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# RECENT ECONOMIC DEVELOPMENTS\*

## Main developments

The economic indicators relating to the first half of 2002 (henceforth, the period reviewed) show that the economic recession continued. The relevant data do not yet enable the claim to be made that the level of activity has stabilized, but it appears that the rate of deterioration has eased. The rate of unemployment rose slightly to 10.6 percent, manufacturing exports showed no change of any significance, while manufacturing production and imports of intermediates increased somewhat.

Economic policy underwent a number of important developments in the period reviewed. The Bank of Israel cut the interest rate by 2 percentage points at the end of December 2001, with the intention of combining monetary expansion with more rigorous fiscal discipline. This reduction caused a sharp depreciation of the NIS, a rise in inflation and inflation expectations, and a change in the public's asset portfolio—increased liquidity, and a switch from local-currency deposits to foreign-currency-indexed ones. When it became apparent that the budget approved in February contained no changes that would ensure the attainment of the deficit target of 3 percent of GDP, and against the background of the deterioration in the security situation, depreciation started again at the beginning of 2002:II, inflation expectations rose to above the target range, and the level of uncertainty in the financial markets rose too. This led the Bank of Israel to raise the interest rate three times in June, by a cumulative 4.5 percentage points. The rise in the interest rate together with the approval of the changes to the budget at the beginning of June which indicated the imposition of more rigid fiscal discipline despite the rise in the deficit target for 2002, resulted in real appreciation from the middle of June, and brought inflation expectations back down to the upper limit of the target range.

In addition to the effects of the changes in economic policy in the period reviewed, the economy suffered from the security situation and its deterioration in March, with the rise in the number of terrorist attacks and the launch of Defensive Shield operation. The global economy continued its recovery, but in view of the adjustment processes taking place in advanced

industries, the recovery is concentrated for the time being in traditional industries, which account for only a small share of Israel's exports. The most recent events in the world's capital markets are apt to slow down the recovery in the global economy. Furthermore, according to the latest available data, the recovery in the US seems to be somewhat slower than previously expected.

The marked slowing down of the deterioration in economic activity in 2002:I was helped by increased public and private consumption and the rise in exports, and by the relatively moderate decline in investments. Supply factors which could have boosted activity included the continuing fall in fuel prices and prices of other imported intermediates (excluding diamonds), and the rise in the input of Palestinian labor. On the other hand, the number of permits issued for foreign workers was reduced. Business-sector product went down slightly in 2002:I, and although GDP rose, the increase was led by a rise in public and private consumption, a fact which calls into question the possibility of maintaining the increase. The sparse data available relating to 2002:II also raise doubts as to whether the elements supporting activity will continue: imports of consumer goods and total goods exports fell, while imports of intermediates stood still. The rise in the number of reservists called up due to the Defensive Shield operation, and the subsequent drop in the number of Palestinian workers as a result of the worsening security situation may lead to supply-side difficulties. Capital goods imports rose, however, and the real depreciation of the NIS is expected to encourage exports, particularly of the traditional industries, and to improve the ability of domestic production to compete against imports.

The business sector continued to react to the recession by cutting the number of employees and reducing the real wage. This was especially notable in industries suffering from the weakness of the high-tech market worldwide (for example, the business services industry) and in industries affected by the security situation (hotels and catering). The number of public-sector employees continued to grow, but the real wage in the sector went down slightly in January–April compared with the last four months of 2001. While on the one hand the decline in the real wage is likely to lower demand and thereby lead to further contraction of activity, the sharp fall in the real wage in the business sector, which was reflected in

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

Table 1. Indicators of Business Activity, 2000–2002  
(all data excluding construction are seasonally adjusted)

	2000	2001	2001			2002		Jan–Jun*		**
			II	III	IV	I	II	2001	2002	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	5.4	-4.8	-8.1	-7.2	-1.4	-0.3	-3.9	2.4	-4.2	6
Large-scale retail trade	10.3	4.0	8.2	-1.3	0.6	-3.8	-1.4	6.2	-0.3	6
Manufacturing production (excl. diamonds)	9.9	-4.8	-16.1	-8.4	-4.5	0.2	5.7	0.6	-5.9	5
Business-sector consumption of electricity	7.4	2.2	8.2	1.0	-1.0	-3.3	4.5	2.6	0.6	5
Index of revenue in commerce	9.7	0.3	-2.3	-5.4	0.4	-7.5	-4.2	4.2	-4.4	5
Index of total revenue	11.3	1.7	-2.0	-4.4	2.1	-3.7	-7.7	5.6	-2.9	5
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	3.6	-50.1	-10.2	-11.9	-16.4	-1.3	-27.0	-49.8	-40.5	6
Immigrant arrivals	-21.6	-27.6	-16.4	32.0	-11.8	-30.7	-2.2	-23.9	-27.7	5
Residential starts	18.6	-30.3	-20.1	5.5	9.8	5.6		-25.7	-2.2	3
of which:										
Government-initiated	51.2	-51.7	-42.7	35.3	14.2	-12.7		-25.6	-22.7	3
Residential completions	-6.5	-13.8	-20.8	44.3	13.5	-3.6		-31.2	25.0	3
of which:										
Government-initiated	-38.1	-18.6	-6.7	54.7	6.3	-6.5		-29.3	43.5	3
Survey of companies (percent) <sup>a</sup>										
Output of manufacturing firms (not adjusted)	11	-15	-16	-20	-18	-13	-3 <sup>b</sup>			6
Output of manufacturing firms (adjusted)	11	-15	-18	-24	-18	-5 <sup>b</sup>	-5 <sup>b</sup>			6
Sales by commerce firms (not adjusted)	5	-24	-33	-30	-23	-48	-42			6
Sales by commerce firms (adjusted)	4 <sup>b</sup>	-24 <sup>b</sup>	-35	-38	-15 <sup>b</sup>	-44	-44			6

\* Compared with same period in preceding year.

