RECENT ECONOMIC DEVELOPMENTS*

Main developments

Indicators of activity in the principal industries in the second half of 2001 (the period reviewed) show that it continued to contract, and some show that the decline became more severe. In the last two months, however, there were some signs that activity was stabilizing at a low level (Figure 1). The contraction of GDP, and in particular of business-sector product, intensified in the period reviewed; domestic uses fell; the state-of-the-economy index continued on the downward path which started in 2000:IV, and the deficit in the goods and services account of the balance of payments grew, with both imports and exports falling, albeit at a slower rate in the fourth quarter. These developments were reflected in a rate of inflation that was lower than expected and a rapid rise in unemployment, which reached 9.9 percent in November. At the end of December 2001 and the beginning of January 2002 the NIS depreciated steeply, as a result of certain policy measures introduced, including a two-percentage-point reduction in the Bank of Israel's interest rate.

The reduction in economic activity in the period reviewed was the outcome of economic shocks, principally on the demand side, but in some industries also on the supply side: first, the renewal of terrorist attacks in Israel in 2000:IV caused a sharp reduction in the number of tourists, in exports to the Palestinian Autonomy, and in the number of workers from the Autonomy, most of whom were employed in construction. Secondly, the slowdown in the US economy in 2000, which spilled over into other countries, caused a worldwide downturn in activity, and also affected Israel's economy, in particular the high-tech industries, which had been in the forefront of exports in the last few years. Thirdly, the terrorist attacks in the US on 11 September, which shook the global economy, aggravated the decline of demand for Israeli exports, specially for tourist services, and strengthened expectations of a continued slowdown in the world economy. These three shocks made economic activity fall even further, reflected by the spread of the slowdown, which had started in 2000, from high-tech industries into the rest of the principal industries.

The slowdown was expressed in various forms: a fall in tax revenues, as a result of which the budget deficit significantly exceeded the planned deficit, leading to an increase in the public debt and to pressure to raise the long-term interest rate; a rapid rise in unemployment, particularly in the period reviewed, which caused a rise in transfer payments in the budget; increased employment in the social and welfare services; and reduced investment.

The deterioration in the balance of payments continued in the period reviewed, although in the current account it was more moderate than at the beginning of the year. All the main categories of the current account showed this deterioration in 2001:III from the previous quarter, and in particular the services account, where there was a marked fall in income from tourism and in the exports of start-ups. The trade deficit rose considerably in 2001:III, but slowed in 2001:IV, when there were indications that it was stabilizing. The decline in capital inflow, which had started with the outbreak of the *intifada*, continued, affected by the sharp drops in the Nasdaq and by the difficulty in issuing shares abroad; direct financial investments by nonresidents fell heavily. The NIS depreciated in the course of 2001:III, and then appreciated; in mid-December, apparently due to media reports about expected policy measures, the NIS started depreciating again, slowly, until the steps were announced, and since then it has depreciated more rapidly.

Fiscal policy: the government's domestic deficit was 5.4 percent of GDP in the period reviewed, and especially in 2001:IV significantly exceeded the deficit in 2000 and also the planned deficit for 2001. The total budget deficit in 2001 was 4.6 percent of GDP, compared with the target of 1.75 percent. Although expenses remained within the nominal budget figures, real expenses exceeded the planned amount. Revenues were far below the planned figures, because as the recession became more severe and as other revenues planned in the budget did not materialize, tax revenues greatly undershot the earlier estimates. As a result of the rise in the deficit, the government debt surged, after falling constantly for many years, and created pressure for a rise in long-term interest rates. The government's domestic purchases, which had risen over a long period, fell, and

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

Table 1. Indicators of Business Activity, 2000–2001
(all data excluding construction are seasonally adjusted)

			2000	2001				July–Dec[a]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	5.1	–5.6	–3.0	–2.2	–9.1	–7.3	–3.8	6.7	–5.2	12
Large-scale retail trade	10.2	4.0	11.3	–6.4	7.0	1.6	2.1	11.9	2.0	12
Manufacturing production (excl. diamonds)	10.0	–4.8	–4.6	–5.4	–13.7	–9.6	–5.1	9.5	–8.6	11
Business-sector consumption of electricity	7.4	1.4	–6.3	10.0	–0.6	–8.4	–1.0	8.8	–1.6	9
Index of revenue in commerce	10.4	–0.1	–7.0	–0.2	–3.2	–0.8	–1.0	9.7	–2.4	11
Index of total revenue 10.8	10.8	0.6	–2.9	1.0	–5.6	–2.2	–2.1	10.4	–2.4	11
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	3.7	–50.0	–40.4	–5.6	–13.4	–12.1	–15.8	–16.6	–50.6	12
Immigrant arrivals	–21.6	–26.8	–0.2	–32.2	–16.6	31.8	–6.7	–29.8	–29.3	11
Residential starts	18.9	–44.4	–15.4	–17.3	–19.7	0.1	–50.1	9.4	–54.3	10
of which: Government-initiated	52.3	–61.7	–30.0	–30.5	–43.0	30.0	–64.6	41.9	–71.3	10
Residential completions	–6.0	–34.0	–27.5	8.7	–20.6	42.2	–63.6	–24.1	–29.7	10
of which: Government-initiated	–38.6	–41.5	–18.6	–30.1	–7.0	57.8	–73.6	–38.5	–41.8	10
Survey of companies (percent)[b]										
Product of manufacturing firms (not adjusted)	11	–16	–12	–6 [c]	–16	–20	–22			12
Product of manufacturing firms (adjusted)	11	–16	–12	3 [c]	–19	–25	–23			12
Net sales by commercial firms (not adjusted)	5	–23 [c]	–25	–11 [c]	–33	–30	–16 [c]			12
Net sales by commercial firms (adjusted)	5 [c]	–22 [c]	–23	–8 [c]	–30	–36	–14 [c]			12

* Last month for which data available.
[a] Compared with same period in preceding year.
[b] Difference between the number of firms reporting a rise and those reporting a fall, as a percentage of all reporting firms.
[c] Denotes non-signifcant result at 5 percent level.

wage payments rose, mainly due to the increase in employment. At the end of the year the government's budget deficit target for 2002 was raised from 1.5 percent of GDP to 3 percent.

