RECENT ECONOMIC DEVELOPMENTS*

Main developments

Between October 2002 and March 2003 (the period reviewed) the recession persisted. This was due to the continuation of the Intifada and the contraction of global demand, especially in the high-tech industry. The recession is reflected in the decline in the composite (State-of-the-Economy) index throughout the period reviewed, as well as in the Bank of Israel's Companies' Survey for 2003:I, with a continued slowing of real economic activity in all the principal industries. Although export data and the manpower survey for 2002:IV indicate some recovery, the data for 2003:I are not encouraging, Manufacturing exports constitute the only area which has expanded in the period reviewed, though the pace at which they have grown has slowed in recent months. According to labor market indicators, employment has deteriorated since the beginning of 2003, as reflected by the trend rise in unemployment and the number of job-seekers, alongside the decline in the number of employee posts. These developments indicate that the improvement in 2002:IV was only temporary, and did not persist in 2003:I. In contrast with these developments, the improvement in the political-security situation with the ending of the war in Iraq and the decision by the US government to grant the loan guarantees led to a rally in the capital markets, local-currency appreciation, and the reduction of inflation expectations. It is still too early to tell whether these developments signal a turnaround in real economic activity, however.

Fiscal developments indicate that the government's budget deficit is growing, primarily because of the ongoing decline in tax receipts, which is not expected to be reversed in the near future. If this trend continues and expenditure is not cut drastically the deficit could reach 6 percent of GDP in 2003, with an ongoing increase in the public debt/GDP ratio, thereby imperiling financial stability. After the new government was formed in mid-March 2003, the Ministry of Finance published its economic plan, which was approved by the government. The plan incorporates short-term policy measures aimed at curbing the expected deviation from the deficit target, and the implementation of changes whose impact on government expenditure will be felt in the long run. If implemented in full, the plan is expected to reduce the deficit to slightly more than 5 percent of GDP in 2003, but most of its effect will be expressed in the declining path of the government deficit and the public debt in the years ahead. Nonetheless, if decisions are of a temporary nature, this effect on the deficit and the debt in the future is not assured either.

Real economic developments during the period reviewed were affected to a great extent by global developments. Since the beginning of 2003 the recovery of the world economy, and the US in particular, has been slowing, in contrast with the signs of a rally in 2002:IV. This was expressed in the rising unemployment rate and steep fall in indices of consumer confidence in western countries at the end of 2003:I. Apprehensions regarding the war in Iraq were reflected in rising oil prices and the downward adjustment of forecasts of economic activity by international entities.[1] The decline in expectations of recovery in the leading economies could lead to a fall in Israel's export growth, which is an engine of its economic growth.

The CPI rose moderately during the period reviewed, but at an uneven pace. Prices fell by 0.4 percent in 2002:IV and rose by 0.8 percent in 2003:I in the context of the shifts in the exchange rate in the period reviewed. The backdrop to local-currency appreciation in 2002:IV was the start of talks with the US about guarantees for borrowing abroad and the reduction of interest rates in the US and Europe. Fears regarding the war in Iraq and the increase in Israel's risk premium led to a trend shift in the exchange rate and to depreciation, which continued until mid-March. The rapid conclusion of the military campaign in Iraq in April, the publication of Israel's economic plan, and the approval of the loan guarantees by the US Congress supported the reduction of Israel's risk premium; all these factors led to the strengthening of the NIS in April, a steep rise in share prices, a decline in nominal yields on bonds, and a drop in the inflation environment. In view of these developments the Bank of Israel lowered its key interest rate for April and May by a cumulative 0.5 percentage points.

The principal industries

According to most indicators, domestic economic activity remained moderate and even declined further.

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

[1] After US forces took control of the oil wells in southern Iraq oil prices returned to their previous level.

Table 1. Indicators of Business Activity, 2001–2003

(all data excluding construction are seasonally adjusted)

			2002				2003	Jan–Mar *		
	2001	2002	I	II	III	IV	I	2002	2003	***
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	113.9	109.4	-2.5	-4.3	-4.1	-3.6	-2.6	-4.4	-3.6	3
Large-scale retail trade	3.9	-2.5	-5.1	-1.9	-9.5	-2.9	-5.7	0.7	-5.0	3
Manufacturing production (excl. diamonds)	-4.6	-3.0	0.5	2.5	-5.4	1.5	1.7	-8.2	-0.1	2
Business-sector consumption of electricity	2.3	3.5	0.1	10.5	12.9	-1.2	-2.1	4.0	5.1	2
Index of revenue in commerce	0.1	-3.1	-10.7	-1.7	1.5	-3.9	8.2	-1.8	-2.2	2
Index of total revenue	1.7	-2.0	-5.3	-2.3	-4.2	0.7	1.1	-0.7	-2.6	2
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	-50.5	-27.9	-0.3	-18.0	17.3	10.6	-27.4	-38.7	-8.3	3
Immigrant arrivals	-27.6	-23.0	-30.7	-1.7	27.0	-0.8	-49.0	-33.5	-20.8	2
Residential starts	-31.3	-0.8	9.3	-9.5	0.9	-18.8		-20.8	-19.3	1
of which: Government-initiated	-50.9	-5.5	-7.3	13.4	-30.9	-2.8		-42.4		1
Residential completions	-10.1	-2.7	-12.6	-8.7	4.2	-22.3		38.3		1
of which: Government-initiated	–17.7	19.5	-4.9	-13.1	41.4	-37.2		30.1		1
Survey of companies (percent)[a]										
Output of manufacturing firms (not adjusted)	-15	-10 **	-13 **	0 **	-13	-16	-23			3
Output of manufacturing firms (adjusted)	-14	-10 **	-7 **	-3 **	-15	-16	-19			3
Sales by commercial firms (not adjusted)	-24	-32 **	-48 **	-40 **	-19	-20	-31			3
Sales by commercial firms (adjusted)	-24	-32 **	-43	-40 **	-26	-18	-27			3