\*\* Last month for which data available.

<sup>a</sup> The net balance is defined as the difference between the number of firms reporting a rise and those reporting a decline, as a proportion of all reporting firms.

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

2002:I by a reduction in unit labor cost, may be expected to moderate the adverse effect on employment.

In 2002:I exports of the advanced industries expanded, but they fell again in 2002:II. The rise in these exports in the first quarter accounts for the temporary increase in total goods exports (excluding diamonds) in that quarter. In contrast, exports of the traditional industries showed a marked rise in 2002:II, possibly due to the real depreciation. The trade deficit continued to increase in the period reviewed, despite the several factors that might have helped to reduce it, such as the recession in Israel, real depreciation, and the improvement in the

terms of trade in 2002:I. The security situation and the position in the high-tech industries contributed to the reduction in direct investment in Israel (although short-term investment by nonresidents did increase). Investment abroad by Israelis rose significantly.

The data regarding the implementation of the budget during the first half of the year indicated a considerable deviation from the government's target deficit, due mainly to a drop in revenues. Towards the end of the period several steps were taken intended to tighten fiscal discipline, restore confidence in the government's commitment to meet the deficit targets and prevent the downgrading of Israel's credit rating. The steps consisted

mainly of budget cuts and tax increases approved by the Knesset at the beginning of June, and the law to restrict private legislation, which was approved in mid-July. Concomitant with these measures, the government decided to increase the deficit target to 3.9 percent of GDP, which will raise the public debt and the future tax burden.

At the end of July the Knesset approved the recommendations of the Rabinowitch Committee for Tax Reform, the main ones being the imposition of a tax on individuals' capital income, the gradual reduction of taxes on labor income, and the reduction of the differentials between tax on capital income in Israel and abroad. Among other things, these changes will reduce the discrimination in Israel between taxation on capital and that on labor. The full implementation of the proposals, however, is expected to create a deficit in financing the reform in the next few years.

The stabilization of the financial markets, appreciation of the NIS, and the lowering of inflation expectations at the end of June were achieved, as stated, by a steep rise in the interest rate and by taking steps to reintroduce fiscal discipline. Further fiscal adjustment is important in order to prevent renewed depreciation and a rise in inflation expectations. This would also help to reduce long-term interest and would enable the Bank of Israel's key interest rate to be cut. Such a process would prevent real interest from remaining at a high level, where it is likely to have an adverse effect on economic activity.

## The principal industries

National Accounts data show that GDP increased in 2002:I after falling in three successive quarters (Table 2). The increase derived largely from the significant rise in public, mainly defense, consumption for the second quarter in succession, Business-sector product, on the other hand, continued to decline, albeit far more slowly than in the previous three quarters. The reasons for this moderation in the fall of business-sector product do not provide a firm basis for a future recovery: the rise in exports, the first in six quarters, was related to diamond exports, whereas exports excluding diamonds went down slightly in 2002:I; the rise in private consumption is likely to be temporary; and investments continued to fall. Exports of both goods and services dropped. Services exports excluding tourism and start-ups fell too in 2002:I. This latter reflects the adverse effect on exports of advanced services such as software which started in 2001:II, so that it is not only start-ups which are affected, but more firmly established companies too. Although private consumption increased in 2002:I, it did so by the same amount as its decrease in the previous quarter, so that it hardly changed from its level in 2001:III. Consumption of durables, which is likely to give a more accurate reflection of consumers' expectations regarding their economic situation in the future than does current consumption, continued to decline for the fourth successive quarter. The reduction in consumption

Table 2. National Accounts, 2000–2002  
(seasonally adjusted)

	2000	2001	2001			2002		Jan–Jun*		**
			II	III	IV	I	II	2001	2002	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	6.4	-0.6	-3.2	-5.2	-6.6	2.4		1.9	-3.2	3
Business-sector product	8.5	-1.9	-6.2	-6.6	-9.9	-1.1		1.3	-6.0	3
Business-sector product excl. start-ups	5.7	-0.6	-2.5	-4.4	-9.6	-0.9		-0.2	-4.4	3
Private consumption	6.6	3.3	2.2	4.5	-5.3	5.4		5.9	1.6	3
Gross domestic investment	-3.5	-3.9	-33.9	-26.2	-43.4	-7.3		5.7	-28.9	3
Gross domestic investment excl. start-ups	-7.4	-6.2	-27.0	-23.1	-32.1	-12.4		-1.8	-24.0	3
Goods and services exports	23.9	-11.0	-20.7	-16.9	-1.6	3.5		1.5	-9.5	3
Goods and services exports excl. start-ups and diamonds	19.7	-6.2	-17.4	-15.0	-8.8	-2.1		3.7	-11.0	3
Goods and services imports	12.2	-4.4	-14.3	-14.8	-9.3	19.1		5.5	-5.8	3
Public-sector consumption	1.1	2.9	3.0	-17.6	32.9	11.6		1.9	5.9	3

\* Compared with same period in preceding year.

\*\* Last month for which data available.

of durables may, however, have been due to depreciation at the beginning of the year and expectations of appreciation to follow that would bring their prices down again. Current consumption rose relatively steeply. Whereas it is hard to see this as an indication of a recovery since there was an exceptionally severe decline in the previous quarter, and in addition a cut in the real wage generally has a negative effect on consumption, nevertheless the rise in current consumption at the beginning of 2002, as in the first three quarters of 2001, raises the possibility that the sharp fall at the end of 2001 was exceptional, and not a reflection of the recession becoming more severe. Investment in fixed assets continued to fall in 2002:I, continuing along the path it followed in 2001. Goods and services imports rose considerably in quantity, a reversal of the downward path in the previous four quarters. Defense imports went down, meaning that the rise in civilian imports was even more marked, even though part of the increase came from the rise in diamond imports.