The low level of economic activity and the crisis affecting the high-tech industries aggravated the slack in the labor market, with unemployment rising quickly to 9.9 percent. The labor supply of Israelis increased slightly, while the participation rate in the labor force remained steady. The derived demand for workers fell, however, so that the number of unemployed Israelis increased, restraining the rise in wages and holding them steady (until October) at the level prevailing in the equivalent period in 2000. In comparison with that period, the labor input of Israelis in the business sector went down and that in the public sector rose, although over the year as a whole it declined in both sectors. Both the number of employed persons and the number of man-hours declined, indications of expectations that the low level of activity will persist. In 2001:III the business sector and the public sector both contributed to the rise in unemployment among Israelis, but the contribution of the business sector, despite the reduction in the number of non-Israelis employed, was double that of the public sector. The number of job-seekers registered at labor exchanges and the number of claims for unemployment benefits rose throughout the year, accelerating in the period reviewed.

The development of the different components of the Consumer Price Index (CPI) and their variance changed from the third quarter to the fourth; the overall index rose by 0.6 percent (in annual terms) in the second half of the year. The dollar depreciated considerably in 2001:III, and more slowly in 2001:IV; this was reflected by a slower rise of the housing component, whose contribution to the change in the CPI over the period reviewed was the major one. In 2001, for the third successive year, the rate of inflation (1.4 percent) was below the lower limit of the target range (2.5 percent), but the difference between them was smaller than in the previous two years. In 2001 inflation undershot the target in part owing to the low level of economic activity, mainly towards the end of the year, and after assessments regarding inflation were in the lower part of the target range for most of the year. Inflation expectations, which in the first half of the year were below the target range, reached the upper limit of the range in 2001:III, and then, until the end of December, were below the target. Following the sharp interest-rate reduction by the Bank of Israel expectations rose again, and in January 2002 they approached the upper limit of the target.

Monetary policy: In the period reviewed the Bank of Israel cut the interest rate by 3 percentage points: prior to 23 December the Bank had reduced the interest rate gradually, with a series of small reductions which totaled 1 percentage point, and on that date the Bank reduced the rate by an exceptional 2 percentage points. The gradual pace of interest-rate reductions was intended to create a firm for base price and financial stability, in the light of the indications of a rise in uncertainty mainly in 2001:III. The relatively steep cut in the interest rate in December was made against the background of the government decision to return to a path of fiscal discipline and to adopt several other measures to benefit the financial markets (including the abolition of the ceiling on Treasury bills, widening the exchange-rate band and giving its lower limit a zero slope, and completing the liberalization of the money and capital markets), and in the light of an accumulation of data on the depth of the recession, the rise in unemployment and the drop in the annual rate of inflation to below the lower limit of the target range. As expected, the cut in the interest rate led to a small rise in inflation expectations, but they remained within the upper part of the target range. Share-price indices rose sharply, the monetary aggregates changed, the main change being the rise in M1 *plus* self-renewing overnight deposits (SROs), and the NIS/$ exchange rate fluctuated more widely. At the end of January 2002 it appears, however, that the market absorbed the change without

Table 2. National Accounts, 2000–2001

(seasonally adjusted)

			2000	*2001*				*July–Dec*[a]		
	2000	*2001*	*IV*	*I*	*II*	*III*	*IV*	*2000*	*2001*	*
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	6.4	-0.5	-10.0	1.8	-3.7	-5.4		8.0	-4.4	9
Business-sector product	8.5	-2.1	-16.7	-4.6	-1.1	-6.0		16.4	-7.3	9
Business-sector product excl. start-ups	5.7	-0.7	-13.8	-3.7	3.0	-3.8		12.9	-4.8	9
Private consumption	6.6	3.1	-2.7	6.8	0.7	4.8		7.8	2.3	9
Gross domestic investment	-3.5	-4.3	104.7	-0.9	-32.0	-8.6		-15.7	6.0	9
Gross domestic investment excl. start-ups	-7.4	-6.5	0.8	-2.6	-25.4	-14.0		-5.3	-10.9	9
Goods and services exports	23.9	-13.1	-41.9	-10.5	-22.7	-16.2		34.4	-23.8	9
Goods and services exports excl. start-ups	19.7	-9.0	-24.6	1.6	-18.9	-15.9		22.2	-15.0	9
Goods and services imports	12.2	-6.4	5.8	-12.3	-13.6	-10.2		-11.7	-7.9	9
General government consumption	1.1	3.2	13.7	0.4	-0.1	-15.8		-0.7	-1.0	9

** Last month for which data available.*

[a] *Compared with same period in preceding year.*

experiencing shocks. This may be attributed in large measure to the structural changes introduced in the last few years in the money and capital markets which made them more robust. It is premature at this stage, however, to assess whether the depreciation will be translated into a one-time moderate increase in prices or into renewed inflation; it is also too early to assess whether this is real depreciation which will improve the situation of exporters when demand from abroad recovers.

The principal industries

National Accounts data for 2001 show that GDP, which had slumped by an unprecedented 10 percent (seasonally adjusted) in 2000:IV, rose slightly in 2001:I, fell in the next two quarters, and in 2001:IV—based on a preliminary estimate of the Central Bureau of Statistics (CBS)—declined more steeply. The use of resources, which serves as an indicator of the level of demand in the economy, also fell in 2001, with the decline becoming more severe, reaching 16 percent in 2001:IV according to the preliminary estimate, with wide fluctuations in the different uses. Several indicators, however, suggest that activity stabilized at a low level in that quarter (Figure 1).

The increased severity of the contraction of economic activity can also be seen from the spread of the slowdown into other industries in the business sector. Whereas in 2001:II the deterioration was reflected mainly by the output of start-ups, with activity in other parts of the sector recovering from the shocks which affected demand following the terrorist attacks on the US, in 2001:III the slowdown spilled over into other industries in the business sector. Business-sector product went down by about 4 percent in that quarter, and according to the National Accounts data for the year, the decline in 2001:IV was about 11 percent.

