account of global developments is based mainly on IMF, *World Economic Outlook*, April 2003.



Table 5. Indicators of Economic Development in Advanced Countries<sup>a</sup> and Forecast for 2003<sup>b</sup>

	2000	2001	2002	Forecast 2003	Forecast 2003 (Sep 2002)
World GDP					
Advanced countries	4.7	2.2	3.0	3.2	3.7
Developing countries	3.8	0.8	1.8	1.9	2.5
World trade	5.7	3.9	4.6	5.0	5.3
Advanced countries	12.6	-0.1	2.9	4.3	6.1
Imports	11.8	-1.3	2.1	4.7	6.2
Exports	12.0	-1.1	2.0	3.8	5.4
Developing countries					
Imports	15.9	1.6	5.4	4.7	7.1
Exports	15.0	2.6	5.1	3.7	6.5
Inflation (CPI)					
Advanced countries	2.3	2.2	1.5	1.9	1.7
Developing countries	6.1	5.7	5.4	5.8	5.8
Countries in transition	20.2	15.9	11.1	9.4	8.8
Prices of unprocessed goods (US\$)					
Oil <sup>c</sup>	57.0	-14.0	2.8	24.2	-0.8
Other	1.8	-5.4	4.2	9.4	5.7
Short-term interest <sup>d</sup> (%)					
Dollar deposits	6.6	3.7	2.1	1.7	
Yen deposits	0.3	0.2	0.1	0.1	
Euro deposits	4.6	4.1	3.4	2.4	
Unemployment rate in advanced countries	5.8	5.9	6.4	6.6	

<sup>a</sup> According to "World Economic Outlook," Israel is classified as an advanced country.

<sup>b</sup> Annual percent rate of change, except for unemployment and interest rates.

<sup>c</sup> Average price per barrel in 2002 was \$25.00; estimated price in 2003 is \$31.00.

<sup>d</sup> Six-month Libor rate

SOURCE: "World Economic Outlook" (IMF), April 2003.

In April 2003 the IMF revised its growth and world trade forecast downwards, and raised its forecasts regarding inflation and prices of unprocessed goods (Table 5). According to the forecast, the GDP of the advanced economies is expected to grow by 1.9 percent. The US is expected to continue to lead the global recovery, even though its GDP growth rate is expected to be lower than in 2002. The revival of consumer confidence and increase in investment, as well as fiscal incentives, constitute the key to recovery. In the euro zone, against the backdrop of weak domestic demand, contractionary fiscal policy, and the appreciation of the euro, expectations of growth have been lowered substantially, and now stand at only 1 percent. In Germany and Japan the slow expansion of GDP is expected to persist. The forecast of the growth rate of the Asian countries was lowered in view of

developments in the advanced economies. The Asian countries' growth rate surpassed expectations in 2002, and is expected to remain stable in 2003 even though the slump in the IT industry could slow growth in the years to come. The impact of the SARS epidemic which spread through Asia at the beginning of the year is expected to be short-term and not to have a lasting effect. Unemployment rates in the advanced economies are rising: in the US the unemployment rate is expected to exceed 6 percent, and in the euro zone to be close to 9 percent. World trade is expected to expand vis-à-vis the last two years, but not to reach its level at the end of the 1990s. Demand for fixed investment rose in 2003, but it does not appear to be robust enough to support a recovery if the rate of consumption moderates.

**Table 6. The Budget and its Financing, 2001–2003**  
(cash flows, as percent of GDP)

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
1. Government domestic expenditure	37.5	37.9	38.0	36.4	40.0	38.4	38.8	37.6	38.6	6
2. Government receipts	33.7	33.9	34.5	34.4	31.9	34.0	30.6	34.7	32.3	6
3. Domestic budget deficit (1)–(2)	3.7	4.0	3.6	1.9	8.1	4.3	8.1	2.9	6.2	6
4. Government and Jewish Agency domestic deficit <sup>a</sup> (5)+(6)	3.1	4.1	4.2	2.7	8.6	4.8	8.2	2.5	6.5	6
5. Government net borrowing from the public	3.7	5.3	3.8	3.8	5.1	6.4	7.6	6.2	7.0	6
6. Public-sector injection <sup>b</sup>	-0.6	-1.2	0.3	-1.2	3.5	-1.6	0.6	-3.7	-0.5	6
7. Bank of Israel injection	1.6	1.9	0.0	1.3	-2.8	2.8	-1.3	4.7	0.8	6
8. Change in monetary base	0.9	0.3	0.0	-0.2	0.3	1.1	-0.9	0.6	0.1	6

\* Last month for which data available.