The Companies Survey for 2002:II shows that activity declined in most of the principal industries (Table 1). The Survey shows that although exports moderated the decline in activity in 2002:II, they are not expected to do so in 2002:III. Most of the fall in sales in 2002:II was on the domestic side, while exports rose slightly. Domestic orders for 2002:III were down, and so were export orders, but to a lesser degree. The decline in manufacturing output was more moderate than in previous quarters. The fall in activity was mainly in the traditional industries, and this is consistent with the rise in the production index for advanced industries and the drop in the index for traditional industries.

The composite (state-of-the-economy) index indicated that the economy was stable in 2002:I, continuing the trend of the previous two quarters, when the decline in the index slowed. In 2002:II, however, the index dropped again (Figure 2), reflecting a reduction in all its components apart from manufacturing. The drop in goods imports (excluding capital goods) and in the sales revenue index may indicate a fall in demand. The reduction in imports and the rise in production are consistent with real depreciation, although the effect of the latter is not necessarily immediate. The fall in sales revenue in commerce and service industries in April–May was more severe than in the previous quarters, and reflected among other things a decline in business services, including computer services.

The rise in the manufacturing production index in the first five months of 2002 is particularly notable in the light of its continuous and severe reduction in every

quarter since the end of 2000 (Figure 1). Nevertheless, the low level of activity is expressed by the fact that the index in April–May was similar to that in the second half of 1999. The rise in January–April 2002 was mainly in the mixed industries (classified according to their degree of technological innovation), which include chemicals (excluding pharmaceuticals), machinery, electrical equipment, and transport vehicles (excluding planes). Exports of those industries actually went down in the first five months of the year, indicating either a rise in domestic demand for their products or a drop in their export prices; prices of manufacturing exports overall (excluding diamonds) did indeed fall in 2002:I.

The construction industry showed some signs of recovery at the end of 2001, and these became firmer in the first months of 2002. On the demand side this was reflected by the rise in the number of new apartments sold in January–April 2002 compared with the level in the three previous quarters (although this was still lower than the level in 2001:I), and by the rise in the number of sales transactions for new and secondhand apartments in 2002:I compared to each quarter of 2001. The rise in sales is surprising in the light of the deterioration in the economic situation and the fact that the campaign of the Ministry of Construction and Housing designed to increase purchases of apartments had ended at the end of 2001. On the other hand, the reduction in the interest rate at the end of 2001, expectations of depreciation of the NIS, the constant rise in rents for apartments, and later on the expectations of a rise in VAT, all these could be expected to encourage buyers to bring forward their purchases of apartments.

On the supply side there were indications of some awakening of activity in 2002:I, with an increase in the number of building starts from the number in the previous quarter. The previous quarter (2001:IV) had also shown a rise from 2001:III, and this was after continuous declines at the end of 2000 and in the first half of 2001. Some of the increase may have been a correction for the decline in the number of building starts in 2001 to a level significantly below the annual increase in the number of households, in other words, lower than the long-term demand. This differential can also be seen in the persistent fall in the stock of apartments for sale (a fall which continued in the first few months of 2002) and in the number of ‘supply months’ (the number of months in which the stock of apartments would be exhausted at the current rate of sales).

Since the beginning of 2002 both rents and apartment prices have risen. To a great extent the rises reflect the sharp depreciation of the NIS, as prices of apartments

(mainly secondhand) and rents are usually quoted in dollars, and are therefore greatly affected in the short term by changes in the exchange rate. The rise in apartment prices followed a persistent decline over the previous two years. Apartment prices were apparently also affected by the drop in the interest rate, which is likely to boost demand. Nonetheless, the rate of increase in January–May, which was slower than the depreciation over the same period, may indicate that demand is still weak.

In 2002:I (before Operation Defensive Shield) incoming tourism dropped relatively slightly, but in 2002:II the persistent downward trend of the previous quarters was renewed. The Companies Survey also shows reductions in bookings for 2002:III. One of the outcomes of the collapse of incoming tourism is that the tourist industry has almost stopped being an export industry, and is currently dependent on domestic demand. In January–June 2002 foreign tourists accounted for only 17 percent of total hotel bed-nights, compared with 25 percent in 2001 and 48 percent in 1999. Figure 5 shows this development clearly. The rise in bed-nights of Israelis, however, offset only a small part of the effect of the decline of tourism on the industry's revenue: in 2002:I hotels' revenue from foreign tourists was almost 40 percent lower than the equivalent quarter in 2001, while that from Israelis was stable. Since bed-nights of Israelis rose by 10 percent in that period, this means that they benefited from reduced prices. In 2002:II bed-nights of Israelis went down, after rising in the previous two quarters.

### The labor market

In 2002:I the labor market reflected the situation outlined above regarding the slower deterioration in the economy. The trend of the previous quarters continued, i.e., the decline in the number of employed persons in the business sector and in their wage, and an increase in the number in the public sector. The public sector offset about half of the effect of the business sector on the rise in unemployment in 2002:I. In this the public sector is in practice adopting an anti-cyclical policy, which slightly reduces the effect of the recession on the labor market, but makes it more difficult to maintain fiscal discipline.

The slowing of the downward spiral in the labor market was reflected by the fact that the decline in the number of employed persons in the business sector in 2002:I was smaller than that in the previous two quarters, and the number of hours worked actually increased after falling in the previous two quarters. The number of work-seekers shows a similar pattern: the rise in January–June was slower than the rise in the previous quarters. The

extensive call-up of reservists at the end of March and the increased demand for security guards may have reduced the number of work-seekers.