* Compared with same period in preceding year.
** Not significant at 5% level.
*** Last month for which data available.
[a] 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.

Manufacturing exports rose, however, constituting the only sector which has expanded since the beginning of the period reviewed, though this trend has moderated in recent months.

National Accounts figures for 2002:IV show that business-sector product was down by 1 percent from 2002:III (in annual terms, seasonally adjusted), and that on the uses side, gross domestic investment fell by 10 percent. A more detailed analysis of investment reveals that investment by the business sector in fixed assets and by the private sector in residential construction declined while inventories remained stable. There was an impressive rise in exports of goods and services, however, after these had declined in 2002:III, and exports returned to their 2001:I level in volume terms. Private consumption expanded in 2002:IV, after declining in 2002:II and 2002:III. The picture is reversed—contraction in 2002:IV and expansion in the two previous quarters—as regards general government consumption, mainly because of defense consumption. Nondiamond civilian goods imports continued to decline, and were down by 3 percent in 2002:IV from 2002:III (annual terms).

The main reason for the contraction of investment in machinery and equipment in manufacturing was the decline

Table 2. National Accounts, 2001–2002
(seasonally adjusted)

			2002				2003	Jan–Mar *	
	2001	2002	I	II	III	IV	I	2002	**
Rates of change (annual averages, percent, constant prices), compared with preceding quarter									
GDP	-0.9	-1.0	1.5	-0.7	-0.2	0.1		-3.2	12
Business-sector product	-2.4	-3.1	0.5	-2.3	-0.4	-1		-5.8	12
Business-sector product excl. start-ups	-1.1	-2.1	0.4	-2.5	0.7	-0.2		-3.1	12
Private consumption	2.5	-0.5	0.9	-2.3	-0.8	4.3		0.2	12
Gross domestic investment	-2.6	-10.2	13.1	4.2	4.7	-10		-21.6	12
Gross domestic investment excl. start-ups	-4.8	-7.0	12.6	3.4	-11.9	1.4		-15.9	12
Goods and services exports	-11.7	-3.5	-2.8	5.1	-7.6	11.1		-12.8	12
Goods and services exports excl. start-ups and diamonds	-6.9	-7.8	-11.8	-6.7	5.7	9.5		-12.7	12
Goods and services imports	-4.5	-2.5	2.9	19.4	-14	11.5		-13.2	12
Goods and services imports excl. start-ups and diamonds	-4.2	-6.9	6.3	-5.8	-9.4	-6.7		-13.2	12
Public-sector consumption	3.3	5.3	-0.3	10.9	2.3	-5.7		5.0	12

* Compared with same period in preceding year.
** Last month for which data available.

in capital utilization, possibly reflecting a fall in demand and/or over-investment in the past (Figure 4). As long as utilization does not rise (due to the expansion of demand or the erosion of capital) this investment will not expand. The development of private consumption in 2002 reflects the effects of the business cycle and the assessment that households' disposable income would contract further. The sharp fall in durables consumption alongside the decline in the saving rate expresses cyclical factors, while a drop in current consumption despite population growth is consistent with the long-term contraction of disposable income. Indicators of private consumption for 2003:I give a mixed picture: since the beginning of the year the index of revenue in the various commerce and services industries has risen. Wholesale trade revenues have risen by an annual 4 percent, while retail trade has remained stable. Sales by the marketing networks—especially of foodstuffs—have risen steeply since the beginning of the year, possibly because the public stocked up on food prior to the war in Iraq. The trend decline in durables consumption and imports of consumer goods, primarily cars, persisted, however, The Companies Survey for 2003:I also indicated a sharp drop in commerce.