<sup>a</sup> Including non-budgetary injection.

<sup>b</sup> The public-sector injection is recorded as a change in the monetary base minus the Bank of Israel injection and adjustments. The adjustments are small and are not presented in the table.

### The general government sector

The implementation of the budget in the period reviewed (the first half of 2003) indicates a marked deviation from the deficit target: the domestic deficit (excluding net credit extended) stood at NIS 15 billion, compared with NIS 6.6 billion in the equivalent period in 2002. This deficit is NIS 12.6 percent above the seasonal path consistent with the deficit target of 3.0 percent of GDP determined in the Budget Deficit Reduction Law. Although the deficit was affected by several one-off factors which contributed to its exceptional increase at the beginning of the year, even adjusting for them, and assuming that the economic package will be implemented in full, it is expected to reach 6 percent of GDP in 2003, i.e., NIS 30 billion.

Most of the deviation from the seasonal path consistent with the deficit target can be attributed to the shortfall in tax receipts, which were NIS 8.8 billion below the original forecast for the period in the budget. This shortfall reflects a shortage of NIS 6 billion in income-tax revenues and of NIS 2.9 billion in excise and bond receipts. About NIS 1.1 billion of this can be ascribed to the nonrecurring deferment of tax rebates from the end of 2002 to 2003, but even adjusting for this, the shortfall in tax receipts amounts to a significant 9.8 percent of expected income. In January–May the shortfall in revenues grew, and in June the rise was checked. It is still too early to tell whether this constitutes stabilization or the one-off effect of the end of the strike by Excise and Income-Tax Authority

employees. Transfers from the National Insurance Institute to the government (by means of bond purchases), amounting to NIS 5.4 billion since the beginning of the year, were NIS 3 billion less than the amount that is in line with the annual forecast in the budget. Other non-tax revenues were down by NIS 0.5 billion from their forecast level in the period reviewed.

Government expenditure in the period reviewed was consistent with full performance of the budget, despite the cuts approved by the Economic Committee of the Knesset, which should have served to reduce spending in May–June. As regards the composition of expenditure, in the first five months of the year the defense budget appears to have deviated from the amount approved by the Knesset as well as from the path consistent with the budgetary supplement approved, and this trend was checked in June. The budgets of the other government ministries displayed marked under-spending in the first five months of the year, however, and in June expenditure picked up. There are still no signs that the across-the-board cuts and other budget reductions approved by the Knesset in April and May are indeed having the desired effect. Note that according to the performance data for 2002 recently published by the Ministry of Finance even if expenditure had been in line with full performance of the original budget there would have been a decline in investment in the transport infrastructure.

Unemployment benefit payments contracted markedly in the period reviewed, continuing the trend evident since 2002:II. In the first four months of 2003 unemployment

## The Economic Package (policy measures under the Economic Arrangements Law) Introduced During the Period Reviewed, and its Contribution to Reducing the Budget Deficit in 2003–06<sup>1</sup>

