

RECENT ECONOMIC DEVELOPMENTS, 112 July–December 2005

Part 1: Current developments, second half of 2005

Main remarks

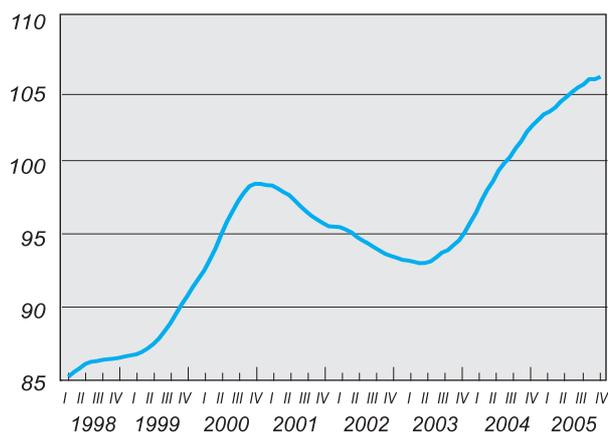
During the review period—the second half of 2005—the economy continued to grow rapidly, as it has in the past two years, with the expansion of trade, services, and tourism accelerating. The consolidation of growth in 2005 was manifested, among other things, in favorable trends in the labor market, stability in the financial markets, high yields, and a significant increase in trading volumes. The unemployment rate declined to 8.9 percent, despite the increase in the number of foreign workers in the first three quarters of the year. An upturn in domestic demand and depreciation of the NIS led to a slight upturn in the pace of price increases and inflation expectations by the beginning of the review period. These developments, coupled with the narrowing of the NIS/dollar interest spread and the rapid growth of means of payment (the M1 aggregate), prompted the Bank of Israel to raise its key rate incrementally in Q4 after eight months of no change.

The review period was eventful, marked by the disengagement, massive natural disasters abroad, and political shocks. The relative stability of the Israeli economy and, especially its financial markets stands out against this background. This stability—supported by a budget policy that adhered to the deficit target and restrained expenditure and a monetary policy that kept interest rates relatively low—was reflected, among other things, in the continued decline of Israel's risk premium abroad. These developments were accompanied by reforms at various stages of implementation: the pensions reform, which led to the marked reduction in the issue of government bonds, together with the removal of restrictions on investments by institutional investors; the start of the implementation of the Bachar Committee recommendations; and the equalization of tax rates on profits from investments in Israel and abroad.

Part B of this survey expands the discussion of two relevant important topics: (1) describing the trade and services industries and how they developed during the past year, and (2) comparing the effects of alternative policy measures on poverty.

Figure 1.1

Level of Economic Activity,* 1988-2005
(index: 2004 average=100)



* The composite index including the change in economic-activity-trend growth.
** Up to December 2005.

Real aggregate and sectoral activity

The improvement in economic activity during the review period was abetted mainly by external factors that were supported by economic and political policies. The dominant factors were continued global growth, an improvement in security, and the relatively smooth implementation of the disengagement plan. The contribution of these factors to growth was supported by a fiscal policy that lowered the tax burden and the public debt without breaching the deficit target, and by a monetary policy that kept interest rates relatively low and encouraged domestic demand. Further evidence of the consolidation of growth was the increase in the public's wealth due to the upturn in wages and strong yields in the capital markets, as reflected in a strong income effect on saving and consumption. These factors led to the expansion of domestic demand, especially for trade and services output. Excess production capacity allowed supply to respond quickly amid mild price increases and real depreciation. In the contrary direction, the surge in oil prices

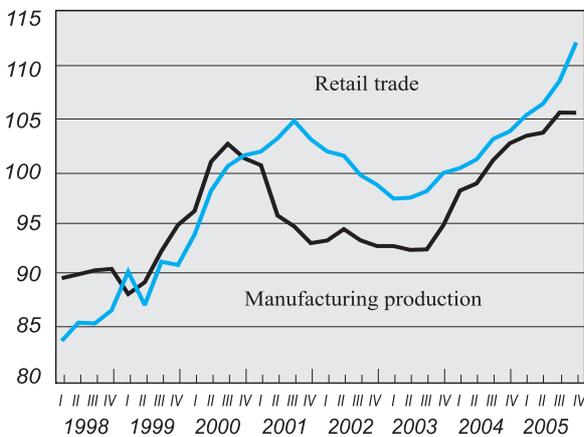
worsened the terms of trade and affected growth in a way that offset some of effects of the other fundamentals.

GDP increased by 5 percent in the second half of the year, driven again by the business sector, which grew at a 6.7 percent pace. Exports remained central as a leader of growth even though their growth rate slowed. Domestic demand gathered strength during the review period and in all of 2005, making a larger total contribution to growth than exports did. The growth rates of private consumption and nonresidential investment accelerated. Public consumption increased (albeit slowly) after two years of decline.

The sectoral GDP data point to much faster growth on the sources side than on the uses side,¹ most notable being the growth of financial and business services. Services and trade made the greatest contribution to the growth of business-sector product in 2005; the service sector alone contributed more than 3 percentage points. Manufacturing product expanded in Q3, but this followed two quarters of almost no change. Overall, in annual terms, manufacturing product contributed only 0.8 percentage point to the growth of business-sector product. Construction product was flat, with the steep decrease in residential construction investment masking an upturn in defense construction and a decline in nonresidential construction.

Figure 1.2

Manufacturing production* (index, average 2004=100) and large-scale retail trade** (index, average 2002=100), 1998-2005

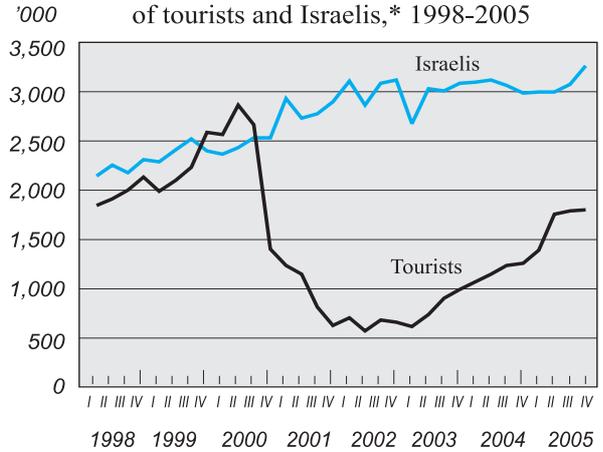


* To November 2005.
** To December 2005.

¹ The most recent update of the National Accounts data, dated January 1, 2006, were not augmented by quarterly data plotting the trend of sectorally differentiated product. Accordingly, the analysis that follows is based on the quarterly data that were received in November 2005 together with the data for Q3. Due to the differences between the two updates, the analysis is qualitative rather than quantitative.

Figure 1.3

The hotel industry: monthly bed nights of tourists and Israelis,* 1998-2005

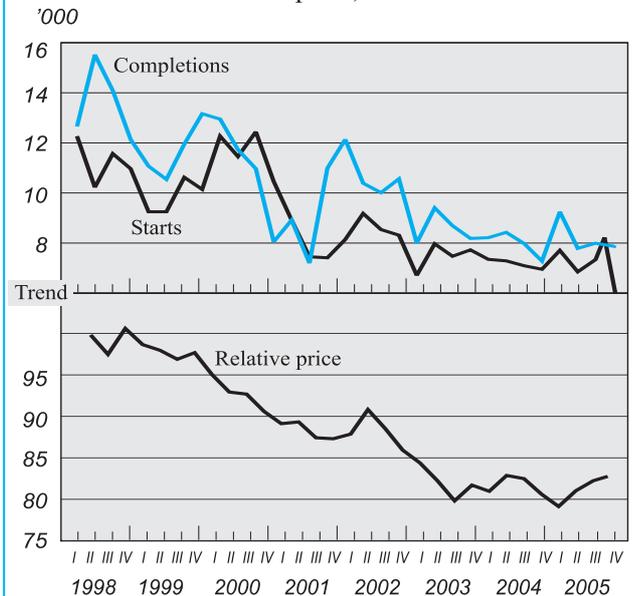


* To December 2005. Seasonally adjusted.

The optimistic picture portrayed by the National Accounts data was slightly clouded by the behavior of the manufacturing output indices, the rise in which was slower than business-sector product during the review period (Table 2 and Figure 1.2). Manufacturing exports hardly rose, although high-tech

Figure 1.4

Housing units: quarterly starts and completions,* and relative price,** 1998-2005



* Original data, to October 2005. Fourth quarter 2005 extrapolated.

** Prices of owner-occupied dwellings relative to CPI. To October 2005.

exports continued to increase in Q4. Notably, this gloomy picture was not reflected in the Companies Survey data, which indicate that activity in manufacturing also continued to expand.

In contrast to the manufacturing data, the data on trade and services painted an optimistic picture of steep increases in turnover and employment. The share of these sectors in economic activity increased rapidly, as has been happening in the developed countries. Their contribution to business-sector growth in the whole of 2005 was 3.8 percentage points (see Part 2 for further details on the trade and services industries).

The security improvement and other auspicious fundamentals led to a perceptible increase in tourism demand and, in turn, to a conspicuous upturn in the activity of this industry (Table 2 and Figure 1.3). During the review period, hotel person-nights—both of inbound tourists and of Israelis—and inbound-tourist arrivals increased significantly. The upturn in tourism activity was also reflected in a sizable increase in exports of tourism services, which began in Q2 and continued in Q3.