National Accounts data for the first three quarters of 2001 (Table 2) also show that all components of uses and resources except for private consumption fell markedly in 2001:III, after most of them had contracted even more sharply in 2001:II. In 2001:III the most notable reductions were in investment (excluding start-ups), imports and exports of goods and services, and public consumption, which had been stable in the previous quarter. The Companies Survey of the Bank of Israel's Research Department for the fourth quarter shows that activity in all the principal industries fell in 2001:IV, that the main constraint on expanding activity was on the demand side, both domestic and from abroad, and at the same time there were reductions in inventories, staffing, and orders for the next quarter.

The decline in economic activity was due to the shock experienced by demand. The shock can be divided into two parts: the first was the renewed terrorist attacks in Israel in September 2000, which led directly to a fall in the output of the tourism and construction industries and in exports to the Palestinian Autonomy, as well as an increase in defense demand. The direct loss of business-sector product attributable to this cause in 2001, excluding derived effects via loss of individuals' income, is estimated at 3 percent of GDP (including the effect on the construction industry of the reduction in Palestinian workers from the Autonomy). The second part of the shock to demand was the drop in the worldwide demand for high-tech products (which include the output of start-ups), whose share in Israel's exports in the last few years exceeded that of all other export industries, and actually led economic growth. In September 2001 the terrorist attacks on the US caused an additional shock effect on the factors responsible for the fall in exports—mainly tourist services. Despite all the above, certain indicators suggest that in 2001:IV there were signs that the decline in economic activity was starting to flatten out, albeit at a low level.

The fall in manufacturing output, which started in 2000:IV, accelerated in 2001:II, and moderated in 2001:III. Labor input also went down: in 2001:I the main drop was in the number of man-hours, with the share of layoffs only rising later. In 2001:III the reduction in labor input was similar to that in manufacturing production (about 2 percent), and labor productivity remained steady. The trends (from January to September) show that the output of the high-tech industries fell sharply, by about 24 percent (annual rate), during the year, compared with a rise of 26 percent in the equivalent period in 2000; in 2001:III the main drop (of about 10 percent, seasonally adjusted) took place in machinery and equipment. The traditional industries fell more moderately, by about 4 percent, with a more pronounce downward trend in August and September. The rate of investment in manufacturing inventory went down in 2001 after rising significantly in 2000:IV; in the light of the drop in demand, this presumably caused a further decline in manufacturing output. The reduced output, as stated above, was paralleled by dismissals of workers, and this together with the sharp decline in inventories, indicates manufacturers' assessments that the recession is not a short-term situation.

Most construction industry indicators show that the weakness from which it has suffered since 1995 became even worse in the period reviewed. Output, i.e., building starts and completions, was considerably lower than that in the equivalent period in 2000 (Table 1), and according to trend data the number of apartments sold in the business sector in 2001:III was 6 percent lower than the number in the previous quarter. The number of private apartments for sale at the end of September was also 6 percent lower than the number at the end of the previous quarter, due, among other things, to the decline in output. On the other hand, the number of mortgages taken up has been rising since May, and the rate at which the government sold land for residential construction slowed greatly. Housing prices fell by 4.2 percent in real terms from January to October 2001, after going down by 5.8 percent in 2000. National Accounts data for 2001, seasonally adjusted, show that in the second half of the year private residential construction and government-initiated construction both fell sharply.

There was no recovery in activity in other industries either. The trading turnover index was 2 percent lower than in the same period in 2000, despite the increase in consumption and the rise in the large-scale retail trade index in 2001; the index of trade and services revenue was even lower—5 percent lower than in the same period in 2000. The number of bed-nights in tourist-grade hotels, which fell sharply in October 2000, continued to decline. An analysis of tourist arrivals by air shows that from August to November the number went down by an average of 5 percent per month, after falling by 2 percent per month from January to July. The cumulative drop from August to November was 19 percent. Whereas bed-nights of Israelis continued to increase (boosted by special offers and price reductions), the decline amongst tourists became more pronounced, and from one million bed-nights in September 2000, the number plunged to only 177,000 in November 2001.

The labor market

The slack which has prevailed in the labor market since the end of 2000 became more pronounced in the period reviewed, reflected in a rise in the rate of unemployment to 9.9 percent (based on trend data to November). The labor supply of Israelis (according to the participation rate in the civilian labor force) rose by 0.8 percent in 2000:III, seasonally adjusted; derived demand for

Table 3. Indicators of Labor Market Developments, 2000–2001
(seasonally adjusted)

			2000	2001				July–Dec[a]		
	1999	2000	IV	I	II	III	IV	2000	2001	*
			('000s)							
Civilian labor force	2,436	2,493	2,458	2,479	2,491	2,510		4.2	2.4	9
Israelis employed	2,223	2,271	2,240	2,265	2,274	2,276		4.3	1.8	9
Business sector	1,559	1,583	1,568	1,570	1,591	1,589		5.4	1.2	9
General government 662	662	691	667	692	691	690		2.3	4.0	9
Average hours worked per employee	38	37	38	37	38	37		1.3	–3.2	9
Business sector	41	40	40	40	40	39		1.9	–4.5	9
General government	31	31	31	31	31	30		0.7	–6.5	9
Labor input of Israelis employed	84,544	84,426	85,979	84,036	85,070	84,172		5.4	–1.0	9
Business sector	63,961	63,197	65,214	62,722	63,807	63,063		7.8	–2.1	9
General government	20,583	21,229	20,766	21,315	21,263	21,109		–1.4	2.4	9
Claims for unemployment benefit	106	118	106	108	111	124	128	–3.1	19.9	12
Work seekers	165	186	168	170	181	194	200	6.2	17.7	12
Real wage per employee post (NIS)[b]	4,562	4,680	4,663	4,704	4,695	4,674	4,649	7.7	0.5	10
of which: Business sector	4,691	4,815	4,834	4,848	4,824	4,788	4,798	6.9	1.0	10
Unemployment rate (%)	8.8	8.9	8.8	8.6	8.7	9.3				9

** Last month for which data available.*
[a] Percent change compared with same period in preceding year.
[b] At 1994 prices.

workers, which can be obtained from the low level of activity in the principal industries and also from the number of vacancies registered in the labor exchanges, fell. As a result of these developments the number of Israelis employed rose by only 0.1 percent. At the same time the number of Israelis in full-time posts fell steeply, they worked significantly fewer hours, and the number of unemployed persons increased. The slack in the labor market in the period reviewed (to October) was reflected in the slowdown in the rate of increase of the real wage per employee post in the business sector, while in the public sector it went down by 1.2 percent compared with the equivalent period in 2000, but this was prior to the implementation of the wage agreements signed during the year (see below).