The contraction of economic activity in the period reviewed is also apparent in the continued decline in the composite index. In 2003:I it dipped by 0.6 percent, further to a similar decline in 2002:IV, due to the fall in the number of employee posts in the business sector and the decline in imports. These factors were partly offset by moderately positive developments in the other components of the index: manufacturing production, revenues in commerce and the services, and goods exports. The number of employee posts has fallen consistently since the beginning of 2003, compared with stability in goods imports. From October 2002 to February 2003 the index of manufacturing production rose, after declining in 2002:II and 2002:III (Figure 1). The rise in the index in the last few months reflects the expansion of production in the high-tech and mixed high-tech industries, despite stability in the manufacturing index of the traditional and mixed traditional industries. Despite the stability of the index of production of the traditional industries, the dollar value of their exports rose, possibly attesting to a decline in domestic demand.

Developments in the construction industry in recent years are primarily the result of demand-side shifts, as supply responds to these changes. This view is borne out by the predominance of the demand constraint in construction companies' replies to the Companies Survey. All the indicators for 2002:IV showed that demand was still falling, continuing the trend evident since July 2002 (Table 1), compared with expansion from October 2001 to June 2002. As expected, the drop in demand was expressed in the reduction of the relative price of housing, longer construction time, and decline in the number of building starts (Figure 5). Sales dipped more steeply than completions (which include both completed apartments and those being built) in the second half of 2002. The contraction of demand was reflected in the continued steep decline, evident since the beginning of 2003, in sales of privately-constructed new apartments throughout Israel, with the exception of Judea and Samaria. The reasons for this include the reduction of rent, in view of the recession, and the slower rate of immigration to Israel. Another reason for the dip in demand was the rise in real yields on government bonds, making it more expensive for mortgage banks to raise capital. The decline in real yields in March and April 2003 is expected to make mortgages cheaper, and may hence cause some increase in demand later in the year.

The hotel and tourism industry has been hard hit in the last two years, following the outbreak of the Intifada. Nevertheless, there was an 11 percent rise, seasonally adjusted, in the number of incoming tourists in 2002:IV, further to the 20 percent increase in 2002:III. The tension prior to the war in Iraq led to a steep drop in the number of incoming tourists in the first two months of 2003, and in March the number of tourists entering Israel reached a low point of only 36,000. The Companies Survey also shows that there was a marked slowing in the activity of hotels as regards both incoming and internal tourism. The rise in hotel bed-nights of Israelis evident since July 2001 reversed in October 2002, and since then their number has fallen. Travel abroad by Israelis has remained stable in the last few months, and this together with the decline in hotel bed-nights of Israelis is consistent with the contraction of private consumption.

The labor market

Developments in the labor market indicate that labor inputs rose in the business sector and unemployment fell in 2002:IV, but these trends reversed in 2003:I. Thus, the improvement in the second half of 2002 was only temporary, and did not persist into 2003.

The labor input of Israelis rose by 3.8 percent in 2002:IV, due to the increase in business sector labor input, mainly in manufacturing, business services, and hotels and catering, while in the general government sector it contracted. The expansion of employment in the second half of 2002, exceeding the increase in the civilian labor force, was expressed in the reduction of the unemployment rate, from 10.6 percent in 2002:I to 10.1 percent, There was no improvement in chronic unemployment, however; the number of persons unemployed for 12 months rose, while the number of persons seeking work for over 27 weeks dipped slightly. According to the manpower survey, the rise in employment in 2002:IV reflected mainly the increase in the number of persons in part-time employment and in those temporarily absent from work—by 3 and 8 percent respectively. The number of persons in full employment rose, but only by 0.5 percent. Data for the first few months of 2003 indicate that the improvement in employment at the end of 2002 was only temporary. This is borne out by the rise in the number of job-seekers and decline in the number of employee posts since the beginning of 2003. The survey of employers undertaken by the Manpower Planning Authority of the Ministry of Labor and Social Affairs also supports the view that the employment situation has deteriorated, as is reflected by the decline in the number of available positions and the negative employment balance (number of positions filled *less* that of employees dismissed). These developments are also reflected in the cessation of the reduction in the unemployment rate at the beginning of 2003 (according to the manpower survey), and the trend data show that the unemployment rate was 10.3 percent in February.

From October to December 2003 the labor force participation rate was 54.2 percent (seasonally-adjusted data), similar to the rate in the two preceding quarters (a slight 0.1 percent increase). A sectoral examination of the participation rate shows that there was an increase in that of new immigrants, reflecting a long-term trend of convergence as part of the process of their absorption in Israel. The participation rate of veteran Israelis declined, however, apparently reflecting the discouraged worker effect.

During 2002 the number of legal foreign workers declined, from 95,000 at the beginning for the year to 84,500 at the end. The government has recently agreed to leave the current number of foreign workers (except for those providing help for the disabled or elderly and infirm) unchanged at 61,000, reducing it to 48,000 next year. The number of Palestinian workers rose beyond that required to compensate for the decline in foreign workers (although their number is still far lower than it was before the Intifada).

The expansion of employment in the business sector in the second half of 2002 was supported by developments in wages. The decline in the real wage per employee post in the business sector, evident since 2001:II, persisted from October 2002 to January 2003, and amounted to 2.7 percent. In the public sector the real wage dipped by 0.6 percent in this period.