	Contribution to reduction of deficit (each year compared to previous year)				
	2003	2004	2005	2006	Cumulative
	(NIS million, 2003 prices)				
Measures					
1. REDUCTION OF GOVERNMENT EXPENDITURE					
a. Reduction of wage costs in public sector					
Reduction of public-sector wages by 4% to mid-2005. Deferment of vacation pay and jubilee grants in 2003 and 2004 <sup>2</sup>	711	119	-830	0	0
Freeze on new employees until end-2006 (= annual 1% reduction of public-sector workforce)		69	69	69	207
Dismissals and early retirement in public sector:					
Dismissal of 1% of workforce in 2003, early retirement of 3 percent of civilian workforce (2% in 2003, 1% in 2004) <sup>3</sup>	-319	900	130	210	921
b. Reform of pension funds <sup>4</sup>	0	-630	-700	-600	-1,930
c. Cuts in transfer payments <sup>5</sup>					
Reduction in job disability payments	153	77			230
Equalizing child allowances for all children (= gradual reduction of payments for third and subsequent children) <sup>6</sup>	0	1,200	420	315	1,935
Reduction of maternity grant	60	220			280
Amendment of widows/widowers law		35			35
Cuts in national insurance benefits in 2004 (the cancellation of the cuts decided on previously was deferred to 2007; the cuts in the child allowance were not cancelled)	0	1,700			1,700

1 In addition to the measures noted, the economic package includes several important measures whose effect on the government budget cannot be precisely quantified. The main ones are as follows: making an emergency regulation regarding private legislation proposals permanent, reforming the electricity system, opening the communications market to competition and establishing a Communications Authority, as well as economic legislation (sections 82–85 of the Economic Arrangements Law)—supervision of and penalty for fraudulently accepting favors, intensification of implementation, collection, and penalty with regard to taxation, the authority to offset government debts from payments it is required to pay to supported entities, supervision and implementation of planning, construction, and land laws. In addition, it was decided to reduce university tuition fees by only 3 percent (rather than the higher rate recommended by the Winograd Committee), and to cut support provided for students aged 23 or more at religious seminaries (yeshivot).

<sup>2</sup> The calculation includes the reduction of indemnity to several entities, especially the Health Funds, in accordance with the wage reduction, and payments due to be made by various authorities because of the saving, and tax deducted because of the wage reduction.

<sup>3</sup> The calculation of public saving assumes that persons dismissed from the public sector will find work in the private sector, and that those taking early retirement will not be replaced. The marked effect of this measure on the deficit in 2004 stems from the one-off payment of early retirement compensation in 2003, so that the saving in 2004 will be considerable.

<sup>4</sup> The effect on the government budget of the pension reform stems from the decline in interest payments due to the cessation of the issue of earmarked bonds and the reduced direct subsidization of pension funds, as well as from the provision for the fund to subsidize the veteran funds. The pension reform includes other important measures whose direct effect on the budget deficit is negligible but will have a marked effect on the pension funds, their members, and possibly also the governments need to cover their deficits in the future. (a) In the established pension funds which are in deficit: charging a 2% management fee on average (reduction of pension) and gradually raising the provision to 20.5 percent; (b) in unfunded pensions: deducting 2% from the wages of recipients of unfunded pensions (1% in 2004 and 2% as of 2005); (c) in new pension funds: guaranteeing the real value of the fund for members.

<sup>5</sup> In addition to making cuts in the size of the payments, they will not be raised until 2007; the effect of this freeze is not included in the calculation above.

<sup>6</sup> Reduction of size of child allowance is offset by annulling planned reduction of child allowance for persons who have not served in the military.