The slower decline in employment in the business sector was supported by changes in the area of wages. The 2.3 percent reduction in the real wage in January–April 2002 was far steeper than the fall in the third and fourth quarters of 2001. The real wage in the public sector went down by 0.3 percent in January–April, after declining in 2002:IV. The rise in the labor cost per hour in the business sector had moderated greatly in the course of 2001, but due to the sharp decline in product per man-hour, unit labor cost had risen. This was not the case in 2002:I, when product per man-hour dipped only slightly, thus contributing to the first drop in unit labor cost in the business sector in almost two years (Table 3). It may be assumed that the unexpected rise in the rate of inflation from the beginning of the year contributed to the decline in the real wage. The rise in inflation has resulted in renewed discussions on a cost-of-living allowance, which would slow down the reduction in the real wage.

The rate of unemployment continued to rise in 2002:I, but more slowly than in the previous two quarters. Based on trend data unemployment in the first five months of 2002 reached 10.6 percent; it was unchanged in March and April, and declined in May. The last time this figure fell was in November 2000, but as the labor market reacts with a lag to developments in the economy, and the processes of adjustment in the business sector have not run their course, unemployment may be expected to continue to rise. The depth of unemployment worsened in 2002:I the share in the total number of unemployed persons of those seeking work for more than 27 weeks rose, as did the share of those who had not worked during the previous 12 months.

The slower rise in unemployment is especially notable in the light of the small rise in the participation rate at the beginning of 2002, which was more than the average rate of any of the previous years. Thus, despite the recession, the trend of a modest increase in the participation rate is persisting, reflecting essentially a rise in the participation of women. Apart from the long-term trend, the reduced possibilities of employment facing men may spur women into joining the labor force, i.e., raising their rate of participation, despite the fall in the wage and the difficulty in finding work. In the last few years unemployment among women has exceeded that among men by one percentage point; in 2001 this gap narrowed due to the faster rise in unemployment among men, and in 2002:I the unemployment rates for men and women were almost the same. The relatively greater

Table 3. Indicators of Labor Market Developments, 2000–2002  
(seasonally adjusted)

	2000	2001	2001			2002		Jan–Jun*		**
			II	III	IV	I	II	2001	2002	
	('000s)									
Civilian labor force	2,433	2,499	2,488	2,512	2,520	2,541		3.4	2.6	3
Israelis employed	2,216	2,265	2,270	2,272	2,259	2,271		3.8	0.4	3
Business sector	1,554	1,574	1,587	1,581	1,555	1,553		2.4	-1.2	3
General government	662	692	686	694	702	715		6.1	4.4	3
Average hours worked per employee	38	37	37	37	37	37		-1.6	-0.3	3
Business sector	41	40	40	39	39	40		-1.4	0.7	3
General government	31	31	31	30	30	31		-0.3	0.2	3
Labor input of Israelis employed	83,918	83,767	84,887	83,591	82,679	84,012		2.1	0.1	3
Business sector	63,300	62,609	64,129	62,431	60,946	62,621		0.9	-0.5	3
General government	20,609	21,146	21,456	20,786	21,211	22,105		5.8	4.6	3
Claims for unemployment benefit	106	118	111	124	127	129	130	3.6	17.9	6
Work seekers	166	186	181	194	200	204	206	7.2	16.8	6
Real wage per employee post (NIS) <sup>a</sup>	4,558	4,677	4,730	4,658	4,611	4,552	4,464	4.7	-4.0	4
of which: Business sector	4,688	4,802	4,832	4,766	4,749	4,619	4,591	4.5	-4.6	4
Unemployment rate (%)	8.8	9.3	8.8	9.6	10.4	10.6				3
	Rates of change (percent)									
	Compared with preceding year		Compared with preceding quarter				Compared with equivalent period last year			
Business sector										
Labor cost per hour worked	5.0	3.9	-1.6	1.0	-0.6	-1.7		7.3	-2.7	3
Labor productivity	6.1	-0.3	-4.1	-1.5	-2.0	-0.7		8.8	-8.0	3
Unit labor cost	-0.9	4.0	2.1	2.3	1.1	-0.3		1.3	5.8	3

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

\*\* Last month for which data available.

<sup>a</sup> At 1994 prices.

adverse effect on men may be connected both to the fact that the number of employees in the business sector has fallen while in the public sector it has risen, and to the industry composition of the widespread lay-offs.

An examination of the labor market by industry shows that the whole economy suffered from the recession, but worst hit were the industries directly affected by the main difficulties—the security situation and the worldwide weakness in high-tech industries. The fall in the real wage in the business sector in 2002:I compared with 2001:I encompassed all industries, but was most marked in the business services industry, which includes computer services and R&D. Business services and hotels and catering (which suffered from the slump in

demand of foreign tourists and Israelis with the increase in the number of terrorist attacks) showed a very large drop in the number of employee posts, but so did manufacturing and agriculture. In business services the large drop in the real wage relative to the decline in the number of employed persons was marked, possibly because this section of the labor market is more flexible. No signs of stabilization in the business services industry are evident yet: the decline in the number of employed persons in 2002:I was more severe than that in the previous two quarters. The share of employed persons in this industry in the total number of employed persons in the economy went down for the third successive quarter, and reverted to its level at the end of 2000.

## RESEARCH DEPARTMENT

The number of permits for foreign workers was cut by about a quarter at the beginning of 2002. It has nonetheless risen by about 10 percent in January–May, and the number is now about 79,000. Labor input of foreign workers (including illegal ones, and excluding workers from the Palestinian Autonomy) fell a little in 2002:I, after three years in which it had fallen in only one quarter. The input of Israelis, on the other hand, rose in 2002:I, unlike in the previous two quarters. Despite the reduction in the input of foreign workers, the total input of non-Israelis increased, and exceeded the rise in the input of Israelis; this was the result of a considerable rise in the number of Palestinian workers at the beginning of 2002 (before Operation Defensive Shield).