The cost of labor declined and labor productivity rose in the second half of 2002, so that unit labor cost fell, after having risen sharply in 2001. The adaptation of wages to

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

			2002				2003	Jan–Mar*		
	2001	2002	I	II	III	IV	I	2002	2003	**
	('000s)									
Civilian labor force	2,498	2,546	2,539	2,529	2,547	2,569		2.3		12
Israelis employed	2,265	2,283	2,271	2,269	2,284	2,310		0.8		12
Business sector	1,574	1,572	1,552	1,556	1,575	1,604		-0.7		12
General government	692	713	714	713	709	717		4.8		12
Average weekly hours worked per employee	37.0	37.2	37.1	36.8	37.5	37.2		-2.5		12
Business sector	39.8	40.2	40.1	39.9	40.1	40.5		-3.3		12
General government	30.6	31.1	31.0	31.2	31.2	30.9		-2.1		12
Labor input of employed Israelis	83,760	84,831	84,247	83,514	85,646	85,917		-1.8		12
Business sector	62,616	63,154	62,293	62,124	63,175	65,023		-4.0		12
General government	21,153	22,163	22,118	22,284	22,096	22,153		2.6		12
Claims for unemployment benefit	117	118	131	129	114	99	93	21.5	-24.8	2
Work seekers	186	195	204	203	194	181	192	21.4	-9.2	2
Real wage per employee post (NIS)[a, b]	4,681	4,427	4,555	4,465	4,368	4,320	4,229	-0.6	-6.9	1
of which: Business sector	4,802	4,516	4,620	4,609	4,452	4,384	4,382	-1.8	-7	1
General government	4,411	4,231	4,408	4,209	4,160	4,146	4,118	2.5	-6.5	1
Unemployment rate (%)	9.3	10.3	10.6	10.3	10.3	10.1				12

* Percent change compared with same period in preceding year.
** Last month for which data available.
[a] At 1994 prices.
[b] Real wage per employee post relates to Israelis and to foreign workers with work permits, and does not include Palestinians.

the development of business-sector product could signal the future expansion of labor input, though the fact that most of the increase in employment in 2002:IV stemmed from the rise in the number of those in part-time employment and those temporarily absent from work is not consistent with an ongoing improvement in the labor market, rather indicating that the rise is only temporary.

The balance of payments

In 2002:IV there was a $ 415 million surplus in the balance of payments on current account, compared with $ 668 million in the equivalent period in 2001. The seasonal surplus of current transfers by the general government sector, and the surplus on the services account, were offset to some extent by the deficits on the trade and factor inputs accounts. Foreign trade data (Table 4) indicate that the deficit on the trade account (seasonally-adjusted data, excluding ships, aircraft, diamonds, and fuel) declined in the period reviewed, continuing the downward trend evident since 2002:I. The improvement in the balance of trade reflects both the rise in goods exports and the decline in goods imports. Alongside developments on the goods and services account in 2002:IV, there was a steeper rise in the prices of imports than in the GDP deflator, as well as a decline in export prices. The result was real local-currency appreciation in 2002:IV, after depreciation in the previous three quarters. The rise in import prices together with the decline in export prices was expressed in the deterioration of Israel's terms of trade.

Global foreign trade figures indicate that the increase in trade between the US and the EU moderated in the period reviewed, and even declined. However, this is primarily a nominal change (in dollar terms),reflecting the weakening of the dollar vis-à-vis the euro.

Goods imports continued to contract in 2003:I, and both capital and consumer goods declined. Imports of raw materials (mainly for the machines, electronics, wood and wood products, and precious metals industries) fell. This

Table 4. Balance of Payments, Foreign Trade,[a] and the Reserves, 2001–2003
($ million, current prices)

	2001	2002	2002				2003	Jan–Mar		*
			I	II	III	IV	I	2002	2003	
Monthly averages										
Trade deficit	313	296	364	299	315	207	110	346	158	3
Goods imports	1,985	1,870	1,920	1,880	1,857	1,822	1,779	1,896	1,800	3
Consumer goods	387	363	400	354	355	341	325	389	333	3
Capital goods	499	456	451	462	432	477	429	454	453	3
Intermediates	1,098	1,050	1,067	1,062	1,067	1,002	1,022	1,052	1,012	3
Goods exports	1,672	1,574	1,556	1,582	1,542	1,615	1,669	1,550	1,642	3
Manufacturing	1,616	1,520	1,507	1,525	1,486	1,561	1,608	1,502	1,584	3
High tech	833	738	763	732	687	772	781	743	776	3
Quarterly averages										
Net current account	-571	-533	-328	-1,084	-1,137	415		170		12
Financial account (excl. foreign-currency balances)	-71	-187	-15	862	-394	-1,198		-282		12
Nonresidents' direct and portfolio investment	806	376	-121	896	478	249		230		12
Nonresidents' portfolio investment	72	194	714	36	470	-443		77		12
Residents' direct and portfolio investment	671	934	1,777	1,449	150	362		1,309		12
Net foreign debt (% of GDP)	2.86	0.64	2.99	2.71	2.48	0.63		2.95		12
End-period Bank of Israel reserves	23,181	23,670	23,945	24,790	24,229	23,670	23,486	23,945	23,486	3