The effects of the deterioration in 2001:III compared with the previous quarter were felt in every one of the labor-market variables—in the increased number and share of those in part-time employment, which means a reduction in the utilization of the labor force, and in a sharp rise (of about 18,000, seasonally adjusted) in the number of unemployed persons, to 9.3 percent, its highest level in the last three years.

The worsening situation in the labor market can also be seen from the leveling off in the rate of participation in the labor force after its steady rise in the last two years. The positive long-term effects on the rate of participation, the main one of which is immigrants 'striking roots' (i.e., the rise in the share of all immigrants who participate in the labor force), was completely offset by negative short-term effects, mainly the 'discouraged worker' effect. The immigrants' contribution to the rate of participation can be split into two components: that of their increasing share in the working-age population, and the 'striking roots'contribution. As immigrants' rate of participation in the labor force exceeds that of the veteran population (62 percent compared with 54 percent), the rise in their share in the working-age population made a positive contribution in 2001:III. The striking roots contribution was also positive, as the share of all immigrants who participated in the labor force also rose in 2001:III. (To illustrate: 56.9 percent of immigrants who arrived in Israel from 1998 are part of the labor force, whereas 61.2 percent of those who arrived in 1990 and 1991 have joined it.) This leads to the conclusion that the full effect of the slack in the labor market is reflected in the reduction in the rate of participation of the veteran population, while the striking roots effect among immigrants outweighs the short term effects.

Total labor input in the business sector in 2001:III was 8 percent lower than in 2000:III; this was the outcome of a 4 percent reduction in the input of Israelis, and a 92 percent reduction in workers from the Palestinian Autonomy, partly offset by a 16 percent increase in the input of foreign workers. Labor input of non-Israelis fell markedly, due to the reduction in the number of Palestinian workers in the period (from about 123,000 in 2000:III to a mere 5,000 in 2001:III), with an increase of 30,000 foreign workers.

The labor market variables developed in similar directions in the different sectors from 2001:II to 2001:III (with the exception of wages, see below): the number of employed Israelis and their number of man-hours fell in both the business sector and in the public sector. At the same time the number of Palestinians employed in the business sector plunged. In 2001:III both sectors contributed to the rise in unemployment among Israelis, but the contribution of the business sector to unemployment, despite the reduction in the number of non-Israelis employed in that sector, was double that of the public sector. Within the business sector, the 2 percent decline (seasonally adjusted) in the number of employed persons in manufacturing and in business services was prominent, while in contrast, the number of employed persons in trade rose at a similar rate.

The real wage per employee post in the period reviewed (to October) was similar to the level in the equivalent period in 2000: in the business sector it rose slightly, by one percent, while in the public sector it did not change, although it is scheduled to rise according to wage agreements signed at the end of the year. Labor relations in the public sector in 2001 were affected to some extent by the deepening recession and the crisis in the high-tech industries, since some of the agreements are based on comparisons of similar occupations in the different sectors. As a result, at the beginning of the year a relatively modest agreement relating to the grades covering most employees in the public sector (excluding teachers, nurses, and academic staff) was signed for the years 1999 to 2001, but the agreement was really just a "down payment," and only guaranteed industrial peace in those grades until September. During the period reviewed collective agreements were signed with the teachers' and students' unions, as was an agreement regularizing the conditions of employment of those employed via manpower agencies. The minimum wage was raised by 10 percent in April, to NIS 3,267 per month. During most of the period reviewed there was regional industrial unrest in the public sector relating to wage claims as well as working arrangements, and this also involved employees in grades covered by the agreements signed at the beginning of the year, as well as those who signed at the end of the year.

Monthly trend data of unemployment, which are calculated after making seasonal adjustments and allowing for statistical discrepancies and which take the number of days of activity into account, show that the rate of unemployment, which was steady in 2000 and in 2001:I, started rising month by month from then on, that the rise accelerated in the period reviewed, and that it reached a peak of 9.9 percent in November. The number of job-seekers also rose steeply, and in the period reviewed was 16 percent higher than in the equivalent period in 2000. Concurrently, the number of claims for unemployment benefits continued rising (Table 3).

The balance of payments

Continuing the trend that had begun at the end of 2000, the current-account deficit continued to expand rapidly in 2001:III, and stood at $ 1.7 billion (Table 4). The increase in the deficit, which accelerated in the first three quarters of 2001, erased the marked improvement in the current account during 2000. The assessment is that it rose in 2001:IV, and that its annual level is even higher than that of 1999, when it reached $ 3 billion.

The deficit deteriorated in each of the three accounts that comprise it: a. The deficit on the goods account rose, with exports falling by more than imports; b. The deficit on the services account expanded appreciably during the year, compared with a notable surplus in the equivalent period in 2000. Most of the deterioration in the services account is due to the fall in exports of tourism and start-ups: tourism income fell from $ 3.2 billion in the first three quarters of 2000 to $ 1.6 billion in the same period in 2001, and was less than tourism imports, which grew by 6.5 percent to stand at $ 2.5 billion in the first three quarters of 2001. Exports of start-ups dropped to an insignificant level because of the world crisis in the high-tech industry. On the other hand, on the services account there was an improvement in factor input services—wage payments to employees fell

Table 4. Balance of Payments, Foreign Trade,[a] and the Reserves, 2000–2001

($ million, current prices)