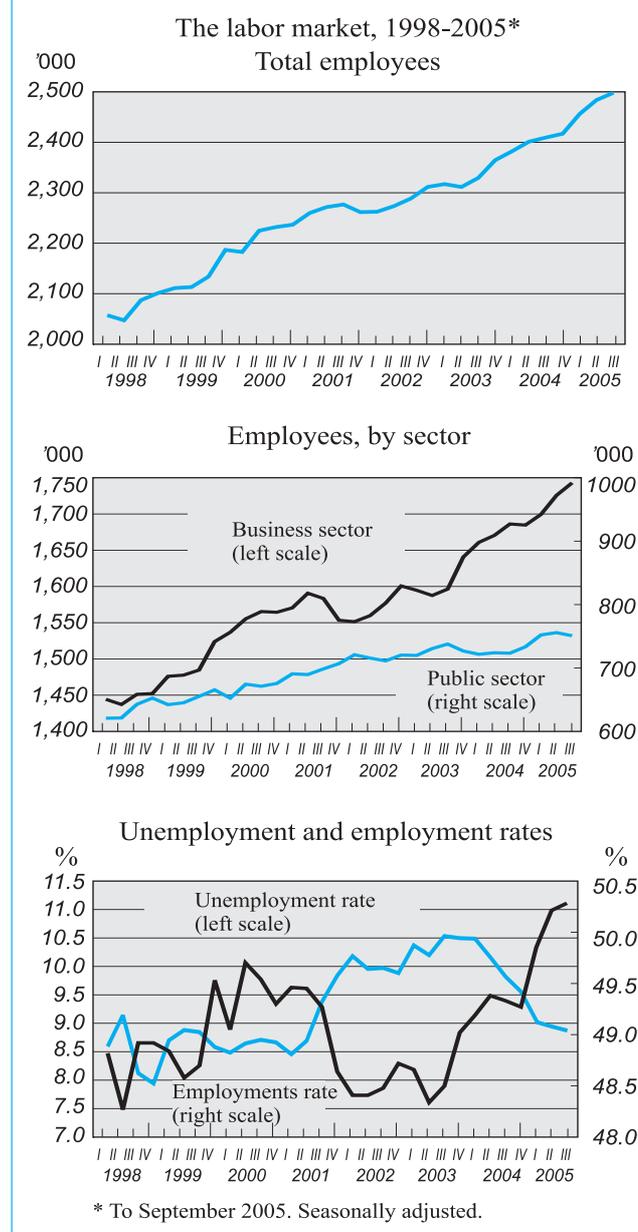
Construction activity remained sluggish during the review period (Table 2 and Figure 1.4). Housing starts, housing completions, and other parameters of industry activity stayed at the languid levels that they have evinced since the lengthy slump began. The Companies Survey reflected these data by reporting a zero net balance in Q3 and a negative net balance in Q4. The relative index of housing prices, which rose slightly in the first half of 2005, fell back again in Q3.

The labor market

The rapid growth during the review period was also reflected in an improvement in the labor market. According to the Central Bureau of Statistics Personnel Survey, the unemployment rate fell to 8.9 percent in Q3² as against 9.1 percent in Q2. The depth of unemployment (the proportion of jobless who sought work for more than half a year) also decreased perceptibly. The participation rate was unchanged at 55.2 percent after rising since the beginning of 2005. These changes were reflected in a slight increase in the employment rate, from 50.2 percent in Q2 to 50.3 percent in Q3 (Table 3 and Figure 1.5). Since the added increment of employment was divided equally between full-time and part-time positions, the proportion of persons employed full-time was basically unchanged. Notably, however, the decline in the unemployment rate was not mirrored in similar decreases

² The trend data for November showed that the unemployment rate rose to 9.1 percent. It must be borne in mind, however, that the data are based on samples from the Labour Force Survey, and therefore may not accurately reflect the actual unemployment rate.

Figure 1.5

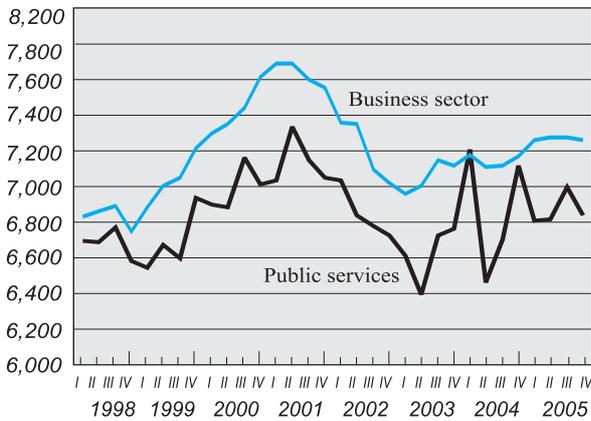


in the number of registered jobseekers and unemployment-compensation and income-support claims.³ The business sector accounted for the entire increase in employment. Sector employment increased by 18,000, contributing 0.4 percentage point to the decrease in the unemployment

³ Compared with the beginning of the decade, the number of jobseekers has rested at a relatively high plateau in the past two years and jobless claims have settled to a low level. The most significant change was in the number of repeat jobless claims, as against first jobless claims, which remained stable throughout the period. These changes are largely the results of changes in policy.

Figure 1.6

Real wage per employee post, 1998-2005*
(NIS, 2004 prices)



* To October 2005. Seasonally adjusted.

rate. The most conspicuous upturn in employment in Q3 occurred in business services⁴—about 17,000 employed, an increase of 5.5 percent. In contrast to business services, the growth of employment in manufacturing slowed to a paltry 0.5 percent. These data point to a structural change that gathered strength during the year, as was also reflected in the National Accounts data. In contrast to the increase in employment in the business sector, employment in the public services edged downward by 0.7 percent. The decrease was especially perceptible in public administration, where the number of persons employed contracted by 4.2 percent in Q3. Importantly, however, the developments in employment in Q3 were aberrant in comparison with the first half of the year, during which public-service employment grew vigorously. Overall, during the first three quarters of 2005, public-service employment increased by 4 percent, slightly outpacing the growth rate of employment in the business sector. Thus, both sectors—public services and business—made very similar contributions to the lowering of the unemployment rate.⁵

The number of foreign workers declined significantly in Q3 and that of territories workers leveled off after a steep increase in the previous quarter. During the first three quarters of the year, however, employment both of foreign and territories workers expanded, in contrast to the government’s explicit policy.

⁴ Which have a notably high proportion of part-time workers and workers who earn less than half of the national average wage.

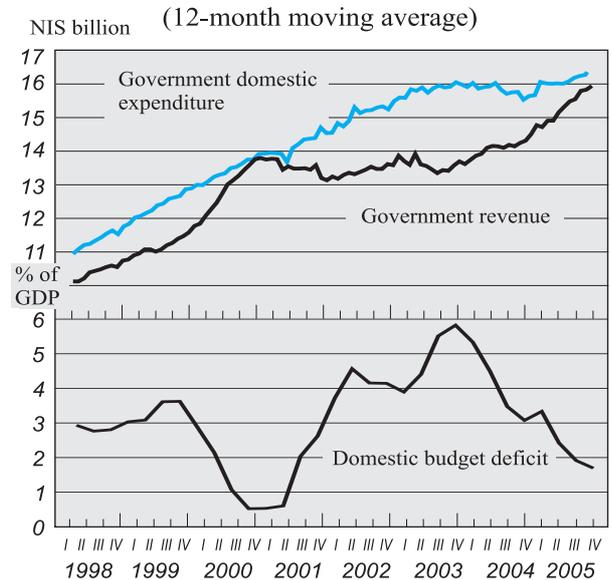
⁵ Notably, however, most of the growth in employment occurred in education and health care, as against stability in public-administration employment. Thus, most of the increase in employment may have occurred in the part of this sector that is privately funded and does not reflect an increase in publicly funded employment.

Real wages rose during the review period but the rate of increase slowed (Table 3, Figure 1.7). Wages in general government actually declined, despite the repeal of the wage cut (defined as an “encouragement of growth” measure) in July. Unit labor cost continued to decrease in 2005, as in previous years. The continued decline in unit labor cost despite visible improvements in the labor market evidently reflects pressure, originating in the relatively high unemployment rate, that is thwarting stronger wage increases.

Four job-placement centers for recipients of income-maintenance benefits opened in August 2005 as part of the Mehalev (welfare-to-work) program. During their first three months of operation, the centers were visited by about 18,000 income-maintenance recipients, of whom 1,190 (11 percent) were placed in full-time or part-time jobs. About 2,200 people failed to report even though they had been summoned and about 1,060 reported but did not meet the terms that they had been assigned in the personal programs that were prepared for them. Thus, 25 percent dropped out of the program before they could benefit from it. Obviously the employment centers have not been open long enough to allow thorough analysis of the success of the program and its effect on the labor market.⁶ Another program, inaugurated in

Figure 1.7

Government cash revenue and expenditure,*
1998-2005



* To November 2005.

⁶ Social organizations have criticized the program, mainly because the operators of the centers are remunerated on the basis of the sum that the government saves in its benefit outlays and not in accordance with the job placement of program participants.

July 2005, involves mainly the subsidization of new hiring in peripheral and development areas. (For an expanded discussion, see the 2005 Bank of Israel *Annual Report*.)

General government

In 2005, the government deficit was 1.9 percent of GDP, far under the 3.4 percent target and significantly lower than the 3.8 percent deficit in 2004 (Table 6 and Figure 1.7).⁷ The contraction of the deficit reflects the sizable underperformance of expenditure, which increased in real terms by only 1 percent, and a significant increase in revenues. Alongside the positive effects of the restraint in government expenditure, with the greater credibility of the government's fiscal policy heading the list and its contribution to lowering Israel's risk premium, there are also less encouraging implications. First, policy measures such as the cuts in transfer payments acted in 2005, is in 2003 and 2004, to increase inequality, at least in the short term. Second, spending restraint, especially when achieved by means of cross-the-board cutbacks and not by greater efficiency, is likely to adversely affect the availability and quality of public services (for further details see Chapter 6 of the Bank of Israel 2005 Annual Report, to be published in March 2006).