## BANK OF ISRAEL

	2003	2004	2005	2006	Cumulative
	(NIS million, 2003 prices)				
<b>d. Infrastructure investment</b>					
Addition of NIS 500 million annually for roads infrastructure in 2004 2007 <sup>7</sup>	-500	0			-500
Cancellation of subsidy for development budget of local authorities	200				200
Reduction of investment in sewerage system	5				5
<b>e. Reduction of other government expenditure</b>					
Across-the-board cuts in national budget	2,976				2,976
Additional across-the-boards from June 2003, incl. in defense	1,000	700			1,700
Defense Ministry budget cuts	-2,000	1,000	1,000		0
Ministry of Agriculture	20				20
Withdrawal of dividend from Natural Disaster Fund	30	-30			0
Ministry of Transport					
Reduction of purchase of buses	100				100
Reduction of budget of National Road Safety Authority	40				40
Ministry of Health					
Reduction of hospital beds and departments	23				23
Program to make Health Funds more efficient	105	-105			0
Reduction of hospitalization	30				30
Reduction of geriatric hospitalization	35				35
Ministry of Religion					
Cuts in support for religious councils	30	20			50
Change in criteria for support for religious seminaries	55	0			55
Miscellaneous					
Cuts in expenditure on computerization of government	30				30
Cessation of government participation in Postal Authority budget	11				11
Cuts in budget base of Settlement Department, part of budget earmarked for activity in Negev	30	20			50
Cuts in budget of Overseas Students Administration	0	50			50
Annulment of Overseas Marketing Fund, channeling its previous income to National Budget	53	50			103
Reducing activities of Development Areas Administration	20				20
Replacement of housing grants by market loans	800	450			1,250
Reducing local authorities' balancing grant and making it more efficient	150				150
Reducing grants to political parties for local elections	0	70	-70		0
Cessation of activity of "Nativ" liaison office	10	30			40
Cuts in budgets of Knesset and State Comptroller	40				40
Reduction in no. of State emissaries abroad	7	20			27
Cancellation of government participation in budget of Economic and Cultural Corporation	11		-11		0
Cancellation of "Birthright" program	10	20			30
Increase in water rates	45				45
Increase in water production impost	10				10
<b>Total budget reductions</b>	<b>3,981</b>	<b>5,985</b>	<b>8</b>	<b>-6</b>	<b>9,968</b>
<b>2. TAX CHANGES<sup>8</sup></b>					
Bringing income-tax reform forward	-1,250	-2,300	-450	-300	-4,300
Reinstatement of national insurance and health insurance ceilings as of 1.7.2003	-500	550			0

<sup>7</sup> Concurrently, the infrastructure budget was cut by a larger amount in the framework of the across-the-board reduction in the government budget, i.e., the amount spent on the infrastructure in the amended budget will be less than it would have been without the economic package.

<sup>8</sup> The tax changes are vis-à-vis existing legislation in effect at the time the economic package was approved.

## RESEARCH DEPARTMENT

	2003	2004	2005	2006	Cumulative
	(NIS million, 2003 prices)				
Reduction of employers' national insurance contributions (net)	0	0	0	0	0
Reduction of regional tax benefits	550	550			1,100
Annulment of tax exemptions for new immigrants and returning residents <sup>9</sup>	25	75			100
Lottery tax (gross)	200	200			400
Imposition of Health Tax on housewives	202	202			404
Reduction of tax exemption for temporary disability <sup>9</sup>	100	100			200
8 percent tax on employment of foreign workers (excl. home-helps)	84	84			168
Total tax changes	-639	-539	-450	-300	-1,928
Of which: new tax measures (excl. income-tax reform and reinstatement of national insurance ceiling)	1,161	1,211	0	0	2,372
<b>Total effect of economic package</b>	<b>3,342</b>	<b>5,446</b>	<b>-442</b>	<b>-306</b>	<b>8,040</b>

<sup>9</sup> According to Ministry of Finance estimates.

Source: A. Brender and K. Braude, 2003. *The Effect of the Economic Package on the Government Budget in 2003–2008* (Bank of Israel website).

benefit was 40 percent below its level in the equivalent period in 2002, despite the notable increase in both the unemployment rate and the number of unemployed persons. Income support payments fell by 23 percent in the first four months of 2003, after rising considerably in 2002, and child allowance payments dropped by 14 percent. These changes clearly reflect the effect of the economic measures introduced in 2002 and at the beginning of 2003 (mainly the 2002 Economic Arrangements Law and the Economic Emergency Package). Other transfer payments declined more moderately, primarily reflecting the 4 percent cut in them and the erosion of their real level because of the nominal freeze on their extent and the rapid rate of price increases in 2002.