			2000	2001				July–Dec[b]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
Monthly averages										
Trade deficit	310	312	320	294	289	322	342	312	322	12
Goods imports	2,093	1,986	2,186	2,126	1,999	1,940	1,880	2,170	1,910	12
Consumer goods	376	388	392	420	366	386	381	389	383	12
Capital goods	494	501	520	519	517	501	467	505	484	12
Intermediates	1,221	1,096	1,270	1,186	1,114	1,051	1,031	1,274	1,041	12
Goods exports	1,783	1,674	1,866	1,833	1,710	1,618	1,537	1,858	1,578	12
Manufacturing	1,721	1,619	1,809	1,778	1,645	1,563	1,488	1,797	1,526	12
High tech	920	833	1,022	970	825	812	726	991	769	12
Quarterly averages										
Net current account	-354	-1,084	-159	-443	-1,096	-1,713		-153		9
Financial account (excl. foreign-currency balances)	767	-75	601	-730	131	373		652		9
Nonresidents' direct and portfolio investment	1,098	887	246	1,048	810	802		1,075		9
Nonresidents' portfolio investment	1,253	188	693	482	478	-397		716		9
Residents' direct and portfolio investment	1,178	438	946	174	631	510		1,440		9
Net foreign debt (% of GNP)	6.48	4.21	6.34	4.46	4.79	4.14		6.69		9
End-period Bank of Israel reserves	23,164	23,181	23,164	23,840	23,074	24,478	23,181	23,164	23,181	12

** Last month for which data available.*

[a] Foreign trade data are seasonally adjusted monthly averages (excluding ships, aircraft, diamonds, and fuel).

[b] Compared with same period in preceding year.

by $ 0.5 billion due to the reduction in Palestinian workers, and interest payments on nonresidents' deposits also declined. c. The extent of unilateral transfers dipped slightly from its level in the same period in 2000, *inter alia* because of a technical delay in the transfer of the US civilian aid.

Foreign trade figures for the period reviewed indicate that the trade deficit expanded appreciably (Table 4), as all categories of imports and exports fell compared with the equivalent period in 2000. This finding is consistent with the slight decline in the imports and exports of advanced economies (Table 5), and the reduction of domestic economic activity.

Most of the decline in exports was concentrated in electronic equipment (down by 18 percent for the year as a whole) and electronic components (14 percent), while exports of medicines soared (37 percent). An analysis of trend data shows that in the period reviewed the decline in goods exports evident in the first half of the year moderated and its composition changed: the fall in high-tech exports, which accelerated in the first half of 2001 (an annual rate of 31 percent), moderated in the period reviewed (18 percent), as did the drop in traditional industries. In exports of the mixed technology industry, on the other hand, the downward trend evident since August intensified (6.8 percent).

Table 5. Indicators of Economic Development in Advanced and Developing Countries,[a] and Forecast for 2002

	1999	2000	Estimate 2001	Forecast 2002
Annual rate of change[b]				
World GNP				
Total	3.6	4.7	2.4	2.4
Advanced countries	3.3	3.9	1.1	0.8
Developing countries	3.9	5.8	4.0	4.4
World trade				
Total	5.4	12.4	1.0	2.2
Advanced countries				
Imports	7.7	11.5	–0.3	1.4
Exports	5.2	11.6	–0.3	0.5
Developing countries				
Imports	1.7	1.7	5.0	6.5
Exports	4.7	15.0	3.4	4.5
Inflation (CPI)				
Advanced countries	1.4	2.3	2.3	1.3
Developing countries	6.8	5.9	6.0	5.3
Countries in transition	43.9	20.1	16.0	11.0
Prices of unprocessed goods (US$)				
Oil	37.5	56.9	–14.0	–23.7
Other	–7.0	1.8	–5.5	1.7
Short-term interest[b] (%)				
Dollar deposits	5.5	6.6	3.8	2.8
Yen deposits	0.2	0.3	0.2	0.1
Euro deposits	3.0	4.1	4.1	2.9
Unemployment rate in OECD countries	7.4	6.6	6.5	7.2

[a] According to "World Economic Outlook," Israel is classified as an advanced country.

[b]Apart from interest and unemployment rates, which are shown as percentages.

[c] 6-month LIBOR rate.

SOURCE: "World Economic Outlook," (IMF), updated to December 2001, other than direct data for OECD, which are talen from the organization's booklet no. 70.

In goods imports, trends were not uniform; imports of consumer goods remained stable during the period reviewed, albeit slightly below the average level in the first half of the year; the decline in imports of capital goods, which serve as an indication of future economic activity, was aggravated during the year, while the decline in imports of intermediates, which constitute an indication of current activity, persisted throughout the year, moderating gradually. Trend data by groups of commodities indicate that the fall in imports of raw materials for machinery and electronics intensified in the first half of the year (35 percent on average) and, as with the industry's exports, moderated in the second half (to 14 percent).

Import and export prices of goods remained stable in 2001:III, after dipping slightly in 2001:II. The 0.5 percent rise in the terms of trade index in 2001:III indicates that the terms of trade improved, after a marked deterioration (by 3 percent) in 2001:I and 2001:II.

Capital inflow was apparently affected by the increased security risk due to the *intifada*, the sharp fall in the Nasdaq, and the difficulties of going public abroad. Direct investment by nonresidents plunged by 40 percent in January–November, mostly in the high-tech industry. Portfolio investment shrank to one-tenth of its extent in 2000 (only $ 0.4 billion in January–November). During 2001 nonresidents sold shares on the Tel Aviv Stock Exchange (TASE) amounting to $ 700 million, an unprecedented amount for Israel. Alongside the process of improving and deepening Israel's foreign-currency market, which affects its stability, short-term factors also influenced the exchange rate: in 2001:III there was local-currency depreciation of 7 percent, *inter alia* as a result of the rise in inflation expectations due to the security situation and the sharp drop in the Nasdaq, whereas in 2001:IV, as expectations of depreciation declined following the events of September 11 and the absence of an interest-rate reduction by the Bank of Israel for two consecutive months, there was local-currency appreciation until mid-December. Subsequent to the 2 percentage-point interest-rate reduction by the Bank of Israel and until the end of the year the nominal appreciation of that quarter was offset, and the rapid depreciation persisted in January 2002.