### The balance of payments

The deficit on the goods account continued to rise in the first half of 2002, and in 2002:I, in particular, further to its 2001 increase (Table 4). This came in spite of several factors that should have served to stimulate exports and reduce imports in this period, including the global

economic recovery, the slump in Israel, real local-currency depreciation, and the improvement in Israel's terms of trade in 2002:I. One reason for the delay in export recovery is that, in contrast with previous years, current US economic growth is not concentrated in high-tech, communications, and information technology. Another reason appears to be the wariness of economic agents abroad of doing business with Israel because of the exacerbation of the security situation.

Figures for goods exports in the first half of 2002 indicate stability but not recovery. Whereas these exports rose in 2002:I, after falling in the four preceding quarters, this was almost completely offset in 2002:II. The expansion of manufacturing exports (excluding diamonds) in 2002:I stemmed from the rise in high-tech exports, which suffered a serious setback in 2001, but exports of this industry declined again in 2002:II. The exceptional increase in exports of the traditional industries in 2002:II contrasts with the fall in high-tech exports in that quarter, and may have been due to real depreciation *inter alia*. Exports of traditional and mixed industries account for about one quarter of total manufacturing exports.

**Table 4. Balance of Payments, Foreign Trade,<sup>a</sup> and the Reserves, 2000–2002**  
(\$ million, current prices)

	2000	2001	2001			2002		Jan–Jun		*
			II	III	IV	I	II	2001	2002	
<b>Monthly averages</b>										
Trade deficit	309	308	285	322	336	347	349	286	348	6
Goods imports	2,093	1,984	1,998	1,939	1,877	1,904	1,892	2,060	1,898	6
Consumer goods	376	388	369	387	383	396	354	391	375	6
Capital goods	493	498	510	498	461	444	474	517	459	6
Intermediates	1,221	1,096	1,118	1,053	1,031	1,062	1,062	1,150	1,062	6
Goods exports	1,784	1,676	1,713	1,617	1,540	1,557	1,544	1,774	1,550	6
Manufacturing	1,723	1,620	1,648	1,562	1,492	1,511	1,488	1,713	1,499	6
High-tech	920	834	818	817	721	762	736	899	749	6
<b>Quarterly averages</b>										
Net current account	-494	-463	-944	-1,383	690	-710		-579		3
Financial account (excl. foreign-currency balances)	927	-119	25	473	-583	36		-183		3
Nonresidents' direct investment	1,131	806	874	670	581	-183		987		3
Nonresidents' portfolio investment	1,271	72	601	-424	-560	774		637		3
Residents' direct and portfolio investment	1,150	671	804	669	840	1,721		587		3
Net foreign debt (% of GDP)	5.34	2.89	3.06	2.55	2.95	2.04		3.19		3
End-period Bank of Israel reserves	23,164	23,181	23,074	24,478	23,181	23,945	24,786	23,074	24,786	6

\* Last month for which data available.

<sup>a</sup> Foreign trade data are seasonally adjusted monthly averages (excluding ships, aircraft, diamonds, and fuel).

Data on goods imports indicate that there was no further deterioration in the period reviewed. The slight rise in goods imports in the first half of 2002 contrasts with their continuous decline during 2001. Imports of intermediates (excluding diamonds) rose in 2002:I and remained unchanged in 2002:II, after falling for five successive quarters. This may indicate the need to renew depleted stocks rather than expectations of increased production. Imports of capital goods, which could reflect manufacturers' expectations of future demand, rose in 2002:II after falling in the four previous quarters. Imports of consumer goods plummeted in 2002:II, though this may be due to the postponement of purchases in the expectation of an exchange-rate adjustment after the sharp depreciation rather than to a worsening of the situation of consumers.

The services account was in deficit in 2002:I, as it was in the three previous quarters, in contrast with the large surpluses in 2000 and at the beginning of 2001. The deficit reflects the continued deterioration in the situation of services exports due to the decline in both incoming tourism and high-tech services exports, whether of start-ups or more established firms, as described above.

Most of the developments on the capital account reflect the shocks to the economy. Foreign direct investment declined sharply in the first half of 2002 relative to the preceding quarters—aggravating the trend evident in 2001. This trend appears to be associated with the security situation, which increases country risk, but is also connected with the state of the global market for high-tech products, in which a great deal of foreign investment in Israel was involved. Total foreign investment was higher in the first half of 2002 than in the second half of 2001, inter alia because of the issuance of government bonds abroad at the beginning of 2002, after a long interval.

Investment abroad by residents, mainly in securities, soared in the first half of 2002. This is probably due to the security situation, expectations that the recession would persist, and a decline in yield spreads. The recommendations of the Rabinowitch Committee on tax reform, namely to reduce the tax differential on residents' capital gains between Israel and abroad, may also have played a part. The development of private-sector net unilateral transfers is also consistent with capital outflow, and in 2002:I they plunged to a lower level than in any other quarter in the last two years.

The net external debt fell by \$ 1.1 billion in 2002:I, amounting to 2 percent of GDP—down by about 1

percentage point from the preceding quarter. This decline has been in evidence for several years.

## Global developments

Growth revived in the advanced economies in the first half of 2002, after the marked slowdown of 2001 that had begun even before the events of September 11 in the US. The rally was led by the recovery of growth in the US, stimulated by a low interest rate, fiscal expansion, and the expansion of private consumption. After the US Federal Reserve reduced interest several times in 2001, it left it unchanged in the first half of 2002. The European recovery has been slower, and will begin to accelerate only in the second half of 2002. As economic recovery becomes entrenched in the US and Europe it is expected that fiscal and monetary expansion there will be gradually reduced for fear of inflationary pressures. Economic recovery is also apparent outside the OECD.