* Last month for which data available.
[a] Foreign trade data are seasonally adjusted and do not include ships, aircraft, diamonds, and fuel.

development is not consistent with the recovery of manufacturing production, but rather with the continuation of the recession, although it could attest to the state of inventories rather than to expectations of a decline in production. The contraction of capital goods imports, together with the fall in capital utilization, does not indicate economic recovery, either. The 4.5 percent fall in imports of consumer goods in 2003:I, further to a similar decline in 2002:IV despite the rise in private consumption at the end of 2002, is the result of the 2.4 percent increase in import prices in 2002:IV. As stated, there was some improvement in goods exports in the period reviewed: according to seasonally adjusted data (excluding ships and aircraft, diamonds and fuel), both manufacturing and agricultural exports were up by 6 percent over the equivalent period last year. The output of the high-tech industry, which includes electronics, aircraft, and medications, rose, and this was also expressed in an increase in export value. However, the trend data, which are adjusted for seasonal and non-serial factors, indicate that these exports stabilized, after rising since September 2002. The output of the mixed high-tech industry, which includes chemicals (but not medications), machines, electrical equipment, and transport vehicles (excluding aircraft), has risen in the last three months, with the continuation of the gentle upward trend. The upward trend of the output of the mixed traditional industry, which includes mining and quarrying, rubber, plastics, basic metals and metal products, evident since early 2001, continued.

The financial account (excluding the foreign exchange reserves) displayed capital outflow of $ 1,200 million in 2002:IV. Direct foreign investment declined to $ 250 million, compared with $ 670 million in the equivalent period in 2001—although this trend was not confined to Israel, rather reflecting in part the drop in foreign investment in emerging markets.[2] The intensity of the contraction in Israel was greater than in the emerging markets, however, due to the large share of the high-tech industry—which is anyway undergoing a crisis—in product and the balance of payments. In nonresidents' investment in tradable securities, there were sales of $ 440 million, due mainly to

[2] Institute of International Finance, *Capital to Emerging Market Economies*, January 2003.

sales of government bonds. The decline in these investments was notable in view of their rise in previous quarters. Both direct and portfolio investment abroad by residents were greater in 2002:IV than in 2002:III, but remained lower than in the first half of 2002, when they rose. In the second half of 2002, when the interest rate rose again, the foreign currency market stabilized, the danger of inflation passed, and the outflow of investment by residents contracted once more.

The foreign exchange reserves stood at $ 23.5 billion at the end of the period reviewed—down by 3 percent from their level at the beginning of the period. The net foreign debt contracted, and amounted to 0.6 percent of GDP. This trend reflects primarily the sharp rise in Israel's foreign assets, especially those of the nonbanking private sector.

Global developments

Since the beginning of 2003 there has been a marked slowdown in the rate of recovery of the world market, in contrast to the signs indicating improvement in 2002:IV, particularly in the US. The slowdown can be seen in the rise in the rate of unemployment and in the sharp falls in the indices of consumer confidence in the industrialized countries at the end of 2003:I caused by concern that the war in Iraq would drag on and cause a rise in fuel prices. Economic recovery in 2003 now appears more precarious, as is reflected by the downward adjustment of forecasts of real activity despite the fall in oil prices that followed the end of the military operation in Iraq.

Table 5. Indicators of Economic Development in Advanced Countries[a] and Forecast for 2003[b]

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

[a] According to "World Economic Outlook," Israel is classified as an advanced country.
[b] Annual percent rate of change, except for unemployment and interest rates.
[c] Average price per barrel in 2002 was $25.00; estimated price in 2003 is $31.00.
[d] Six-month Libor rate
SOURCE: "World Economic Outlook" (IMF), April 2003.

Table 6. Selected Price Indices, 2001–2003
(annual rates of change during period, percent)

			2002				2003	Jan–Mar		
	2001	2002	I	II	III	IV	I	2002	2003	*
CPI	1.4	6.5	9.8	16.3	2.6	-1.8	3.2	3.6	0.6	3
CPI excl. housing, fruit and vegetables	0.2	6.3	3.2	16.3	5.8	0.4	2.7	0.4	1.6	3
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	-4.2	6.9	6.3	15.9	6.3	-0.4	4.2	0.8	1.9	3
Index of housing prices	5.2	8.2	36.7	21.9	-12.7	-5.7	3.8	16.7	-1.1	3
Wholesale price index	-1.9	6.9	7.6	15.9	3.9	0.8	15.4	2.3	7.8	3
NIS/$ exchange rate	4.8	9.8	41.6	25.7	-12.7	-6.6	7.6	16.4	0.2	3
NIS/currency-basket rate	3.7	14.2	38.2	39.2	-8.9	-2.8	15.0	13.1	5.7	3

* Last month for which data available.