In the period reviewed government expenditure was NIS 2.8 billion lower than the path consistent with full performance of expenditure. Total expenditure was only NIS 1 billion higher than that in the equivalent period in 2004, while expenditure on the Disengagement exceeded the budgeted sum by a similar amount. Hence, total expenditure excluding expenditure on the Disengagement did not differ from that in the equivalent period in 2004, despite the constant reduction in expenditure in 2003 and 2004 that reduced it to a very low level. Due to the moderate upturn in expenditure and the concurrent rapid growth of GDP, the share of public expenditure in GDP fell by 1.9 percentage points and for the whole of 2005 came to 49.3 percent of GDP, its lowest level since 1970.

Regarding the composition of expenditure, defence expenditure, including the cost of erecting the security fence and the Disengagement, exceeded the budgeted amount by 15 percent. Expenditure by the social and economic ministries reached only 80 percent of the budgeted amounts. Allowances of the National Insurance Institute rose by 2.7 percent in the period reviewed, with a rise in the General Disability Allowance, Old-Age Pension, and Maternity Benefits, and a sharp cut in Income Support and Child Allowances.

⁷ The deficit of general government (composed of central government, the National Insurance Institute, municipal authorities, NPOs that derive most of their income from general government, and the Zionist National Institutions) was 2.7 percent of GDP.

In 2005, as in 2004, a large share (more than 14 percent) of government expenditure took place in December, but despite the increase, there was still considerable underperformance of expenditure. This apparently indicates that the ministries are finding it difficult to adjust their activities to a lengthy series of new restrictions on activity and on the composition of the budget, resulting in surpluses in certain expenditure items. In order to utilize these surpluses, the ministries should have transferred them to other expenditure items, but such transfers entail the approval of the Ministry of Finance and, at times, of the Finance Committee of the Knesset as well. For this reason, most of the money held back was not released for spending until year's end, by which time the ministries found it difficult to put it all to use. Thus, despite the acceleration of expenditure in December, the overall rate of expenditure in the budget was very low, 97 percent. This may impair the operating efficiency of government (because the hasty performance of expenditure at year's end may result in inefficient use of sources) and its ability to realize its order of priorities as reflected in the approved budget, as the strong influence of administrative measures can adversely affect the ability of the various ministries to implement their budgets.

Government revenue in the period reviewed was consistent with the path of the budget forecast, and exceeded the revenue in the second half of 2004 by some NIS 5 billion. Most of the rise derived from higher tax revenue (a rise of 8.2 percent from the level in the second half of 2004), which rose markedly despite the legal changes that acted to reduce them.

At the beginning of June 2005 the government approved the long-term tax program, the core of which was the reduction of taxation on individuals and companies, and the unification of tax rates on capital gains, interest and dividends (measures which were intended to make the tax system appropriate to global competition). As part of the program two provisional directives were approved, effective from July 2005 to June 2006: a) accelerated depreciation of 100 percent on investment of manufacturing, construction, agriculture and tourism companies would be recognized; b) the first bracket of property purchase tax was cancelled. In addition, in October VAT was reduced by half a percentage point (bringing forward the reduction that was originally intended to come into effect in January 2006), and in December purchase tax on vehicles was reduced. These steps contributed to the reduction of NIS 350 million in tax revenues.

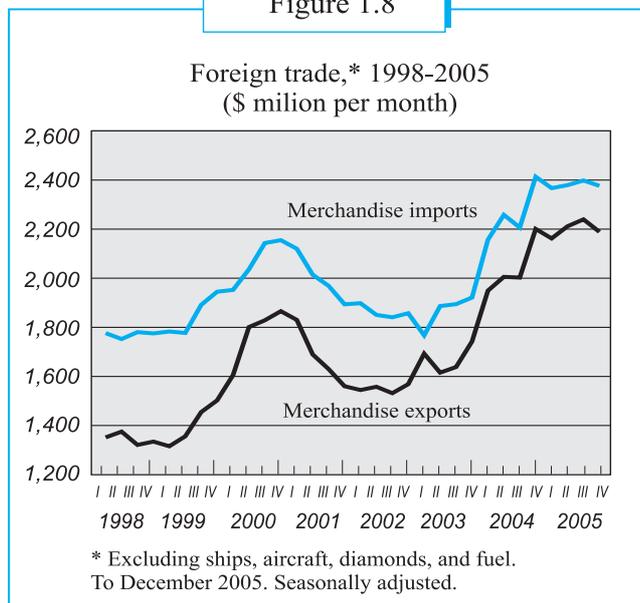
The contraction of the deficit, the change in the composition of its financing, and the acceleration of growth resulted in a significant decline in the public-debt/GDP ratio, even though depreciation and the upturn in the Consumer Price Index acted in the opposite direction. The (gross-)public-debt/GDP ratio fell by 3.6 percentage points to 101.6 percent and the (net-)public-debt/GDP ratio went down by 5.7 percentage

points to 85.5 percent. At the same time, the composition of sources used to finance of the deficit changed: proceeds of privatization were high (relative to the program and relative to past performance) and \$2 billion in government foreign-currency deposits in the United States were converted.⁸ The combination of smaller financing needs and the additional sources available made it unnecessary to raise capital by issuing bonds, resulting in negative net government bond issues that helped to lower the debt. The decrease in new government bond issues also reflects, among other things, the effect of the pension-system reform, which led to the ending of the issue of earmarked bonds by the government. This was one of the most influential factors on developments in the capital market during the review period particularly and in the past two years generally (see below).

Balance of payments

The foreign-trade data indicate that the growth of imports and exports of goods almost halted in the second half of 2005 (Table 4 and Figure 1.8). Exports of goods (excluding ships, aircraft, and diamonds) increased in the second half of the year by only 0.9 percent relative to the first half of the year, and imports (excluding ships, aircraft, diamonds, and fuel) rose even more slightly, by only 0.3 percent. Industrial exports (excluding ships, aircraft, and diamonds) increased by only 1.4 percent in the second half of the year relative to the first half. These data are inconsistent with the balance-of-payments data for Q3, which point to increases

Figure 1.8

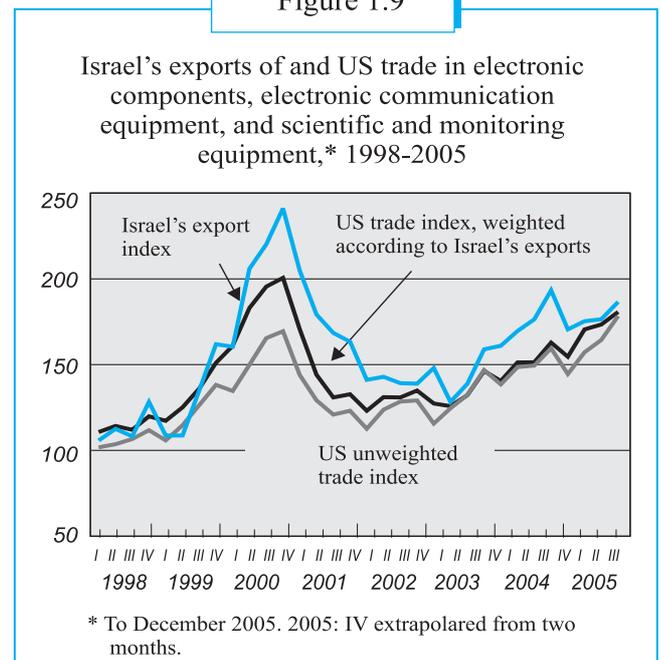


⁸ The deposits are of funds raised with the backing of U.S. guarantees and not yet used.

of 4.8 percent in exports of goods and 2 percent in imports of goods. A small part of the explanation for the discrepancy traces to the decline in export and import prices in Q3⁹ and another part originates in the rather large increase in statistical adjustments between foreign trade and the balance of payments.¹⁰ The index of terms of trade (excluding diamonds, ships, aircraft, and fuel) improved in Q3 because import prices fell more steeply than export prices. However, the upturn in fuel prices—reflected in an increase in import prices when this factor is included—caused the overall terms of trade to worsen by 3.5 percent.

A point of light in the gloomy picture created by the foreign-trade data during the review period was the continued increase in high-tech exports during Q4 as well. Even this, however, was less vigorous than the increase in global trade (see Figure 1.9). In contrast, exports of traditional and mixed/high-tech industries declined and exports of mixed/traditional industries were flat. The decrease in imports of goods encompassed all types of imports, but while imports of capital goods continued to rise at the beginning of the review period and declined steeply afterwards, imports of raw materials and consumer goods were almost unchanged throughout the period.

Figure 1.9



⁹ Goods export prices (excluding diamonds, ships, and aircraft) declined by 1.3 percent and import prices (excluding fuel, diamonds, ships, and aircraft) fell by 2.2 percent.

¹⁰ The statistical adjustments include the adjustments required to present foreign-trade data in accordance with the definitions of the balance of payments. Thus, a large adjustment item reflects a gap that derives mainly from the measurement and classification of the components of foreign trade.

The current account had a \$1.2 billion surplus in Q3, bringing the cumulative surplus in the first three quarters of the year to \$2 billion as against \$1.7 billion in all of 2004. The increase reflects a handsome upturn in exports of both goods and services.¹¹ Resident income from investments abroad also expanded swiftly, in accordance with the steep upturn in investments abroad. The 2 percent increase in imports of goods and services was composed of upturns in imports of diamonds, fuel (mainly due to the increase in fuel prices), and high-tech services, as against decreases in imports of other goods and tourism services.

Net capital outflows were \$1.5 billion in Q3. The increase in net capital exports—apart from its being a mirror image of the increase in the current-account surplus—reflects some of the significant trend of change in the Israeli capital market, in both resident investments abroad and foreign investment. Resident portfolio investments abroad increased perceptibly in Q3 and surpassed \$2.5 billion. The increase in investments, which was especially conspicuous in corporate bonds, followed a steep upturn in the first half of the year and reflected the increase in demand for investments abroad after a series of far-reaching changes in the capital market. (See details in that section.) In contrast, other investments declined considerably, as reflected mainly in the withdrawal of banks' investments. Foreign investment in Israel decreased considerably in Q3, mainly due to the realization of corporate bonds in what may have reflected a temporary increase in uncertainty during the quarter. The decline in foreign investment in Q3, however, follows an increase in this indicator in the first half of the year, so that total nonresident involvement in the Israeli capital market in the first three quarters of 2005 increased.