The Bank of Israel's foreign-exchange reserves stood at $ 23.2 billion at the end of the period reviewed, slightly above their level at the beginning of it; this excludes most of the US civilian aid of $ 0.7 billion, which has been held up for several months. The Bank of Israel's total interest receipts on the foreign-exchange reserves and capital gains, which reached $ 1.3 billion in 2001, were offset, mainly by currency revaluation differentials ($ 0.3 billion) and public-sector purchases ($ 1 billion).

Global developments

The slower rate of growth of the global economy, which began with the high-tech crisis in the US, spilled over into other industries, intensified during the period reviewed, and extended to almost all regions. At the same time, there were sharp falls in share prices in world capital markets. The expansion of world trade, which had reached 12 percent in 2000, slowed to 1 percent in 2001, and in the developed countries exports and imports even contracted slightly. The events of September 11 exacerbated these trends, and indices of consumers' and firms' confidence as reported by the IMF have since plummeted. Growth forecasts for 2002, which were prepared in 2001, indicate ever-increasing pessimism and uncertainty (in July 2001 the modal forecast showed a growth rate of 3 percent in the US and Germany, and 1 percent in Japan; in October the rate fell to 2 and –0.3 percent respectively, and in November it was 1 and –0.7 percent). Concurrently, the standard deviation of forecasters' estimates rose, even though this should fall as the forecast year approaches.

Alongside the deterioration in global macroeconomic conditions in 2001, there was no significant change in the financial conditions in either the advanced or the developing countries, and only in emerging economies did they worsen significantly. The principal share indices, including the Dow Jones on Wall Street, the FTSE in London, and the Nikkei in Japan, which plummeted after September 11, began to rise to their previous levels towards the end of 2001. Exchange-rate shifts were relatively moderate, and the dollar appreciated against the euro and the yen. The global inflation rate remained at its 2000 level, and is expected to decline in 2002; in emerging markets the marked decline in the inflation rate persisted throughout 2001, and it is expected to continue falling significantly in 2002.

As Israel's economy is increasingly exposed to the world economy and international financial markets, the effect of world developments on the level of activity in 2001 is notable. Concurrently, the global macroeconomic forecast for 2002 is relatively advantageous for Israel: although no acceleration of the growth rate of global GDP is expected, the forecasts indicate a slight rise in world trade, particularly in the imports of the advanced economies. The rapid fall in oil prices will persist, improving Israel's terms of trade, and the downward trend of global inflation will continue. Short-term interest rates on dollar and euro deposits will also decline, enabling Israel's interest-rate policy to be more flexible. Recent data has indicated a slight recovery in the GDP of the US in 2001:IV, and this should have a positive effect on trends in Israel.

During 2001 the NIS weakened against the currencies traded in Israel (except the yen), after it had strengthened in the last two years. During the period reviewed the NIS depreciated by 5.7 percent against the dollar (compared with 3.0 percent in the first half of 2001), and by 9.7 percent against the euro (after appreciating by 6.6 percent in the first half). During 2001 the euro depreciated by 5 percent against the dollar.

The euro, which was launched as a currency in circulation at the beginning of 2002, is of lesser economic importance than the dollar: in 2001 most of Israel's trade (imports and exports, excluding diamonds) was in dollars (66 percent), the euro accounted for just 22 percent (sterling and the yen accounted for 6 percent each), and the composition of the currency basket was determined accordingly. At the same time, the share of the dollar in the public's foreign-currency deposits also grew, and reached 80 percent. The euro accounted for 14 percent (and the share of sterling and the yen were 4 and 2 percent respectively). The distribution of foreign-currency credit was even more dollar-biased: the dollar accounted for 90 percent, the euro for 5 percent, and the yen for 4 percent. The standard deviation of the changes in the exchange rates against the NIS showed greater volatility of the euro than the dollar.

The general government sector

The government's domestic deficit (excluding net credit extended) was considerably higher in the period reviewed, especially in 2001:I, when it was 5.4 percent of GDP (Table 7), than the deficit of 2.1 percent of GDP in the equivalent period in 2000. For the year as a whole the domestic deficit was 4.6 percent of GDP—a notable departure from the annual deficit target of 1.75 percent of GDP. Because of the deviation from the target, the public debt rose to 100 percent of GDP, compared with 92 percent of it at the end of 2000, after declining almost uninterruptedly since the 1980s. Concurrently, the interest payment and tax benefit items in the budget grew, expressed in pressure for a rise in the long-term interest rate. Most of the substantial deviation of the deficit from the target stemmed from a shortfall in revenues, especially in 2001:IV, while nominal expenditure went ahead as planned, and even fell slighly below the planned amount ($ 0.8 billion). In real terms, however, expenditure exceeded the planned level, and there was a significant rise in the current expenditure/ GDP ratio. The expansion of the deficit led to increased net borrowing by the government, focused mainly on bond issues and the utilization of government deposits with the Bank of Israel, thereby generating upward pressure on capital market yields and halting the process of reducing real long-term yields. The latter even rose to some extent in 2001:IV, despite the reduction of the Bank of Israel's key interest rate and the deepening of the economic slowdown.

The growing recession, slower than expected land sales, shortfall in revenues from the G3 cellphone auction, and the annulment of the 'Negev Law' were among the factors reducing government revenues. To these were added a lower than planned rise in prices, which lowered nominal income. Government income in GDP terms was the lowest for a long time in 2001:IV. Because

Table 6. Selected Price Indices, 2000–2001

(annual rates of change during period, percent)

			2000	2001				July–Dec[a]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
CPI	0.0	1.4	1.9	–1.9	6.6	3.6	–2.3	–0.7	0.6	12
CPI excl. housing, fruit and vegetables	0.9	0.2	1.5	–3.5	6.6	0.4	–2.4	–1.1	–1.0	12
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	0.6	0.2	–2.2	–1.6	5.9	1.1	–4.4	–1.8	–1.7	12
Index of housing prices	–2.4	5.2	3.2	7.4	1.6	12.6	–0.4	–1.4	5.9	12
Wholesale price index	2.0	–1.9	1.4	–4.2	5.0	–5.5	–2.7	–0.1	–4.1	12
NIS/$ exchange rate	–2.7	4.8	4.3	8.4	–0.2	16.3	–4.3	–1.2	5.5	12
NIS/currency-basket rate	–6.3	3.7	6.2	7.2	–6.3	24.6	–7.4	–4.7	7.4	12