The revival of growth is expected to increase world trade by 2.5 percent in 2002 and to affect goods imports to the OECD countries by slightly less. Both the slow recovery of world trade and the composition of US growth in 2002 will hamper the recovery of Israel's

Table 5. Indicators of Economic Developments in OECD Countries, and Forecast<sup>a</sup>

	2001	Forecast 2002	Forecast 2003
1. GDP			
US	1.2	2.5	3.5
OECD	1.0	1.8	3.0
2. Inflation			
US	2.2	1.5	1.6
OECD (excl. Turkey)	1.9	1.5	1.4
3. Unemployment rate			
US	4.8	5.6	5.3
OECD	6.4	6.9	6.7
4. Short-term interest <sup>b</sup>			
US	3.7	2.3	3.8
Japan	0.1	0.1	0.0
Eurozone	4.2	3.3	3.9
5. Goods imports to OECD	-0.8	2.3	8.2
6. World trade (goods)	0.0	2.5	9.5

<sup>a</sup> Annual rate of change. Excludes interest and unemployment rates, which are presented as levels.

<sup>b</sup> For 3 months.

SOURCE: OECD Economic Outlook, June 2002.

exports. The US rally does not at present encompass high-tech industries such as information and communications technology, which account for a large part of Israel's exports. The process of adjustment and inventory reduction is still continuing in these industries. There is a close connection between US imports (from all over the world) in several high-tech industries and Israel's exports in those industries, and both of these have been particularly hard hit since the end of 2000 (Figure 9). US imports in these industries continued to dip in 2002:I despite the renewal of growth there. Nevertheless, US imports in these industries rallied in 2002:II and Israeli exports of them stabilized. On the investment side, the more cautious attitude to the high-tech industry adopted by foreign investors also impairs the ability of Israeli high-tech firms, including start-ups, to raise capital, as is indicated by the fall in foreign investment in them after reaching impressive heights in 2000.

Several factors threaten the continued economic growth and the expansion of world trade. First, the series of accounting frauds by huge US corporations could rock the capital market. The significant falls recently recorded in various share price indices reduce the value of households' assets, and could hence hamper private consumption. Second, the decline in oil prices in 2001 is not expected to continue in 2002. Third, protectionist trends are emerging in the US and Europe, expressing pressures to impose protective tariffs (e.g., on steel).

### The public sector

During the period reviewed several important fiscal decisions were made. In February the Knesset approved the budget for 2002. In June it accepted a package of budgetary changes including tax hikes and spending cuts. V.A.T. was raised by 1 percent in mid-June, as were taxes on diesel oil and cigarettes, and regional tax benefits were reduced. The ceiling on health tax and National Insurance payments was annulled, and the government's participation in payroll tax was reduced. The spending cuts included a reduction in the government's consumption budget and in some National Insurance benefits, the introduction of tougher criteria for eligibility for unemployment benefits, and the reduction of housing assistance. Note that the reduction of child allowances paid to persons who have not done military service has not yet been implemented. The deficit target for 2002 was raised to 3.9 percent of GDP, and attainment of a deficit of 1 percent of GDP was deferred to 2007. At the end of the period the government announced its intention of making further

cuts as part of the 2003 budget. In mid-July the Knesset approved a law restricting private legislation. The spending cuts and announcements of additional ones indicate that the government is trying to recoup fiscal restraint and credibility, in view of fears that Israel's credit rating will be downgraded and that local-currency depreciation will accelerate.

The measures adopted in June have conflicting implications for income distribution, growth, and employment. The reduction of benefits and increase in V.A.T. are regressive, but the abolition of the ceiling on health tax and National Insurance payments is progressive. Concentrating the cuts in transfer payments and current expenditure while at the same time refraining from harming infrastructure investment could serve to stimulate growth, but raising taxes could hinder it. The reduction of government participation in payroll tax could depress demand for workers, but cutting transfer payments and imposing tougher criteria for unemployment benefits eligibility could increase the incentive to look for work.

As stated, among the measures recently introduced are tougher criteria of eligibility for unemployment benefits. This is often perceived as a way of reducing unemployment, constituting an incentive to unemployed persons to seek work. In effect, however, since one of the purposes of unemployment benefits is to afford unemployed persons a reasonable period of time in which to look for work commensurate with their skills, cutting this benefit could exert pressure on them to accept unsuitable employment. Mismatching of this kind is inefficient, and represents a loss of product for the economy as a whole and loss of income for the individual. It also increases the probability that the worker will lose his or her new position. It is important to take this consideration into account when discussing further cuts in unemployment benefits in Israel. Furthermore, in view of the low current level of demand for workers, increasing the incentive to look for work will not help significantly as long as there is no reduction in the number of foreign workers. Reducing their numbers will help unskilled Israelis, among whom there is the greatest unemployment.

In June the government accepted the recommendations of the Rabinowitch Committee on tax reform, and these were approved by the Knesset at the end of July. The main points were lower taxes on labor income (primarily among medium-income workers) and higher taxes on residents' capital gains in Israel (some exemptions on income from abroad were also canceled). The reduction

Table 6. The Budget and its Financing, 2000–2002  
(cash flows, as percent of GDP)

	2000	2001	2001			2002		Jan–Jun		*
			II	III	IV	I	II	2001	2002	
1. Government domestic expenditure	36.3	37.8	40.0	37.8	40.1	37.8	39.1	36.7	38.4	6
2. Government receipts	35.8	34.1	34.6	35.9	31.0	35.7	35.5	34.6	35.6	6
3. Domestic budget deficit (1)–(2)	0.5	3.8	5.3	2.0	9.1	2.0	3.6	2.1	2.8	6
4. Government and Jewish Agency domestic deficit <sup>a</sup> (5)+(6)	-0.4	3.1	3.9	2.0	9.1	0.5	4.3	0.8	2.4	6
5. Government net borrowing from the public	0.2	3.7	4.9	1.4	7.5	8.6	4.0	3.0	6.2	6
6. Public-sector injection <sup>b</sup>	-0.6	-0.6	-1.0	0.6	1.6	-8.1	0.3	-2.2	-3.8	6
7. Bank of Israel injection	0.6	1.6	2.0	-2.1	1.4	9.7	0.0	3.7	4.8	6
8. Change in monetary base	0.1	0.9	1.1	-1.6	2.4	1.2	0.0	1.5	0.6	6

\* Last month for which data available.