Global developments

Strong global growth continued during the review period even though the rate of increase slowed. Furthermore, the expansion of activity trickled into countries that had exhibited relatively weak activity until then. The U.S. economy continued to grow rapidly, growth in Japan spread to domestic activity, and indications of recovery appeared in the eurozone countries, where growth has been hindered by sluggish domestic demand. Although the most significant development during the review period—the steep increase in oil prices—triggered further upturns in energy prices, especially in distillates, the inflation environment did not change significantly and consumer confidence was not impaired (except for the U.S. consumer-confidence index, which was adversely affected by the Gulf of Mexico

hurricanes in September). However, the combination of rising demand for energy in emerging-market economies and the depletion of readily extractable oil reserves is expected to keep oil prices high in the medium term and affect demand in the OECD countries and elsewhere.

The OECD countries' leading indicators point to continued growth momentum in the short term, allowing GDP growth to keep up with potential. The outlook is especially rosy for the U.S. and Japan but the recovery in the eurozone is also expected to solidify and accelerate in 2006. The main engines of growth are exports and investments, abetted by the income effect of the increase in the profits of the oil producers.¹² Relatively low long-term interest rates, stable inflation, and monetary policies that are in line with the strength of activity in individual areas are expected to support these pro-growth factors and allow growth to continue and the unemployment rate to drop amid continued financial stability and low inflation. Several factors threaten the growth outlook. (a) If oil prices continue rising, they may spill into inflation and result in a growth-dampening tightening of monetary policy. (b) The balance-of-payments deficits—mainly those of the U.S.—may lead to instability if the terms of their financing worsen. (c) The effect of interest rates on the housing market may lead to a decline in housing prices and, in turn, a negative income effect on demand.

For emerging-market economies, too, 2005 was a year of prosperity that was reflected in relatively strong growth rates. As developed countries delivered rather poor yields and emerging-market economies reported favorable developments, demand for investment in the latter increased, manifested in a stronger upturn in yields than in developed countries and in a decline in risk premium. Israel is one of the beneficiaries of the heightened interest in emerging-market economies because investors widely regard it as a member of this group.

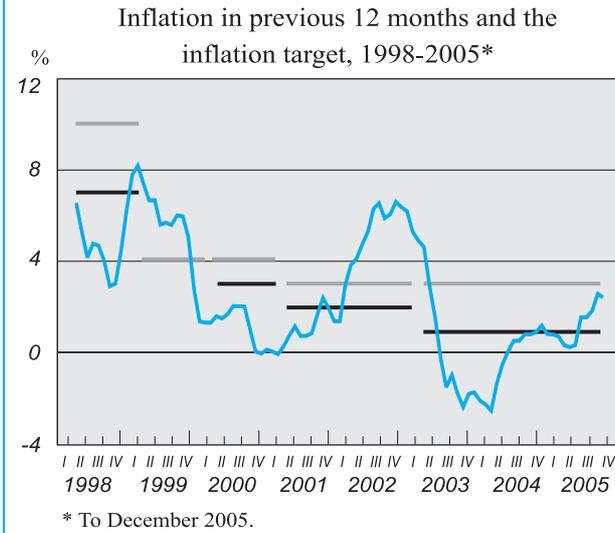
Prices, monetary policy, and the money and capital markets

The Consumer Price Index rose during the review period by 1.9 percent, bringing inflation for the year to 2.4 percent, within the inflation target range (1–3 percent; Table 7 and Figure 1.10). Net of its volatile components (fruit and vegetables, clothing and footwear), the CPI rose during the review period at a rate approaching the upper bound. The acceleration of price increases, reflecting the consolidation of the exit from the domestic and global recession, was strongly influenced by the upturn in demand, the depreciation

¹¹ Exports of services increased by 5.1 percent in Q3 relative to Q2, with upturns of 11.3 percent in exports of tourism services (not including spending by foreign workers) and 8.5 percent in high-tech services.

¹² Clearly, the rise in oil prices also has a negative income effect on oil importers, in addition to the negative effect it is likely to have on inflation.

Figure 1.10



of the NIS, the increase in housing prices that surpassed the depreciation of the NIS against the dollar, and the increase in energy prices. The Wholesale Price Index climbed even more rapidly than the CPI during the review period.

Inflation expectations twelve months forward accelerated at the beginning of the review period and decreased later (Table 9 and Figure 1.11). The NIS lost considerable ground to the dollar during the review period. However, the exchange rate behaved unevenly during the period: at first (in July) the currency depreciated due to the upturn in political

Figure 1.11

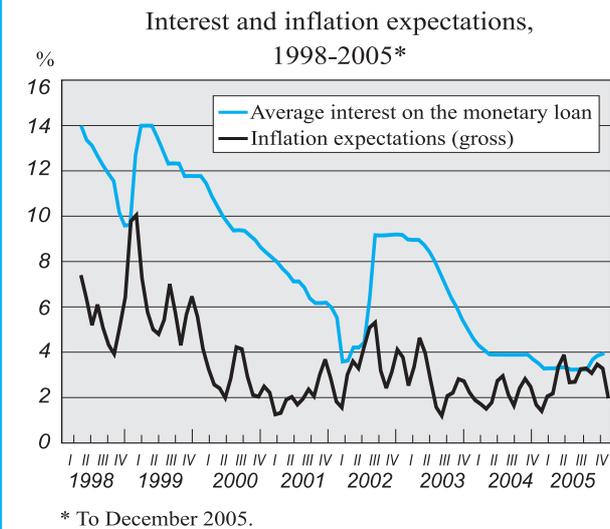
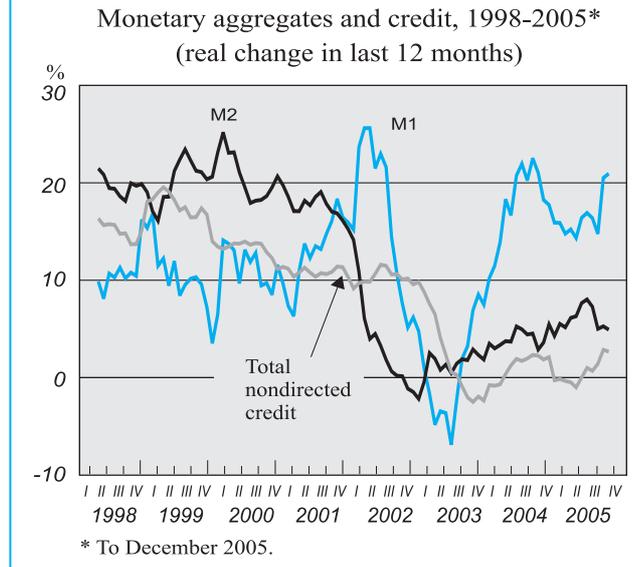


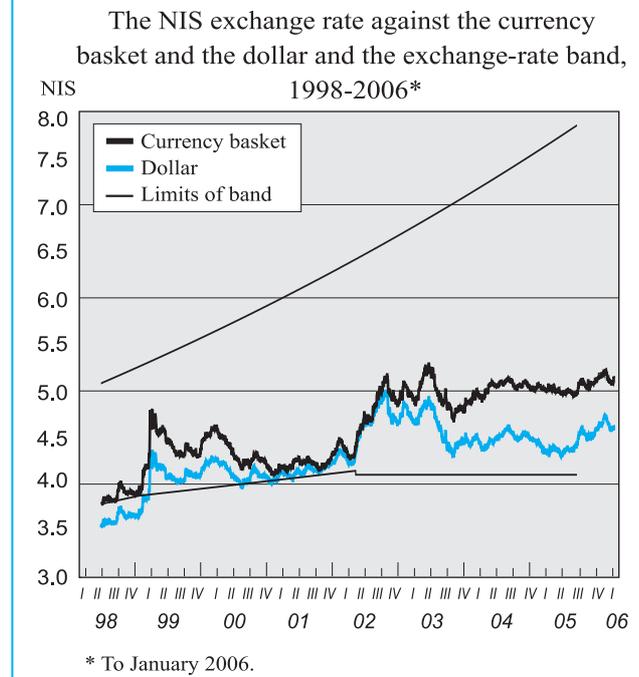
Figure 1.12



and security uncertainties and the narrowing of the NIS/dollar short-term spread. Later (in September–October), depreciation reflected mainly the strengthening of the dollar world wide, while towards the end of the year, (November–December) the NIS rallied against the dollar (Figure 1.13).

As pressure for continued increases in prices and inflation expectations built up, and with the intention of keeping

Figure 1.13



inflation within the bounds of the government’s target range, the Bank of Israel—as expected—raised the monetary lending rate by a quarter percentage-point in October, a quarter percentage-point in November, and half a percentage point in December. These hikes followed eight months without change (Table 9 and Figure 1.11) and a lengthy period when the key rate was held below the rate that would be consistent with long-term price stability in order to support economic activity. Accordingly, the interest rate was raised, in order to maintain inflation within the target range, taking into account the expected contraction of the output gap.