** Last month for which data available.*

[a] Compared with same period in preceding year.

of the slower than planned rate of price increases, real expenditure was greater than planned, mainly in current expenditure items, which are difficult to reduce in the future, and in those that do not contribute to growth. According to National Accounts data, for the first time in many years domestic purchases dropped in nominal terms in the period reviewed, but defense imports soared, as did wage expenditure. In view of the slump, the government decided to maintain the high level of public expenditure, and the deficit target for 2002 was raised from 1.5 to 3 percent of GDP. This expansion followed the adjustment of the forecast of GDP growth from 4 to 2 percent, which means that government revenues are expected to fall and that a drastic cut in expenditure is required.

According to State Revenue Administration figures, the government's tax receipts in the period reviewed were 1.4 percent less than in the equivalent period in 2000, and the decline was especially marked in 2001:IV. Tax receipts on civilian imports were down by 18 percent over the same period in 2001; direct taxes fell slightly, while indirect tax receipts rose moderately. By contrast, National Insurance payments to households were up by a real 11 percent (until November) over the equivalent period in 2000. The fastest rise was in unemployment benefits (21 percent) and income support (16 percent), inter alia because of the rise in unemployment (hard-core unemployment grew) and sharp increase in child and disability benefits.

Prices, and the money and capital markets

The Consumer Price Index (CPI) rose by 0.6 percent in annual terms in the period reviewed, and by 1.4 percent in the year as a whole, compared with a negligible increase in 2000. The moderate rise in the period reviewed was not uniform; after rising in 2001:III, with high variance between its items, it declined in 2001:IV, and its variance declined sharply, being expressed in a fall in all the main indices (Table 6). The drop in the CPI in 2001:IV stemmed from the exacerbation of the economic slump, the depreciation of the NIS against the dollar after the sharp appreciation of 2001:III, seasonal factors, and the fall in prices of goods whose prices are supervised or controlled.

In 2001, as in the two preceding years, the inflation rate was below the lower limit of the target range, 2.5 percent, but within the long-term range (1–3 percent). Inflation expectations derived from the capital market were below the inflation target in the first half of 2001, but began to rise gradually towards the target range in June, and in September, after the terrorist attacks in the US, reached its upper limit, 3.5 percent. Starting in October, as the financial markets settled in Israel and the rest of the world, inflation expectations declined below the lower limit of the target range, though towards the end of the year, after the interest-rate cut, they rose again, reaching the upper limit of the target range at the beginning of 2002.

Table 7. The Budget and its Financing, 2000–2001

(cash flows, as percent of GDP)

			2000	2001				July–Dec[a]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
1. Government domestic expenditure	36.3	37.6	38.4	33.4	40.0	38.0	39.0	36.2	38.5	12
2. Government receipts	35.8	33.9	33.8	34.6	34.7	36.0	30.2	34.1	33.1	12
3. Domestic budget deficit (1)–(2)	0.5	3.8	4.6	–1.2	5.3	2.0	8.8	2.1	5.4	12
4. Government and Jewish Agency domestic deficit[b] (5)+(6)	–0.4	3.1	4.5	–2.4	3.9	2.0	8.8	2.4	5.4	12
5. Government net borrowing from the public	0.2	3.7	–0.4	1.1	4.9	1.4	7.3	–1.5	4.3	12
6. Public-sector injection (9)–(8)–(7)	–0.6	–0.6	4.9	–3.5	–1.0	0.6	1.6	3.9	1.1	12
7. Bank of Israel injection	0.6	1.6	–5.3	5.4	2.0	–2.1	1.4	–4.1	–0.4	12
8. Private-sector foreign-currency conversions	–0.1	–0.4	0.0	–0.5	–0.2	–0.2	–0.7	0.0	–0.4	12
9. Change in monetary base	0.1	0.9	–0.4	2.0	1.1	–1.6	2.3	0.0	0.4	12

* Last month for which data available.

[a] Compared with same period in preceding year.

[b] Including non-budgetary injection.

In the period reviewed the contribution of the housing component to the CPI was prominent. The rapid rise in prices in this industry in 2001:III outstripped that in the CPI (and was offset primarily by the decline in the seasonal component of clothing and footwear). In 2001:IV the housing item dipped slightly, though by less than the CPI as a whole. The housing item accounts for 21 percent of the CPI, and since its composition (rent and owner-occupied housing) is denominated in dollars, the wide fluctuations in the exchange rate vis-à-vis the dollar greatly influenced the CPI as a whole. The decline in world oil prices caused the price of oil and chemical products to drop in the period reviewed (by 8.1 percent), accounting for about 0.5 percent of the decline in the CPI. As regards the effect of the seasonal items on the CPI—the fall in clothing (4.7 percent) partly offset the rise in fruit and vegetables (8.3 percent).

The NIS depreciated by 7.4 percent in annual terms against the currency basket in the period reviewed, and by 5.5 percent against the dollar—with appreciation against both in 2001:III and depreciation in 2001:IV. The rise in import and export prices vis-à-vis the GDP deflator in 2001:III strengthens the assumption of real depreciation. During the period reviewed, by contrast, the ratio of prices of tradables to those of nontradables in the CPI declined, undermining the assumption.

The wholesale price index of manufacturing output for domestic markets fell by 4.1 percent in the period reviewed, mainly due to the fall in the cost of refining oil and its products. Import prices remained stable in 2001:III, while export prices rose by 4.7 percent.

The Bank of Israel's key interest rate was reduced by 3 percentage points in the period reviewed, as a result of the gradual reductions which accumulated to one percent by mid-December, and the one-off 2 percentage-point cut on 23 December. Both the series of gradual reductions and the appreciable one-off cut were the result of developments in Israel and abroad, as well as of the economic policy mix.