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

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

of the tax on labor income is intended to increase the supply of labor, and together with the increase in tax on capital gains should also improve net income distribution. Increasing the tax on residents' capital gains in Israel relative to abroad will make it more worthwhile to invest abroad, and could—at least in the short term—create pressure for local-currency depreciation. The reduction of taxation on labor income is supposed to be introduced by stages until 2008. Note that in each of the coming years there will be a deficit in the financing of the reform, and this could undermine the credibility of the commitment to reduce taxes.

The ongoing recession is also reflected in tax receipts, which were 6 percent lower in the first half of 2002 than in the first half of 2001. In contrast with some other indices, tax receipts do not indicate any moderation of the recession, as they declined more steeply in the first half of 2002 than at the end of 2001. The fall in tax revenues reflects a steep drop in direct taxes and a rise in indirect taxes; the latter were affected only partly by the increase in V.A.T., which went into effect only in mid-June. Indirect taxes rose even without the change in legislation, despite the reduction in economic activity—apparently because of the local-currency depreciation and increase in prices.

The measures approved in June will apparently make it possible to attain the new deficit target of 3.9 percent of GDP. Had these measures not been approved, 2002 would probably have ended in a deviation by 1.8–2.2 percent of GDP from the original deficit target of 3

percent, deriving from revenues that were lower than predicted when the original budget (approved in February) was prepared.

## Prices, and the money and capital markets

In the first half of 2002 there was a marked acceleration of price increases and deviation from the inflation target. The CPI rose by 6.3 percent in this period, compared with 1.1 percent in the equivalent period in 2001. The inflation rate rose after declining in each of the three previous quarters. The rate of price increases in 2002:II was higher than in 2002:I.

The dominant feature of the development of prices in the period reviewed was the sharp 15.5 percent local-currency depreciation against the dollar. Inflation rose despite the recession and drop in dollar prices of exports and imports in 2002:I. The high level of the CPI in June was also the result of the increase in V.A.T. in the middle of the month. There was a particularly steep rise in the housing price index (13.6 percent, more than twice as much as in the CPI as a whole) in the period reviewed. This is only slightly below the local-currency depreciation evident since the beginning of the year, and reflects the fact that rental contracts are generally denominated in dollars. Adjusted for housing, controlled prices, and goods whose prices are affected by seasonal factors (fruit and vegetables, and clothing and footwear), the CPI rose by 5.4 percent.

Table 7. Selected Price Indices, 2000–2002  
(annual rates of change during period, percent)

	2000	2001	2001			2002		Jan–Jun		*
			II	III	IV	I	II	2001	2002	
CPI	0.0	1.4	6.6	3.6	-2.3	9.8	16.3	2.2	13.0	6
CPI excl. housing, fruit and vegetables	0.9	0.2	6.6	0.4	-2.4	3.2	16.3	1.4	9.6	6
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	0.6	0.2	5.9	1.1	-4.4	6.3	15.9	2.1	11.0	6
Index of housing prices	-2.4	5.2	1.6	12.6	-0.4	36.7	21.9	4.4	29.1	6
Wholesale price index	2.0	-1.9	5.0	-5.5	-2.7	7.6	15.9	0.3	11.7	6
NIS/\$ exchange rate	-2.7	4.8	-0.2	16.3	-4.3	41.6	25.7	4.0	33.5	6
NIS/currency-basket rate	-6.3	3.7	-6.3	24.6	-7.4	38.2	39.2	0.2	38.7	6

\* Last month for which data available.

At the end of December the Bank of Israel slashed its key interest rate by an exceptional 2 percentage points, in the framework of an agreement whereby the government would restore fiscal discipline so that the deficit in the 2002 budget would be 3 percent of GDP. In the wake of the interest-rate cut there was sharp local-currency depreciation in January and February, amounting to 9 percent vis-à-vis the dollar. In March the Bank of Israel raised the interest rate by 0.6 percentage points, and the exchange rate stabilized. The accelerated depreciation was renewed in April, amounting to 7 percent by the second week of June. The growing deviation from the deficit target, difficulties in imposing fiscal discipline, e.g., the inability to curb private legislation, and the exacerbation of the security situation led to the revival of depreciation and a sharp increase in inflation expectations, alongside departure from the inflation target. The depreciation and rise in inflation expectations were not checked even though the security situation became calmer in the weeks following the Defensive Shield campaign, there was an interest-rate hike at the end of May, and changes to the budget were approved by the Knesset at the beginning of June. Another two interest-rate hikes—in the middle and at end of June—were required in order to reverse the trend and lead to significant appreciation, with a notable decline in inflation expectations. The appreciation and the decline in inflation expectations continued throughout July, too, and towards the end of the month expectations reached the upper limit of the target range (1–3 percent). These processes reflect the efforts invested in restoring the credibility of economic policy. The interest-rate hikes implemented by the Bank of Israel in the period reviewed amounted to 5.3 percentage points, 4.5 of them in June. Thus, at the end of the

period the interest rate was 3.3 percentage points higher than just before the large interest-rate reduction, and thus reverted to its level in August 2000. The US Federal Reserve rate remained unchanged throughout this period, so that the Bank of Israel's interest-rate changes were expressed in equivalent changes in the interest-rate differential vis-à-vis the US.