Assessments made by the Bank of Israel's Research Department<sup>7</sup> show that even if the economic package is implemented in full, its effect on the deficit and the government debt in 2003–2004 will be moderate, and the deficit is expected to be 6 percent of GDP in 2003 and 5.4 percent in 2004, while the government debt will be 106.7 percent of GDP in 2003 and 107.1 percent in 2004. Nevertheless, the effect of the economic package is expected to be cumulative in the coming years and to contribute to the gradual reduction of the deficit and the public debt in the medium term (see Box). The erosion of the public expenditure/GDP ratio as a result of the freeze on transfer payments and government spending is expected to make the greatest contribution to reducing the deficit. The specific measures decided upon by the

government are also expected to make a marked contribution to reducing the deficit in the medium term. However, bringing forward the income-tax reform is expected to increase the deficit in the short and medium terms, relative to the deficit that could have been expected given the original path of the reform.

### Prices, monetary policy, and the money and capital markets

The CPI fell by an annual 1 percent in the period reviewed (Table 6), although this was not uniform throughout the period: in 2003:I the CPI rose by 0.8 percent, while in 2003:II it declined by 1.3 percent. The main factors affecting the development of prices in the period reviewed were the exchange rate and real economic activity. At the beginning of the year the local-currency depreciation against the dollar served to increase the prices of housing and tradable goods, making a sizeable contribution to the rise in the CPI despite the economic slowdown. As of end-February, when the exchange-rate trend reversed, the marked local-currency appreciation against the dollar served to lower the index of housing prices. The recession, too, played a significant role in the decline in the housing price index, so that price indices adjusted for seasonal and volatile components (clothing and footwear, and fruit and vegetables) rose more moderately. Tight monetary policy contributed to the slowing of the rate of price increases by giving rise to local-currency appreciation, dampening demand, and lower inflation expectations. The reduction in the price of energy once the war in Iraq was over also served to lower the rate of price increases.

<sup>7</sup> A. Brender and K. Braude, 2003. *The Effect of the Economic Package on the Government Budget in 2003–2008* (Bank of Israel website).



Table 7. Selected Price Indices, 2001–2003  
(annual rates of change during period, percent)

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
CPI	1.4	6.5	16.3	2.6	-1.8	3.2	-5.0	13.0	-1.0	6
CPI excl. housing, fruit and vegetables	0.2	6.3	16.3	5.8	0.4	2.7	0.8	9.6	1.8	6
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	-4.2	6.9	15.9	6.3	-0.4	4.2	-0.2	11.0	2.0	6
Index of housing prices	5.2	8.2	21.9	-12.7	-5.7	3.8	-26.2	29.1	-12.5	6
Wholesale price index	-1.9	6.9	15.9	3.9	0.8	15.4	-7.9	11.7	3.1	6
NIS/\$ exchange rate	4.8	9.8	25.7	-12.7	-6.6	7.6	-29.7	33.5	-13.0	6
NIS/currency-basket rate	3.7	14.2	39.2	-8.9	-2.8	15.0	-23.2	38.7	-6.0	6

\* Last month for which data available.

An examination of the components of the CPI shows that there was considerable variance between them. The price of fruit and vegetables rose relatively sharply at the beginning of the period, and declined in June. The trend for clothing and footwear was the reverse, and their prices rose in 2003:II after having fallen in 2003:I. The price of housing, which has the greatest influence of all the CPI components, began to fall in March. Notwithstanding, most of the variance in the components of the CPI stemmed from seasonal effects and did not reflect increased uncertainty. The rise in the prices of controlled and supervised goods in 2003:I outstripped that of the other components of the CPI, because of the increase in energy prices. The development of the prices of tradable and nontradable goods was affected by exchange-rate movements: in January–April prices of tradable goods rose more steeply than those of nontradable ones, while in May–June their prices fell more sharply.