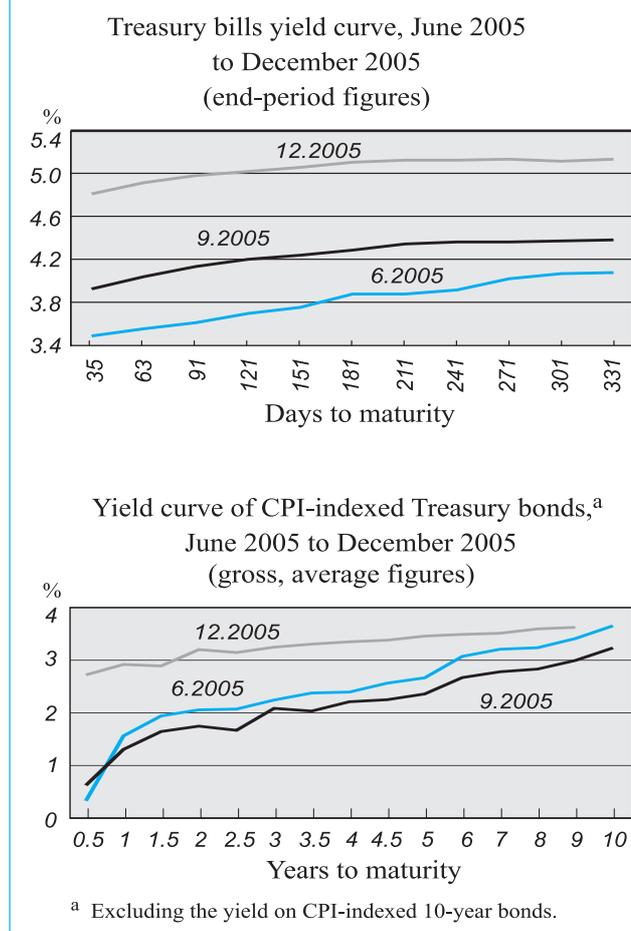
Means of payment (the M1 aggregate) expanded much more steeply than M2 during the review period (Table 8 and Figure 1.12). The increase reflects the continuation of portfolio liquidation in view of the low rates of inflation and interest. Nondirected bank credit expanded slightly after three years of significant contraction that left the level of such credit low. The low level of bank credit reflects the redirection of capital raising to nonbank sources, which have enjoyed an impressive efflorescence in recent years. The increase in bank credit was accompanied by a change in its composition—more domestic-currency credit (indexed and nonindexed) and less dollar credit, consistent with the increase in dollar interest and the appreciation of the dollar around the world.

With the government deficit and the public debt in decline, the government’s capital-raising needs decreased perceptibly. These factors, coupled with the pension reform, the easing of investment restrictions on institutional investors, and developments in global capital markets, were manifested in stronger demand for bonds. The upturn in demand, along with the decrease in Israel’s risk premium, dampened real yields to maturity of five- and ten-year bonds (Table 9 and Figure 1.14) at the beginning of the review period. The rate increases in Q4 were mirrored in the resumption of upturns in yields. The Treasury bill curve responded to the expectations of higher inflation and rate-hiking before the end of Q3 and did so again, with greater intensity, in Q4.

The Tel Aviv Stock Exchange experienced a bull market during the review period, as evidenced in developments in both the primary and the secondary markets. The General Share Index gained 19 percent, bringing the total increase since the beginning of the year to 30 percent. In addition to the fundamentals describe above and in previous sections of this report, which helped to enhance foreign investors’ confidence and lower the risk premium, Israeli shares benefited from the global trend of faster market gains in emerging-market economies than in developed markets.

The share indices fell perceptibly at the beginning of the review period (July), when the implementation of the disengagement plan was shrouded in uncertainty. Although the decrease was steep, it was also temporary; in late August, after the disengagement went ahead, the indices rebounded and totally offset the decline in July.

Figure 1.14



The upturn in share indices was accompanied by a significant increase in trading volumes. An important factor in the increase, apart from heightened demand and the use of market makers,¹³ was the decrease in the share of holdings of parties at interest in recent years and its outcome, a larger quantity of shares held by the public. The privatization in recent years may have also played a part.

The surge in the secondary market during the review period was also felt in the primary market. Although total share issues decreased significantly relative to the first half of 2005, their level resembled that of the second half of 2004. In the bond market more than NIS 16 billion (43 percent of total issues in 2005) was raised via the issue and allocation of corporate and institutional bonds and the exercise of bond options during the review period.¹⁴ The decrease in issuing in the second half as against the first half evidently traces

¹³ Market makers on the Tel Aviv Stock Exchange went into action in March 2004 but are not active in all trading markets.

¹⁴ Excluding banks, structured bonds, CDs, and exchange-traded funds (ETFs). Correct as of November 2005.

mainly to the uncertainty that surrounded the disengagement plan in Q3. In Q4, issuing resumed more vigorously than before, suggesting that the decline in volume did not trace to the exhaustion of the market's potential. The steep increase in bond issues reflects both supply- and demand-side effects. The contraction of bank-credit supply, coupled with low interest rates, gave firms an incentive to swap bank debt for private debt. Indeed, 60 percent of issues were made for the purpose of restructuring corporate liabilities. Notably, many of the issuing companies were relatively small and unranked and quite a few were in the real-estate industry, which has been struggling for several years. These data indicate that the issuing firms are very risky, making one ask whether their principal motive in raising capital on the capital market is to exploit relatively low interest rates or to establish new financing alternatives. On the demand side, the structural reform of the investments of pension and provident funds and the cessation of earmarked-bond issues for pension funds has created demand for long-term bonds. Indeed, 73 percent of issues were bought up by institutional investors.

During the review period, the financial markets were strongly affected by the phased implementation of reforms. Government involvement in the bond market diminished greatly due to the pension reform. The decrease in government financing needs led to a significant downturn in government bond issues, giving the corporate-bond market more room to develop and become more efficient. The application of the Bachar Committee recommendations also acted to reduce the share of banks in financial activity. Thus, even before the end of the review period, banks began to sell off provident funds, on the one hand, and to enter the pension market, on the other hand. Furthermore, the easing of restrictions on the investments of institutional players, coupled with the equalization of tax rates on external and domestic investments, made the financial markets more open to the rest of the world. This was reflected by the steep increase in the share of Israelis' investments abroad and nonresident involvement in the domestic capital market.

Table 1. National Accounts,^a 2004–2005

	2004	2004			2005			Last month for which data available
		IV	I	II	III	III ^b		
GDP	4.4	6.7	3.7	6.7	4.6	5.4	Sep	
Business-sector product	6.3	9.5	4.0	8.4	6.7	7.1	Sep	
Private consumption	5.0	10.1	0.9	5.3	4.9	5.3	Sep	
Gross domestic investment	4.0	-15.8	5.0	38.3	-0.8	5.0	Sep	
Fixed investment	-0.2	24.5	-13.1	13.2	5.2	6.5	Sep	
Goods and services exports	17.4	21.1	-0.3	8.1	18.2	11.4	Sep	
Goods and services exports								
excl. diamonds	19.3	16.6	0.3	6.7	16.6	9.8	Sep	
Goods and services imports	11.8	7.6	-2.3	21.8	3.9	7.4	Sep	
Goods and services imports								
excl. diamonds	12.7	14.9	0.1	13.5	7.3	8.8	Sep	
Public sector consumption	-2.4	-1.2	5.6	7.6	0.3	3.0	Sep	
Public sector consumption								
excl. defense imports	-1.8	-0.7	3.7	4.0	2.8	2.4	Sep	

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

^b Compared with 2004:III.

SOURCE: Central Bureau of Statistics.

 Table 2. Indicators of Business Activity,^a 2004–2005

	2004	2004			2005			Jul–Dec 2005 ^b	Last month for which data available
		IV	I	II	III	IV			
Composite state-of-the-economy index	1.2	6.5	3.9	3.9	3.4	1.8	3.8	Dec	
Large-scale retail trade	3.9	2.8	6.0	4.1	8.3	14.0	6.7	Dec	
Manufacturing production									
(excl. diamonds)	7.4	6.4	2.8	1.1	7.5	-0.1	3.3	Nov	
Index of revenue in commerce	6.8	8.3	9.9	2.6	9.8	10.9	8.0	Nov	
Index of commerce and services revenue	7.9	6.2	9.5	4.2	12.2	9.5	8.4	Nov	
Tourist arrivals	41.5	-5.0	47.3	51.2	9.2	15.6	26.4	Dec	
Residential construction ^c									
Starts	-4.9	4.2	-5.9	3.4	19.5		9.7	Oct	
Completions	-4.5	12.5	-7.5	0.2	11.4		8.3	Oct	
Nonresidential construction ^c									
Area of starts		30.9	-14.4	5.2	19.6			Sep	
Survey of companies (net balance, percent) ^d									
Weighted balance of the business sector		15 ^e	21	21	23	27		Dec	
Output of manufacturing firms		26	21	21	29	29		Dec	
Sales by trading firms		37	31	30	25	27		Dec	

^a Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted except for construction industry data.

^b Compared with July 2004–December 2004.

^c Change from equivalent period one year earlier.

^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.

^e Not significant at 10% level.

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

Table 3. Indicators of Labor Market Developments,^a 2004–2005

	2005		2004	2005				Jul–Dec 2005 ^b	Last month for which data available
	III	IV	IV	I	II	III	IV		
	('000s)		Percentage change from previous period						
Civilian labor force	2,745		0.0	0.9	1.0	0.4		2.4	Sep
Israeli employees	2,500		0.3	1.6	1.2	0.6		3.6	Sep
<i>Of which:</i> In general government	748		1.5	2.7	0.5	–0.7		3.9	Sep
In business sector	1,749		–0.1	0.9	1.6	1.0		3.5	Sep
Foreign workers and Palestinians (unadjusted)	361		1.3	1.3	1.1	–4.2		–0.6	Sep
Average hours worked weekly per employee	37		0.3	0.5	1.1	–0.8		2.8	Sep
Labor input in business sector, weekly hours (incl. foreign workers and Palestinians)	84,440		0.2	2.9	1.3	0.7		5.1	Sep
<i>Of which:</i> Israelis	74,043		0.2	3.1	1.1	1.3		6.2	Sep
Labor input in general government (Israelis)	18,431		1.7	3.8	1.3	–2.7		8.9	Sep
Unemployed	245		–2.9	–5.7	0.0	–1.5		–7.4	Sep
Work seekers	228	226	–2.8	1.2	0.5	–1.6	–0.7	–0.2	Nov
Claims for unemployment benefit	73	70	–0.3	–0.4	1.7	1.3	–4.2	0.4	Dec
	Nominal NIS (unadjusted) ^c								
Real wage per employee post ^d	7,230	6,878	2.0	–0.8	1.5	0.7	–2.0	3.6	Oct
In general government	7,101	6,570	7.4	–5.1	0.1	3.1	–2.7	4.5	Oct
In business sector	7,288	7,020	0.8	1.6	0.2	0.0	–0.3	3.2	Oct
Nominal wage per employee post ^d	7,379	7,084	2.4	–0.4	1.8	2.0	–1.1	5.6	Oct
In general government	7,247	6,766	7.7	–5.4	0.8	4.3	–1.7	6.5	Oct
In business sector	7,439	7,230	1.2	1.2	0.2	1.7	0.7	5.2	Oct
Participation rate			54.6	54.9	55.2	55.2		0.0	Sep
Employment rate			49.3	49.8	50.2	50.3		1.9	Sep
Unemployment rate			9.8	9.2	9.1	8.9		–11.8	Sep
Depth of unemployment ^e			42.6	41.0	43.9	36.6		–7.8	Sep

^a Seasonally adjusted.