Even though the interest rate (and the differential) was, as stated, significantly higher at the end of the period reviewed than at the beginning, when it was reduced, and in spite of the changes to the budget made in June, the exchange rate was still significantly higher at the end of July than before the interest-rate cut. The factors which might serve to keep the exchange rate at a higher level in 2002 than in 2001 despite the widening of the interest-rate differential include the following: the fact that the deficit target has been raised, the security situation has deteriorated, the credibility of economic policy and its ability to attain its declared targets has been undermined, Israel's exports are encountering difficulties, foreign investment in Israel is declining for reasons (given above) not connected with the interest rate, and possibly also the impact of the recommendations of the Rabinowitch Committee on tax reform which, as stated, make it more worthwhile to invest abroad. It is reasonable to assume that downward price rigidity will also hamper the return of the nominal exchange rate to its previous level.

At the end of the period reviewed the nominal changes were translated into real depreciation. While real depreciation was far smaller than nominal depreciation, it marks a deviation of the trend of local-currency appreciation that has been in evidence in recent years. The extent of real depreciation is illustrated by the fact

Table 8. Monetary Indicators and Nondirected Bank Credit, 2000–2002  
(annual terms, percent)

	2000	2001	2001			2002		Jan–Jun		*
			II	III	IV	I	II	2001	2002	
Rates of change	Average		Compared with preceding quarter					During period		
M1 <sup>a</sup>	11.0	14.2	21.7	28.3	4.6	50.7	9.7	13.1	26.4	6
M2 <sup>b</sup>	20.0	17.2	12.8	14.9	14.2	-11.2	-2.2	15.0	-8.4	6
M3 <sup>c</sup>	16.9	15.5	11.3	13.3	13.1	-0.6	7.3	14.7	3.6	6
Nondirected bank credit	13.1	10.8	9.5	12.7	8.1	9.6	14.7	10.0	14.0	6
Unindexed local-currency credit	25.2	15.0	10.5	7.8	6.3	0.3	3.3	14.2	1.9	6
CPI-indexed credit	6.9	4.7	6.2	13.8	9.6	1.0	9.3	5.0	5.9	6
Foreign-currency-indexed and denominated credit	9.5	15.7	13.3	17.9	8.2	39.1	39.2	12.5	45.8	6

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

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

<sup>b</sup> M1 plus unindexed time deposits (up to one year) plus SRO deposits.

<sup>c</sup> M2 plus deposits in and indexed to foreign-currency, and deposits indexed to the CPI (up to one year).

that the data for the third week of July indicate cumulative depreciation of 10 percent since December, whereas the CPI rose by 6.3 percent from December to June. The entrenchment of real depreciation could stimulate exports and economic activity. The marked rise in real interest could impair activity, however. A return to a declining budget deficit path could contribute to both the entrenchment of real depreciation and the creation of the conditions for the reduction of the real short-term interest rate.

The narrowing of the interest-rate differential between Israel and abroad, expectations of depreciation, and increased uncertainty in the markets have all given rise to changes in the composition of the asset portfolio, with an increase in liquid assets and diversion of assets from unindexed local-currency deposits to those denominated in or indexed to foreign currency (as well as to a rise in investment abroad by Israelis, as described above). The rate of expansion of the narrow money supply (M1) rose sharply in 2002:I, following the interest-rate cut, but

Table 9. Interest Rates, Yields, and the Share-Price Index, 2000–2002

	2000	2001	2001			2002		Jan–Jun		*
			II	III	IV	I	II	2001	2002	
Nominal interest										
Nondirected local-currency credit	12.9	10.0	10.3	9.6	9.2	7.4	7.8	10.8	7.6	5
Average monetary loan	9.3	6.7	7.0	6.2	5.8	3.7	4.9	7.3	4.3	6
SRO deposits	8.0	5.6	5.9	5.2	4.7	3.1	2.4	6.2	2.7	6
3-month Eurodollar	6.4	3.7	4.1	3.3	2.0	1.8	1.8	4.6	1.8	6
Yield to maturity on										
Treasury bills	8.8	6.5	6.6	6.4	5.7	4.8	7.2	6.9	6.0	6
10-year bonds	5.5	4.9	4.9	4.6	4.6	4.1	5.3		4.7	6
5-year bonds	6.0	4.9	5.0	4.3	4.5	3.2	4.4	5.4	3.8	6
General Share-Price Index (points)	248.6	197.5	196.5	194.7	196.1	199.6	183.4	199.5	191.5	6
Expected inflation (gross)	2.6	1.9	1.6	3.0	1.2	2.9	4.2	1.8	3.5	6
Interest derived from expected inflation (gross)	6.0	4.3	4.8	3.4	4.1	2.1	3.4	4.9	2.7	6

\* Last month for which data available.

declined again in 2002:II. Another expression of asset portfolio adjustment is the marked contraction of M2 while M3 remained stable in 2002:I and rose in 2002:II.

Following the reduction of the Bank of Israel's key interest rate, yields on medium- and long-term bonds dipped slightly, but soon began to rise beyond their level in December. This appears to reflect the relaxation of fiscal discipline and the worsening of the security situation.

The general share-price index rose by less than 2 percent in 2002:I, after rising moderately in the previous quarter and declining continuously (albeit at a pace that has become progressively slower) since the end of 2000. The rise in this index at the end of 2002:I is in line with the interest-rate reduction. The index declined further and at a faster rate in 2002:II, and its low level indicates pessimistic expectations regarding the economic situation as well as the influence of share indices abroad.