Uncertainty increased in 2001:III and had the potential to undermine economic stability, and in August the reduction of interest stopped for two months. It was renewed in October, and at the end of December, when information emerged concerning the extent of the slump and the decline of the inflation rate to below the lower level of the 2001 target, it was decided that a series of economic measures would be introduced. These included returning to a path of fiscal restraint and an appreciable, one-off, 2 percentage-point reduction of the Bank of Israel's key interest rate, in conjunction with a package of other additional steps in the financial markets: the ceiling on government bond issuance was removed, enabling the Bank of Israel to replace government bonds with its deposits from banks; the exchange-rate regime was made more flexible by making the lower limit of the exchange-rate band flatter and lowering it by one percentage point, to NIS 4.1 against the currency basket; raising the share of capital that institutional investors are allowed to invest abroad to 20 percent, and removing the ceiling by the end of 2002. Alongside the reduction in the Bank of Israel's key nominal interest rate, real interest also declined in the period reviewed, from 5.4 percent at the beginning to an average of 3.98 in December and 1.8 percent at the end of December, after the interest-rate cut.

The uncertainty that prevailed in Israel during the period

Table 8. Monetary Indicators and Nondirected Bank Credit, 2000–2001

(annual terms, percent)

			2000	2001				July–Dec[a]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
Rates of change	*Average*		*Compared with preceding quarter*					*During period*		
M1[b]	11.0	14.2	6.5	11.2	21.7	28.3	4.5	13.7	17.8	12
M2[c]	20.0	17.2	22.7	19.7	12.8	14.9	14.0	23.7	13.5	12
M3[d]	16.5	15.5	16.2	20.6	9.7	11.9	28.2	16.6	36.3	12
Nondirected bank credit	13.1	10.8	10.9	11.5	9.5	12.7	8.0	11.8	8.7	12
Unindexed local-currency	25.2	15.1	15.8	22.0	10.5	7.8	6.9	19.1	7.7	12
CPI-indexed	6.9	4.7	–2.7	0.3	6.2	13.8	9.1	3.5	7.5	12
Foreign-currency-indexed and denominated	9.5	15.7	30.6	17.1	13.3	17.9	8.0	17.0	12.1	12

** Last month for which data available.*

[a] Compared with same period in preceding year.

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

[c] M1 plus short-term local-currency deposits.

[d] M2 plus foreign-currency-indexed and denominated.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2000–2001

			2000	2001				July–Dec[a]		
	2000	2001	IV	I	II	III	IV	2000	2001	*
Nominal interest										
Nondirected local-currency credit	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	11
Average monetary loan	9.3	6.7	8.4	7.7	7.0	6.2	5.8	8.7	6.0	12
SRO deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	11
3-month Eurodollar	6.4	3.7	6.6	5.2	4.1	3.3	2.0	6.6	2.7	12
Yield to maturity on Treasury bills	8.8	6.5	8.3	7.3	6.6	6.4	5.7	8.6	6.1	12
10-year bonds	5.5	4.9	5.7	5.4	4.9	4.6	4.6	5.7		12
5-year bonds	6.0	4.9	6.2	5.7	5.0	4.3	4.5	6.2	4.4	12
General Share-Price Index (points)	248.6	197.5	226.4	202.5	196.5	194.7	196.1	244.4	195.4	12
Expected inflation (gross)	2.5	1.9	1.6	1.8	1.4	2.8	1.7	2.0	2.3	12
Interest derived from expected inflation (gross)	6.0	4.3	6.5	5.3	4.9	3.6	3.6	6.3	3.6	12

** Last month for which data available.*

[a] Compared with same period in preceding year.

2001:III, the relatively high rates of price shifts and the rise in inflation expectations. This rise, which began in June, continued for four successive months, after which the expectations declined until the end of December. The one-off interest-rate cut in December was larger than other one-off cuts in the past, and gave rise to faster local-currency depreciation, so that inflation expectations approached the upper limit of the inflation target range. Notwithstanding, the depreciation may also be connected with the public's assessments that taxes will be imposed on its income from interest on deposits.

During 2001, as central banks all over the world cut interest rates, the rapid contraction of the interest-rate spread between local-currency and foreign-currency credit was checked, and in the period reviewed, until 23 December, the spread even widened, enabling the Bank of Israel to reduce the interest rate at the end of the year. The Bank of Israel's gradual interest-rate reductions were reflected in the rapid expansion of the money supply, but the persistent economic slowdown served as a counterweight, and the inflation rate even slowed during the period reviewed. A trend analysis shows that during the period reviewed expected short-term real interest declined, as did long-term interest—though to a lesser extent—and with them the real yield to maturity on 10-year bonds. While the reduction of the short-term interest rate can be attributed primarily to the Bank of Israel's interest-rate cut, the decline in long-term interest is largely due to the slump and expectations that it would persist.

Together with the gradual reduction of interest during the period reviewed, the money supply grew slowly, as expected, and in October and November it contracted. In December, however, with the steep interest-rate cut, it rose again. At the same time, the wider monetary aggregates grew, albeit by less than the money supply (Table 8). The public's confidence that the inflation rate would remain low is attested to by the rise in the share of long- and medium-term deposits in total local-currency deposits, even though short-term deposits still predominate, accounting for 73 percent.

Despite the economic slowdown, there was no change in the extent of sources raised by the private sector by the end of 2001:III. During the first three quarters of the year the banks, the stock markets, and nonbanking financial intermediaries made NIS 55 billion available to the public in annual terms, the same as in 2000. However, the composition of the financial intermediaries from which the sources were raised did change: most notable is the increased share of the banks and decline in that of world stock markets and hedge funds. During the year the rise in the share of long-term investment in the public's asset portfolio has continued, but as of 2001:III, as real short-term interest declined to a level below that of long-term interest, this trend should reverse. The General Share-Price Index was 25 percent lower on average in the period reviewed than in the equivalent period in 2000 (Table 9), after a continuous decline in the first three quarters of 2001. In 2001:IV it rose slightly. The yield to maturity on 5- and 10-year bonds also fell in the first three quarters, and stabilized in the fourth.