In April the IMF lowered its forecasts of growth and world trade for 2003 (Table 5) in the light of the slowdown in the recovery in the industrialized countries and increased uncertainty regarding the results of the Iraq war. The average of the *Economist* poll of forecasters for 2003 was also reduced at the beginning of April, to 2.2 percent in the US, 1.0 percent in the euro zone, and 0.7 percent in Japan.

In the US the Consumer Confidence Index (CCI) went down for the fourth successive month, and reached its lowest level for ten years due to anxiety that the war in Iraq would be a protracted one and that oil prices would rise, and due to pessimistic expectations for the immediate future.[3] The decline in the index occurred against the background of an increase in the number of claims for unemployment benefit (a small rise in the rate of unemployment in February, to 6.0 percent), and a drop in the demand for manufactured consumer and capital goods. On the other hand, the number of building permits rose, and the number of hours worked in manufacturing remained unchanged. The indices of disposable income, wholesale sales and manufacturing output all rose (albeit the last by a disappointing 0.1 percent), while employment fell. In the light of the assessment that the slowdown would persist, the Fed left the interest rate at its low level of 1.25 percent, with the object of helping economic activity in the short term.

The European Central Bank (ECB) cut the interest rate at the beginning of March by 0.25 of a percentage point, having previously reduced it in November and December 2002, so that the cumulative reduction in the period reviewed was 1.25 percentage points. The decision was taken in the light of the lower rate of inflation and the slowdown in real activity. In March the CCI plunged to a level not seen for nine years, due in part to uncertainty regarding the results of the war in Iraq (although the level of uncertainty did decline once the war ended), and the rate of unemployment continued to rise, reaching 8.7 percent in February. These developments constitute a threat to private consumption, which account for about half of the uses in the euro zone. The Purchasing Managers' Index recorded a negative value in March, after crossing the 50-point line that indicates stability in February. In contrast the Index of Manufacturing Output rose by 1.1 percent in January 2003, and the Index of Wholesale Trade by 2.5 percent.

In the light of the decline in the indices of consumer confidence and manufacturing output, in the output forecast, the number of building starts and the level of retail sales, the Bank of England cut the interest in February by 0.25 of a percentage point. Employment and disposable income, on the other hand, both rose.

In Japan the level of activity was low, and in February and March many indices—of consumer confidence, manufacturing output, retail sales, disposable income, and hours worked—showed reductions. In contrast, the number of building starts and wholesale sales rose, and unemployment fell to 5.2 percent. Orders for capital goods remained unchanged. Inventories fell to their lowest level in fourteen years due to fears of a drop in demand, and exports were also adversely affected by the war in Iraq. The spread of Severe Acute Respiratory Syndrome (SARS) is likely to harm economic activity in South East Asia, particularly in tourism and in visits by businessmen and traders, and several forecasts of growth in those countries have been cut back. This situation could well affect Israel's

[3] The survey was carried out before the outbreak of the war.

exports to those destinations which had grown relatively rapidly in the last few months.

World oil prices rose during 2002 and at the beginning of 2003 due to concern over the war in Iraq and serious disruptions it was expected to cause. The severe winter in North America and the general strike in Venezuela added to this concern, but with the end of the strike oil prices slumped at the beginning of March. Although they rose again briefly with the outbreak of the Iraq war on 20 March, they fell again to their pre-strike level once the oil wells in the south were under the control of the US-UK Alliance.

In the last few years real developments in Israel's economy in general and in exports and investments in particular were affected by global economic developments. Figure 9, which illustrates the link between Israel's high-tech exports and world-wide demand as measured by US imports from the relevant industries, shows that Israel's exports are dependant on world-wide demand. In the first three quarters of 2002 US imports rose, while Israel's exports only stayed steady; in 2002:IV exports rose by 9 percent, apparently in response to the increase in global demand. From the beginning of 2003 this demand declined steeply, apparently due to the Iraq war, and as a result Israel's exports stabilized. The downward adjustments of forecasts of world trade and growth in the industrialized countries dampens the chances of faster growth in high-tech exports in the rest of 2003.

The general government sector

The government's domestic deficit in 2002 amounted to 4.1 percent of GDP. Fiscal developments at the beginning of 2003 indicate that this negative trend continued: in 2003:I the domestic deficit excluding credit granted deviated significantly from the path consistent with achieving the target deficit of 3 percent of GDP. Most of the deviation reflects reductions in income from direct and indirect taxes beyond the negative effect of the business cycle on tax collection and the decline in income of the National Insurance Institute.

Against the background of the growing deficit and the formation of the new government, in mid-March the government accepted the economic program proposed by the Ministry of Finance. The program combines short-term policy measures intended to provide at least partial solutions to the problem of the expected deviation from the deficit target with changes whose effects will be felt in the longer term.

In January–March 2003 the domestic deficit totaled NIS 5.3 billion, up from NIS 4.0 billion in January–March 2002. Based on the seasonal pattern, this deficit was NIS 5.5 billion higher than it should have been to be in line with the annual target of 3 percent of GDP. Although the deficit at the beginning of the year was affected by several non-recurring factors that boosted it by an exceptional amount, even after taking these factors into account the data show that the without major adjustments to the budget, the deficit will exceed the (3 percent) target by at least 3 percent of GDP.