^b Compared with July 2004–Dec 2004 (unadjusted).

^c The fourth quarter is extrapolated from October data only.

^d Including foreign workers and Palestinians.

^e 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 Israeli employed, which are the Central Bureau of Statistics' National Accounts estimates.

Table 4. Foreign Trade, Balance of Payments, and the Reserves,^a 2004–2005

	2005	2004				2005		Jul–Dec 2005 ^b	Last month for which data available
		IV	I	II	III	IV			
Percentage change from previous period ^c									
Trade in goods ^d									
Goods imports	20.8	9.6	-2.0	0.1	0.9	-1.4	2.8	Dec	
<i>Of which:</i> Consumer goods	17.4	13.3	-4.1	7.3	-3.7	-1.8	4.3	Dec	
Capital goods	15.1	3.7	0.5	0.1	5.1	-6.1	4.4	Dec	
Intermediates	24.3	10.8	-2.3	-2.1	0.9	0.6	1.8	Dec	
Goods exports	21.9	10.2	-1.8	2.1	1.0	-2.2	5.0	Dec	
<i>Of which:</i> Manufacturing	21.8	9.5	-2.3	2.8	1.3	-2.4	4.9	Dec	
<i>Of which:</i> High-tech	22.1	3.3	-3.3	7.3	-1.0	0.6	4.7	Dec	
\$ million									
Balance of payments									
Goods and services exports	51,445	13,743	13,825	14,224	15,042			Sep	
Goods and services imports	52,040	13,801	13,908	14,601	14,936			Sep	
Balance of trade in goods and services	-595	-58	-83	-377	106			Sep	
Current account balance of payments	1,474	877	413	245	1,168			Sep	
Financial account (excl. foreign exchange reserves) ^e	-570	93	-848	-1,166	-276			Sep	
<i>Of which:</i> Nonresidents' direct investment ^e	416	775	1,927	1,198	370			Sep	
Nonresidents' portfolio investment ^e	1,391	1,725	2,698	744	-114			Sep	
Residents' direct and portfolio investment abroad ^e	1,375	1,069	1,786	1,498	1,918			Sep	
Net foreign debt (percent of GDP) ^e	-9.3	-9.2	-13.0	-15.8	-16.5			Sep	
Bank of Israel reserves, end-period ^e	26,632	26,632	26,704	26,210	27,319	27,768		Dec	

^a Seasonally adjusted.^b Compared with July 2004–December 2004 (unadjusted).^c The change relates to the dollar values of imports and exports, not to their volumes.^d Data on trade in goods do not include ships, aircraft, diamonds, and fuel.^e Unadjusted data.

SOURCE: Central Bureau of Statistics.

Table 5. Indicators of Economic Development in Advanced and Developing Countries^a
(annual rate of change, percent)^b

	2002	2003	2004	2005	2006 forecast
World GDP	3.0	4.0	5.1	4.3	4.3
Advanced countries	1.5	1.9	3.3	2.5	2.7
Developing countries	4.8	6.5	7.3	6.4	6.1
World trade	3.4	5.4	10.3	7.0	7.4
Advanced countries					
Imports	2.6	4.1	8.8	5.4	5.8
Exports	2.2	3.1	8.3	5.0	6.3
Developing countries					
Imports	6.5	11.1	16.4	13.5	11.9
Exports	6.7	10.8	14.5	10.4	10.3
Commodity prices (US\$)					
Oil ^c	2.5	15.8	30.7	43.6	13.9
Nonfuel	1.7	6.9	18.5	8.6	-2.1
Inflation (CPI) in advanced countries	1.5	1.8	2.0	2.2	2.0
Short-term interest ^d (%)					
Dollar deposits	1.6	1.0	1.4	3.1	4.2
Euro deposits	3.3	2.3	2.1	2.1	2.4
Unemployment rate in advanced countries	6.4	6.6	6.3	6.1	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 2004 was \$37.76.

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

SOURCE: World Economic Outlook (IMF), September 2005.

Table 6. Government Budget Performance vis-à-vis Deficit Target, 2004–2005

	2004		2005				Jul–Dec 2005	Last month for which data available
	2004	IV	I	II	III	IV		
Domestic deficit as percent of GDP	-2.9	-5.8	3.5	-1.5	-0.6		-0.6	Sep
	Deviation from path ^a (domestic budget, excl. credit extended)						(NIS billion) ^b	
Government revenue	-1.5	2.8	1.7	-1.0	-0.2	0.4	5.1	Dec
Government expenditure	-3.4	3.1	-2.6	-3.4	-0.8	-2.0	1.1	Dec
Domestic deficit	-1.9	0.3	-4.3	-2.4	-0.6	-2.4	-4.1	Dec
Total government deficit	-20.4	-9.8	3.7	-5.0	-1.8	-7.7	-3.5	Dec
	Percent change from respective period, previous year							
Government tax revenue	5.2	7.1	3.2	8.3	10.6	4.8	8.2	Nov
<i>Of which:</i> income tax, net	4.6	7.1	5.0	8.0	10.8	11.8	8.3	Nov
VAT, gross	4.7	4.8	1.2	12.5	11.0	4.1	7.6	Dec
Government expenditure	0.2	11.7	-1.0	4.2	9.0	-6.4	0.5	Dec
National insurance allowances	-4.9	-0.5	-3.4	1.7	4.6	0.0	2.8	Nov
<i>Of which:</i> Unemployment benefit	-12.8	-8.7	-18.4	-3.2	1.6	-4.2	-0.4	Nov
Income support	-9.7	6.9	-10.2	-3.5	-3.0	-6.1	-4.4	Nov
National insurance contributions received from the public	1.6	4.5	2.1	4.5	8.1	2.1	7.4	Nov

^a The path was determined on the basis of a deficit of 4 percent of GDP in 2004, and 3.4 percent of GDP in 2005.

^b Data in this column relate to actual changes from the second half of 2004, not to deviations from the path.

SOURCE: Ministry of Finance.

Table 7. Selected Price Indices,^a 2004–2005

	2004		2005				Jul–Dec 2005	Last month for which data available
	2004	IV	I	II	III	IV		
CPI	1.2	0.0	-2.4	4.5	5.7	2.0	3.8	Dec
CPI excluding housing, fruit and vegetables	2.1	2.0	-1.5	5.1	3.1	0.8	1.9	Dec
CPI excluding housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.5	-0.3	0.9	2.4	6.4	-2.6	1.8	Dec
Index of housing prices	-2.5	-14.9	-4.8	6.4	14.0	8.9	11.4	Dec
Wholesale price index	7.6	7.7	4.0	6.3	6.7	3.8	5.2	Dec
NIS/\$ exchange rate	-1.2	-13.1	-1.2	15.2	4.9	6.6	5.7	Dec
NIS/currency-basket rate	1.8	-1.4	-3.5	4.3	5.0	0.9	2.9	Dec

^a Annual rates of change during period, percent.

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit,^a 2004–2005

	2004	2005					Jan–Dec 2005	Jul–Dec 2005	Last month for which data available
		IV	I	II	III	IV			
Rates of change							During period		
M1 ^b	18.0	1.4	17.3	23.4	24.3	23.1	23.5	24.2	Dec
M2 ^c	4.2	5.7	7.7	6.3	7.9	-1.1	4.6	1.9	Dec
M3 ^d	4.6	5.1	9.9	8.8	14.0	1.9	7.9	6.1	Dec
Nondirected bank credit	1.2	0.4	-2.1	0.8	5.7	7.6	2.4	4.2	Dec
Unindexed local-currency credit	5.6	11.7	15.5	6.3	11.9	10.4	9.5	9.1	Dec
CPI-indexed credit	0.0	-6.9	-8.1	1.5	6.8	6.9	2.0	4.8	Dec
Credit in and indexed to foreign currency	-2.8	-4.3	-17.1	-8.7	-5.6	4.1	-7.9	-4.4	Dec

^a Percentage change from previous period, in annual terms.

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

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

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

SOURCE: Bank of Israel.

Table 9. Interest Rates, Yields, and the Share-Price Index,^a 2004–2005

	2005	IV	2005				Jul–Dec 2005	Last month for which data available
			I	II	III	IV		
Nominal interest on								
SRO deposits	3.1	3.1	2.7	2.7	2.7	3.0	2.8	Nov
Nondirected local-currency credit	6.8	6.8	6.3	6.2	6.2	7.0	6.6	Dec
Effective local-currency credit	4.4	4.2	3.7	3.7	3.6	4.2	3.9	Dec
LIBID 3-month dollar interest	1.5	2.2	2.7	3.2	3.6	4.2	3.9	Dec
Yield to maturity on:								
Treasury bills	4.8	4.6	4.2	4.0	4.2	4.9	4.6	Dec
10-year bonds	4.2	4.2	3.8	3.7	3.5	3.5	3.5	Nov
5-year bonds	3.8	3.6	3.1	3.0	2.7	3.1	2.9	Dec
Risk premium ^b	0.6	0.4	0.4	0.3	0.3	0.3	0.3	Dec
Inflation expectations ^c (gross)	2.0	1.7	2.4	3.0	3.1	2.8	2.9	Dec
General Share-Price Index (change from previous)	17.4	12.5	6.6	-1.2	13.2	11.7	26.5	Dec

^a Period average, percent.