As stated, the development of prices in the period reviewed reflected that of the background conditions, and was in line with that regarding the assessment of the inflation environment. In January–February 2003 security, political, and economic uncertainty soared in the context of the expectations of war in Iraq and misgivings regarding the economic package and the government budget. These developments led to a deterioration in all the indicators of the inflation environment, contributing in particular to local-currency depreciation and thereby to the rise in the CPI and the marked increase in inflation expectations, which deviated from the limits of the inflation target in this period (Figure 11). In view of these developments, the Bank of Israel left the interest rate unchanged in February and March. As of end-February a series of economic events and processes got under way

which served to reduce economic and political uncertainty and contributed to the gradual reduction of the inflation environment. These included the inauguration of the new government, the announcement of the economic package and its speedy approval by the government, the conclusion of the war in Iraq, the establishment of a new Palestinian government and the resumption of the peace process, and the authorization by the US of loan guarantees to Israel. All these factors led to local-currency appreciation, a rise in share prices, and a decline in long-term nominal and real yields. Concurrently, there was a marked decline in inflation expectations for various terms. Expectations for a year ahead stabilized in the lower part of the inflation target, and those for longer terms dipped, so that almost the entire expectations curve also declined to within the target, for the first time since the first half of 2002.

Alongside the decline in the inflation environment, the Bank of Israel renewed the process of reducing the interest rate, at first by a moderate 0.2 percentage points for April, and then by gradually increasing amounts—0.3, 0.4, 0.5, and 0.5 percentage points for May, June, July and August respectively. Despite these reductions, the real expected interest rate remained at a relatively high 6 percent (Figure 11).

The development of the yield curves on indexed and unindexed bonds was also consistent with the background conditions (Figure 15). In January–February long- and medium-term yields rose, the nominal curve rose in its entirety, and the slope of the real curve changed from flat to positive due to the decline in short-term yields on indexed bonds. As of March, with the improvement in the inflation environment and reduction in economic uncertainty, long-term yields declined (thus, for example, yields to maturity on 10-year indexed bonds, which were 5.6 percent in December 2002, rose to approximately

Table 8. Monetary Indicators and Nondirected Bank Credit, 2001–2003  
(annual terms, percent)

	2001	2002	2002			2003		Jan–Jun		*
	Average		II	III	IV	I	II	2002	2003	
Rates of change			Compared with preceding quarter					During period		
M1 <sup>a</sup>	14.2	15.6	10.5	-12.8	-14.7	13.2	0.3	26.0	2.5	6
M2 <sup>b</sup>	17.2	2.2	-2.2	2.5	5.6	-0.1	-3.2	-8.6	-2.3	6
M3 <sup>c</sup>	15.5	6.1	7.3	0.5	2.4	6.3	-4.8	3.6	0.0	6
Nondirected bank credit	10.8	10.5	15.4	9.4	5.9	1.0	-5.8	14.8	-3.8	6
Unindexed local-currency	15.0	6.5	2.0	18.6	17.2	-1.3	10.1	0.1	5.9	6
CPI-indexed	4.7	7.6	12.4	10.4	-0.9	-3.8	-2.4	9.8	-4.7	6
Foreign-currency-indexed and denominated	15.7	20.5	38.8	-1.7	2.7	11.0	-26.6	45.1	-14.0	6

\* Last month for which data available. Data for the last quarter are preliminary.

<sup>a</sup> Narrow money supply (cash in the hands of the public and demand deposits).

<sup>b</sup> M1 plus short-term local-currency deposits.

<sup>c</sup> M2 plus foreign-currency-indexed and denominated deposits.

5.8 percent in February 2003, and declined gradually from March to around 4.6 percent in June). The positive slope of the nominal curve moderated as a result of the steep decline in short-term yields on unindexed bonds,<sup>8</sup> while the slope of the real curve reversed and became steeply negative because of the rise in short-term yields on indexed bonds.

The composition of the public's asset portfolio did not evince major changes in the period reviewed despite the significant developments in the inflation environment, uncertainty, and the exchange rate. As of April, the share of unindexed and foreign-currency-indexed assets declined slightly, while that of Israeli shares rose gradually. Some of the change reflected the effect of relative prices—local-currency appreciation on the one hand, and the rise in share prices on the other.