Most of the considerable deviation of the deficit in 2003:I from the path that would be consistent with the target resulted from the fact that income was NIS 4.2 billion below the level determined by the seasonal path. The gap reflects a shortfall of NIS 2.9 billion in income tax revenues and of NIS 1.3 billion in the receipts of the Customs and VAT Department. About NIS 1.1 billion of the shortfall in 2003:I may be attributed to the nonrecurring postponement of the repayment of tax rebates from the end of 2002 to 2003, but even without this item the shortfall of tax receipts is considerable, about 7.5 percent of the income expected for this period. The data show that income tax revenues from companies fell sharply by 34 percent in January–February and those from the self-employed by 44 percent from their levels in the first two months of 2002. The persistent recession in activity in the business sector led to a real decline in indirect taxes on domestic production. An 8 percent reduction in income tax revenues from wage-earners and company managers reflected in the main a real fall in the wage per employee post. Transfers from the National Insurance Institute to the government (via the purchase of bonds) were NIS 1 billion below the amount required according to the annual budget forecast.

Government expenditure in 2003:I exceeded by NIS 0.5 billion the seasonal path consistent with the ceiling expenditure determined in the budget. Defense expenditure was greater than that in the defense budget passed by the Knesset, and also greater than the path consistent with the authorized supplementary budget. The other government ministries, however, underspent compared to their budgets. There was a real increase in expenditure on interest in 2003:I compared with the figure in 2002:I. Based on developments hitherto, and without reference to the economic program proposed by the government, the deficit in 2003 is likely to amount to more than 6 percent of GDP. As mentioned above, the program is based mainly on structural reforms and changes, and combines a considerable cutback in government expenditure by reducing the wage of public-sector employees, cutting National Insurance allowances and benefits, and an across-the-board cutback in purchases by government ministries, with a plan to deal with the actuarial

Table 7. The Budget and its Financing, 2001–2003
(cash flows, as percent of GDP)

	2001	2002	2002 I	2002 II	2002 III	2002 IV	2003 I	Jan–Mar 2002	Jan–Mar 2003	*
1. Government domestic expenditure	37.5	37.9	37.2	38.1	36.4	39.9	37.1	38.4	38.5	3
2. Government receipts	33.7	33.9	35.0	34.5	34.4	31.9	32.9	32.9	32.4	3
3. Domestic budget deficit (1)–(2)	3.7	4.0	2.2	3.6	1.9	8.1	4.2	5.6	6.1	3
4. Government and Jewish Agency domestic deficit[a] (5)+(6)	3.1	4.1	0.7	4.2	2.7	8.6	4.7	4.8	6.6	3
5. Government net borrowing from the public	3.7	5.3	8.6	3.8	3.8	5.1	6.2	8.0	5.6	3
6. Public-sector injection[b]	-0.6	-1.2	-7.9	0.3	-1.2	3.5	-1.5	-3.2	0.9	3
7. Bank of Israel injection	1.6	1.9	9.5	0.0	1.3	-2.8	2.7	5.5	0.0	3
8. Change in monetary base	0.9	0.3	1.2	0.0	-0.2	0.3	1.0	1.8	0.6	3

* Last month for which data available.
[a] Including non-budgetary injection.
[b] The public-sector injection is recorded as a change in the monetary base minus the Bank of Israel injection and adjustments. The adjustments are small and are not presented in the table.

deficits of the pension funds and proposals to increase competition and to introduce structural changes in electricity, communications and the railways.

The receipt of an additional defense grant of $ 1 billion from the US government is not expected to reduce the deficit, as it will be used to cover a further increase in defense expenditure. The economic program, if fully implemented, is expected to trim the 2003 deficit to a little more than 5 percent of GDP, but its main effect would be reflected in a downward path for the government deficit and for the public debt in the next few years.

Prices, monetary policy, and the money and capital markets

The CPI rose by 0.3 percent in the period reviewed. This modest rise did not occur evenly over the period, but after declining by 0.4 percent in 2002:IV, the index went up by a cumulative 0.8 percent in 2003:I. The reduction in the last quarter of 2002 was the outcome of the appreciation of the dollar—which was reflected in a decline in the housing component—and of the seasonal drop in fruit and vegetable prices, which was partially offset by seasonal increases in clothing and footwear prices. These took place against the background of the moderating activity and tight monetary policy required to restore public confidence in the Bank of Israel's determination to persist in striving for price stability. These background conditions continued to accompany price changes in 2003:I which were affected by depreciation that reflected a rise in Israel's risk premium caused by the concern over the war in Iraq. The rapid conclusion of the military operation in Iraq, the publication of the economic program and the confirmation of the guarantees by the US Congress supported a reduction of Israel's risk premium; they also led to significant appreciation of the NIS, so that the CPI is expected to be low in the next few months.