^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

Main Developments in Trade and Services

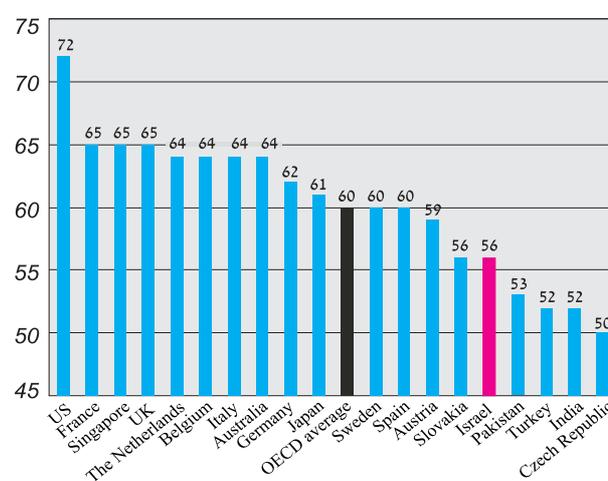
Israel's trade and service industries have been developing rapidly in recent years and are making a steadily rising contribution to economic growth. The most conspicuous factors behind this development are the openness of the economy, its integration into the globalization process, and an upturn in global demand for high-tech products and services—allowing the economy to utilize its comparative advantage in human capital and develop a system of ancillary services (foremost business services). The output of the industry grew at a 44 percent cumulative rate in the past decade, compared with a rise of 34 percent in total business-sector product.

The upward trend of trade-and-services activity that began in the second half of 2003 continued in 2005. The industry posted an especially strong growth rate this year, estimated at 6.8 percent, after expanding by 5 percent in 2004. The continuation of economic growth amid the easing of security tension, coupled with the recovery of global demand, prompted the sector to develop rapidly in 2005. The National Accounts data on the development of business-sector product in 2005 imply that this industry, which generates nearly 53 percent of business-sector product, made a direct contribution of 3.5 percentage points to the growth of business-sector product. The relative increase of trade and services in business-sector product (up from 45 percent in the early 1990s) is one of the manifestations of the long-term economic restructuring that most developing countries are undergoing. Nevertheless, the proportion of trade and services in Israel's business-sector product remains rather low by international standards (see Figure).

The main improvement in the industry can be attributed to the further growth in exports, which is based on the expansion of the high-tech industries (computer and R&D services) and of tourism services. Although the expansion of these industries slowed during the last three years (an increase of 11 percent in 2005 as compared to 24 percent in 2004), this industry's exports are still one of the principal components of the growth in total exports. The more rapid pace of growth in service exports than in goods exports is one of the features of the structural change that has occurred in the economy during recent years.

Figure 2.1

The Share of the Trade and Services Industry in Business-Sector Product in Selected Countries, 2004-05 (percent)



SOURCE: Based on data of the Federation of Israeli chambers of commerce.

The commerce and service industries, which employ approximately half of the employed persons in the business sector, contributed to the decline in the unemployment rate in the economy during 2005. This was due to a 4 percent increase in the number of persons employed in the sector compared with 3.2 percent in the business sector as a whole. The increase in the number of employed persons encompassed most of the sub-industries, from commerce, food and accommodation services to financial services, business services and computer services. Overall, nearly 40 percent of the new workers in the business sector in 2005 were recruited in the commerce and services industries. However, the development of wages was heterogeneous and in line with the level of human-capital intensity: Real wages per employee post in the industries employing less-educated workers rose by less than one percent on average, compared with a 4 percent increase in financial services, business services and R&D services, which employ highly educated workers.

A separation of the industry into its two components shows that services, which account for 70 percent of the industry's product, expanded by a slightly higher rate than commerce in 2005 – by 8 percent as compared to 7.2 percent respectively. This development resulted from the growth in private consumption during recent years. We will present a brief review of the main elements that contributed to the industry's expansion in 2005.

Banking and business services

Driven by the growth in the business sector, the buoyant activity in the financial markets and the reforms in the capital market, the improvement in the banking and financial services industries continued in 2005. Business services and banking services contributed 3 percent and 1.5 percent respectively to total commerce and services product during the year. Particularly notable in business services was the contribution of intermediation services, machinery and equipment rental, and legal and accounting services, which provide numerous services to the computer sector. The improvement in the banking industry also continued, with the expansion clearly reflected by the record profits that the commercial banks recorded in 2005. The banking industry's added value rose by 11 percent. The index of the banks' activity - which weights bank credit, the number of debits, the amount of loans granted and transaction turnover - rose by 6 percent. In contrast to previous years, the banks' labor inputs grew by 2.6 percent due to the expansion in activity, the increase in the number of branches, the decrease in the use of ATMs despite a further increase in the use of computerized information channels (the Internet). Real wages in banking and business services rose by 3.6 percent.

Computer and R&D services

The industry's activity, which is largely a function of developments in global demand, increased during the year as the result of a further expansion in high-tech industry. This is one of the components of the high-tech sector that during the last two years has benefited from a general shift in activity from the production of high-tech products to the export of advanced services (computer and R&D services). The industry is heavily human capital-intensive, and thereby makes it possible to utilize the economy's relative advantage. The burgeoning demand for advanced services is also contributing indirectly to an expansion in business services (as previously mentioned), such as legal and accounting services.

Accommodation and food services

The improvement in the industry's revenue has continued for nearly three years despite a slower rate of increase in 2005. The product of accommodation and food services rose by ten percent in 2005 and contributed to approximately half of industry product. Against the background of the

relatively stable security situation and the vibrant activity in the economy, the substitution trend between local and foreign tourism continued while the composition of tourism to Israel changed: The number of tourists arriving by air rose by 23 percent concurrent with an increase of over 43 percent in the total number of tourist's hotel bed-nights. However, the number of bed-nights recorded among Israelis remained practically unchanged and rose by only 0.1 percent. These figures, together with a Tourism Ministry analysis, show a decrease in the number of visitors arriving in Israel for the purpose of visiting relatives, and an increase in the number of visitors arriving for the purposes of sightseeing and diving. Total revenue from tourism in 2005 is estimated at approximately \$ 2 billion, half that recorded during the period preceding the intifada.

While the number of workers employed in the accommodation and food services sector rose by 6.5 percent in 2005, the level of wages in it remained practically unchanged.

The Impact of Alternative Policy Measures to Combat Poverty

Public debate about the situation of the weaker sections of the population has broadened recently, and the government appointed a team to formulate policy measures to reduce poverty in Israel. As a result of the limitation on resources which the government faces, the choice between the alternatives necessitates analysis of the costs and benefits of each one, an analysis that will be based on their direct effects—the extent of financial benefits to the target population at whom the policy is directed—as well as the indirect effects, in the context of the new equilibrium that will prevail in the goods market and the labor market. These indirect effects include the reactions of individuals to the measures in question, for example changes in goods prices or in wages, which are likely to moderate the direct effects.

Various policy measures that could reduce the extent of poverty in the short run are under consideration, such as lowering taxes and increasing transfer payments to raise the wages of low-income employees. These are in addition to a long list of other policy measures included in the long-term program. These other measures include policy instruments in the fields of education and health as well as organizational steps intended to enhance the effectiveness of government policy in various spheres that affect the poor.

An examination of some of the alternative policies for reducing poverty that have been the subject of public debate recently shows the wide differences between them with regard to the sums of money likely to reach the poorer strata. The analysis studies the programs with a uniform budget of NIS 1 billion a year, and is based on the direct effect on the income of families by income group. Below we present a qualitative examination of several indirect effects related to

the different measures. The following describes the various measures, each costing NIS 1 billion, as stated.

1. Reduction of VAT. A reduction in VAT implies a decrease in an indirect tax whose rate in Israel is high relative to the level in Western countries. As consumption constitutes a higher proportion of income among low-income households, reducing VAT is a progressive step. Clearly however, in comparison with more target-focused measures this is not an effective means for reducing the extent of poverty: A decile-distribution of the benefit inherent in such a reduction shows that it actually favors the high-income deciles because their consumption is higher than that of the low-income ones.

2. Reduction of VAT on food to 12 percent. This is a more progressive step than an overall reduction of VAT because the proportion of expenditure on food is higher among low-income families. However, since expenditure on food per household is similar in size among all income deciles (although in the low deciles per capita expenditure is lower, family size is larger on average), the benefit would be divided almost equally among all income deciles. The three lowest deciles would therefore benefit from 28.6 percent of the total benefit. However, the average benefit per family in the three lowest deciles would amount to about only NIS 500 a year, and would be about 10 percent lower than among the three highest deciles.

3. Replacement of the lowest health tax bracket by income tax. This measure will enable relatively low wage-earners to utilize a larger part of the income-tax credit points (such as personal points, points for children and points for a working woman). Most of the benefit in this measure—66.5 percent of the total—would reach families in the fourth to eighth deciles. This is mainly because by means of this change, families with two breadwinners would be able to fully exploit the tax credit that they do not currently utilize due to their relatively low wages. The three lowest deciles would receive only 18.6 percent of the total benefit inherent in this measure. This program would focus on families with wage earners, in line with the policy adopted by the government in the last few years of raising the participation rate.