Developments in the stock market<sup>9</sup> were also consistent with the change in the background conditions. The year began with a 7 percent fall in share prices, continuing the decline evident at the end of 2002, and with relatively low turnover. One of the factors affecting trading at that time, beyond the general ones mentioned above, was the reform of the taxation of the capital market in January 2003. This imposed a turnover tax of 0.5 percent in January–June, and 1 percent (5 percent in the TA25-Maof market) from end-June to end-2003. In mid-February the downward trend of share prices reversed, and from then

until end-June they rose sharply, amounting to a 46 percent increase, 6 percent of it in June. Concurrently, there was a gradual rise in the volume of daily trading in 2003:II, reaching a peak of NIS 538 million in May. The steep share-price rises encompassed all the indices and most industries, with particularly sharp increases in oil firms and partnerships, insurance companies, the commercial banks, and chemical companies—which were up by an average of 40 percent as a six-month average.

Capital raised in the primary market via public offerings and rights issues contracted notably in the first half of 2003, despite the rise in share prices. In the wake of the tax reform, activity in the derivatives market declined at the beginning of the year—in trading in options and forwards on the TA25 and on dollar options—despite the exchange-rate volatility which characterized the first two months of 2003. Turnover in options rose in 2003:II, to reach a peak of 191,000 units a day in May. On the other hand, activity in the bond market increased, as regards both turnover and capital raised, against the backdrop of the decline in the inflation rate, interest-rate reduction, and volatility of the exchange rate against the dollar. Since June 2002 there appears to have been increased resort to structured bonds.

During the period reviewed short-term capital inflow by nonresidents increased, while long-term capital inflow expanded only moderately, in the context of the relatively wide interest-rate spread between local and foreign currency and the increased capital flow to emerging markets that had begun at the end of 2002. The greater relative attractiveness of investing in emerging markets derived primarily from their greater financial stability, as

<sup>8</sup> Yields to maturity on unindexed one-year bonds dipped from 8.5 percent in March to 6.9 percent in June. See Figure 15 for yields on Treasury bills.

<sup>9</sup> Based on data from the TASE.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2001–2003

	2001	2002	2002			2003		Jan–Jun		*
			II	III	IV	I	II	2002	2003	
Nominal interest on:										
Nondirected										
local-currency credit	10.0	9.9	8.5	11.9	11.8	12.0	11.8	7.5	11.9	4
Average monetary loan	6.7	6.7	4.9	9.1	9.1	8.9	8.5	4.3	8.7	6
SRO deposits	5.6	5.8	4.3	7.9	7.9	7.7	7.5	3.1	7.9	4
3-month Eurodollar	3.7	1.7	1.8	1.7	1.4	1.2	1.1	1.8	1.2	6
Yield to maturity on										
Treasury bills	6.5	7.4	7.2	8.9	8.7	8.5	7.6	6.0	8.1	6
10-year bonds	4.9	5.2	5.3	5.6	5.8	5.8	4.8	4.7	5.4	6
5-year bonds	4.9	4.8	4.4	5.8	5.9	5.6	5.2	3.8	5.4	6
General Share-Price Index (points)	197.5	183.7	183.4	177.8	174.1	171.7	219.0	191.5	195.3	6
Expected inflation (gross)	1.9	3.3	4.3	2.6	3.5	3.8	1.9	3.5	2.9	6
Interest derived from										
expected inflation (gross)	4.3	4.1	3.3	6.1	4.8	4.3	4.7	2.7	4.5	6

\* Last month for which data available.

well as the trend among international investors to seek a high yield even at a higher risk (lower risk premium). The processes which led to the decline in economic uncertainty in Israel as of March contributed to the reduction in its risk premium and attracted foreign capital. From February to April 2003 short-term capital inflow of nonresidents amounted to \$ 2 billion, mainly through NIS forward purchases. Alongside the benefits of short-term

capital flows, which increase market discipline and provide a speedy indicator of market imperfections for policymakers, they serve to exacerbate exchange-rate shifts, making price indices more volatile and hampering the implementation of monetary policy. In addition, by generating local-currency appreciation capital inflow could depress exports and stimulate imports, while capital outflow could lead to sharp depreciation.