4. Negative income-tax (Earned Income-Tax Credits, or EITCs) given directly to low wage earners in low-income families with children. Earned income-tax credits, meaning direct subsidies for families with children in which the main breadwinner is earning a low wage, will significantly increase the income of these families. In such a program, 70 percent of the benefit inherent in EITCs would accrue to the lowest three deciles while the highest three deciles will together receive only one percent of the benefit. Most of the benefit would reach families in the second and third deciles, while families in the lowest decile, which includes many families without any breadwinner at all, will benefit to a lesser degree.

The comparison clearly shows that the benefit deriving from the allocation of NIS 1 billion to the policy measures examined differs between the populations grouped by income-earning decile. It is clear that among the measures examined, EITCs are the most effective in helping low-income earners and therefore in reducing poverty. Reducing the VAT on food has a similar effect on all income-earning deciles, and the overall VAT reduction has a greater benefit for the high deciles. Replacing health tax with income tax at the lowest bracket mainly benefits the intermediate strata.

Distribution of the benefit in different policy measures by income-earning deciles

Decile ^a	Replacement			Distribution of benefit inherent in reducing overall VAT
	Earned income-tax credits ^b	with lowest health tax bracket by income tax	Abolition/ reduction of value added tax on food ^c	
	(percentage of total value of the program)			
1	12.5	4.6	9.6	5.7
2	35.7	5.7	9.3	6.8
3	21.9	8.3	9.7	7.6
4	15.1	11.6	9.6	7.8
5	9.3	14.9	9.9	8.9
6	3.0	15.2	9.9	9.8
7	1.4	13.4	10.0	10.8
8	0.7	11.4	10.4	11.6
9	0.4	9.1	10.6	13.8
10	0.0	5.7	10.9	17.1
Total population	100.0	100.0	100.0	100.0

^a The highest decile is that with the highest income per standard capita.

^b According to the proposal by Brender and Strawczynski submitted to the committee set up to examine earned income-tax credits. The figures do not take into account the effect of EITCs on employment.

^c Excluding food and beverages consumed in restaurants, and assuming that the reduction in VAT is reflected fully in the lowering of prices.

It is important to note that in addition to their direct effect, policy measures also have indirect effects. In response to the lowering of VAT in general or VAT on food, firms can be expected to pass only part of the reduction on in the form of price reductions, thus reducing the benefit that reaches both poor and wealthy families. Similarly, earned income-tax credits, even if it is implemented by paying the benefit directly to the employees, is likely to motivate some employers to cut the wage they pay them. Nonetheless, empirical evidence from the US based on experience gained from the EITC system shows that this effect on the relevant population is weak.

Events from July–December 2005

Month	Date	Event	Details
July	14	Order issued for stay of proceedings and compilation of recovery program for the Clubmarket retail chain	The chain's collapse as the result of large debts to suppliers could have ramifications for the wholesale market in the food industry and for the chain's 3,500 employees.
	25	Teva announced the acquisition of the American IVAX company for \$ 7.4 billion.	Following the acquisition, Teva became the world's largest generic drugs manufacturer, with sales of \$ 7 billion and 25 thousand employees.
	26	The Knesset approves the Bachar Report for reforms in the banking system.	The main elements of the report are: 1. The gradual sale of all the banks' holdings in provident funds and mutual funds, according to the size of the bank. 2. Allowing the banks the opportunity to charge distribution fees for provident funds, mutual funds and pension funds. 3. Allowing the banks the opportunity to distribute life insurance and pension insurance.
	26	The Knesset approved the draft law for tax reform.	Its main elements are: 1. A gradual decrease in the tax rate for individuals from 49 percent in 2006 to 44 percent in 2010. 2. A reduction in the rate of corporation tax from 34 percent in 2006 to 25 percent in 2010. 3. A reduction in the rate of VAT from 17 percent to 16.5 percent on 9.1.05. 4. On 1.1.06, raising the taxation for individuals in the capital market from 15 percent to 20 percent as well as further tax benefits, such as an exemption from tax on the purchase of an apartment up to the amount of NIS 550,000, accelerated depreciation for machinery and equipment, and an increase in old age allowances.
	26	3.5 percent of the shares of Bank Leumi were sold for NIS 611 million.	As a result of the sale, the State's holding in Bank Leumi fell to 20 percent.
August	7	Finance Minister Binyamin Netanyahu resigned, and Minister Olmert was appointed as acting Finance Minister.	
	8.15– 9.12	The disengagement from the Gaza Strip and its transfer to Palestinian control.	
	30	Hurricane Katrina hits Gulf of Mexico states in the USA.	The hurricane caused many casualties and damage to property. The hurricane also hit the oil industry in the region.
September	1	VAT was cut by 0.5 percent to 16.5 percent.	A result of the tax reform. Financial institutions and non-profit institutions will continue to pay tax at the rate of 17 percent.
	29	€ 750 million were raised from an issue of government bonds in the UK.	The amount of the issue was nearly double the amount planned, and was made at a relatively low interest rate of 3.78 percent.

Month	Date	Event	Details
October	2	The government approved the Governor's draft Bank of Israel Law	<p>The main changes are:</p> <ul style="list-style-type: none"> - A change in the decision-making structure – a Monetary Committee will be established for determining monetary policy, monitoring its performance and discussing other matters related to monetary policy. When the Monetary Committee is formed, the Advisory Committee and the Advisory Council will be abolished. - Definitions of rules for transparency and reporting to the government and the public. - An Administrative Committee for the Bank of Israel will be formed. This will engage in central bank matters that are not connected with monetary policy, including the approval of the Bank's work program, its administrative budget, the Bank's financial report and human resources policy at the Bank.
		Ramla municipality floated the first municipal bond issue in Israel.	<p>This bond issue is the first of its type in Israel, and thereby represents a breakaway from the local authorities' traditional banking and government finance.</p> <p>The Ma'alot rating company gave the issue a rating of A+. The bonds will be backed by the municipality's revenue from city taxes. This policy will spread to other local authorities.</p>
November	1	Unrestricted transfer between pension funds begins.	Unrestricted transfer between pension funds is permitted once a month as compared to twice year before this date.
		The mortgage insurance reform begins: Mortgage insurance policies will be sold by insurance agents, and not directly by the banks.	
	9	Clal Insurance purchased all of Bank Discount's provident fund and mutual fund assets.	<p>The sale was in line with the implementation of the Bachar Law.</p> <p>Discount's proceeds from the sale amounted to NIS 1.31 billion. The assets managed by Ilanot-Discount amount to NIS 14.6 billion. The transaction implied a ratio of NIS 41 million for each billion NIS managed. This ratio was less than in the sale of Bank Hapoalim's Poalim Mutual Funds, in which the ratio was NIS 45 million, and more than in the sale of Bank Leumi's Pia mutual funds, in which the ratio amounted to NIS 33 million for each billion NIS managed.</p>

Month	Date	Event	Details
	17	The privatization sale of Bank Leumi to the Cerberus-Gabriel group was completed.	The Barnea investment group (Cerberus-Gabriel) purchased a controlling stake in Bank Leumi at a record price of NIS 2.474 billion for 9.99 percent. The transaction price reflects a premium of 54 percent above equity for the core parcel of shares and a premium of 16 percent (NIS 17.5 per share) above the stock market closing price on the previous day. The proceeds totaled NIS 2.474 billion as stated. If the option is exercised after a year and half, the overall proceeds will amount to NIS 4.617 billion. 7 bidders competed for the tender - 4 of them strategic investors (2 foreign and 2 Israeli) and 3 financial investors.
	21	Prime Minister Ariel Sharon decided to leave the Likud party and form a new party under his leadership.	A decision was taken to hold elections on 3.28.06.
	27	Leumi sold its provident funds to Harel and Solomon Markston.	The sale forms part of the implementation of the Bachar Committee's recommendations. The Leumi group agreed to sell the provident funds managed by Leumi-Gemel in two separate transactions. The first transaction was with the Harel Investment group and the second with Solomon-Markston. The transactions totaled NIS 1.148 billion.
December	1	The banks published their financial reports for the third quarter. The five largest banks' profits rose by 32 percent during the first three quarters compared with the same period of 2004.	
	8	The Bank of Israel announced a six-month postponement of the prohibition on overdraft excess.	Complaints that the banking corporations and their customers sent to the Banking Supervision Department showed they were not prepared operationally for applying the directive, and that its implementation on the date scheduled would lead to numerous difficulties. Moreover, many complaints were received from consumer representative organizations, which suggested that applying the directives on the designated date could lead to serious problems among small businesses that had yet to prepare properly for the directive.
		Two years earlier than planned: The Finance Committee approved by a majority vote the Finance Minister's request to abolish stamp duty from 1.1.2006 instead of from 1.1.2008.	The Stamp Duty Law is an anachronistic taxation law. The Knesset enacted it in 1961 and it derived from legislation during the time of the Mandate. It applies to transactions and not to businesses. The law brought into the State Treasury NIS 850 million in 2003, NIS 880 million in 2004 and revenue from it in 2005 is expected to reach approximately NIS 750 million. This is after part of the agreements covered by the law in the past were removed from its provisions – principally bonds that are issued in series. Two years ago, the Treasury asked for it to be abolished gradually over 4 years. As stated however, a decision was taken to abolish it earlier than planned as a result of the Finance Minister's request.

Month	Date	Event	Details
	19	Prime Minister Ariel Sharon is hospitalized due to a slight stroke.	
	22	Menorah agreed to buy Union Bank's provident funds.	This was in line with the implementation of the Bachar Committee's recommendations. The acquisition came in the wake of other acquisitions by Menorah, including the purchase of the Emda mutual funds from Bank Mizrahi, Bank Yahav-Massad's provident funds, and the provident funds of the old Mivtahim. The total assets managed by Menorah amount to NIS 9 billion.
	29	Union Bank began to market pension products.	The banks began to market pension funds and to engage in pension advice. This is in line with the implementation of the Bachar Committee's recommendations.