The movement of prices in the period reviewed thus indicated a reduction in the inflation environment. Prices excluding the volatile items (i.e., the CPI excluding housing, fruit and vegetables, controlled-price goods, clothing and footwear) rose by 1.9 percent (annual terms)in the period reviewed, a rate consistent with the long-term target of price stability.

The index of wholesale prices rose by 3.8 percent, in annual terms. Experience has shown that changes in wholesale prices are not a precursor of changes in retail prices, so that a rise in the wholesale price index does not indicate that the CPI will rise in the next few months.

Despite the return of the inflation environment to the target range, the high volatility of prices in the period reviewed indicated that there was much uncertainty regarding inflation, and this was reflected in inflation expectations. Twelve-month expectations averaged 3.5 percent, with high volatility around that figure. In October and December expectations went down by 0.9 percentage points, and dipped below the upper limit of the target inflation range of 3 percent. This trend reversed, however, at the beginning of 2003, and in February average expectations stood at more than 4 percent. From October 2002 to March 2003

Table 8. Monetary Indicators and Nondirected Bank Credit, 2001–2003

(annual terms, percent)

	2001	2002	2002 I	2002 II	2002 III	2002 IV	2003 I	Jan–Mar 2002	Jan–Mar 2003	*
Rates of change	Average		Compared with preceding quarter					During period		
M1[a]	14.2	15.6	50.7	10.5	-12.8	-14.7	14.6	28.2	2.1	3
M2[b]	17.2	2.2	-11.2	-2.2	2.5	5.6	-0.1	-4.6	-1.1	3
M3[c]	15.5	6.1	-0.6	7.3	0.5	2.4	6.3	1.5	1.5	3
Nondirected bank credit	10.8	10.5	9.6	15.4	9.4	5.9	0.7	7.8	0.6	3
Unindexed local-currency	15.0	6.5	0.3	2.0	18.6	17.2	-1.5	2.2	2.8	3
CPI-indexed	4.7	7.6	1.0	12.4	10.4	-0.9	-3.9	5.5	-3.2	3
Foreign-currency-indexed and denominated	15.7	20.5	39.2	38.8	-1.7	2.7	10.5	19.2	3.1	3

* Last month for which data available. Data for the last quarter are preliminary.
[a] Narrow money supply (cash in the hands of the public and demand deposits).
[b] M1 plus short-term local-currency deposits.
[c] M2 plus foreign-currency-indexed and denominated deposits.

long-term inflation expectation converged to a level of 5.5 percent, significantly higher than the upper limit of the long-term inflation target. In January–May 2002 these expectations had converged to a level below the upper long-term limit despite rapid depreciation in that period; in the second half of 2002 and in January–February 2003 there was a marked upward trend, together with a rise in forward real yields. This may have reflected concern over loss of control in the management of fiscal policy and public anxiety of a rise of public debt in terms of GDP. In March and April 12-month inflation expectations declined, as did long-term expectations, although the rate of the decline became less steep the longer the horizon. The lowering of inflation expectations derived from the capital market at the end of 2002 and their rise at the beginning of 2003 may have been affected by the implementation of the recommendations of the Rabinowitch Committee on Tax Reforms (discussed in Box 2, p.13 in the previous issue of this publication), that are likely to affect the pricing of the financial assets used to derive inflation expectations. Nevertheless, in the last two years there has been a high correlation between the exchange rate and inflation expectations. Hence, fluctuations around the level of 3.5 percent in the period reviewed may be attributed to the change in the exchange rate of the NIS against the dollar and the currency basket. The strengthening of the NIS against the dollar in March and April and the low CPI in March were expressed in a reduction in expectations to a level of about 2.5 percent. However, longer term expectations (derived from the capital market) are still higher than 4 percent, i.e., above the upper limit of the long-term inflation target.

From October to December the Bank of Israel's interest rate remained unchanged, against the background of the deviation of inflation expectations from the target range. The fact that the interest rate was not cut in that period, with the rise in the interest-rate differential between the NIS and foreign currencies, as well as assessments concerning the receipt of defense aid and guarantees from the US led to continued appreciation of the NIS and reduced short-term inflation expectations. This was the background to the 0.2 percentage-point reduction in the interest rate in January, to 8.9 percent, the first cut since the cumulative rise of 4.5 percentage points in June and July 2002. In January and February 2003 inflation expectations rose to above the upper limit of the inflation target, apparently due to a rise in security-related uncertainty and to the realization that the budget that was passed is not consistent with the achievement of the inflation target. As a result the interest was not reduced in those two months. The decline of inflation expectations in March and the appreciation of the NIS, which apparently reflected expectations that the economic measures of the government's new economic policy would be adopted and the end of the war in Iraq, enabled the Bank of Israel to start a process of cautious and gradual reductions in the interest rate, intended to support accelerated real economic activity without jeopardizing price stability.

The path followed by the public's short assets (of up to one year) held in banks (henceforth M3) was consistent with the other nominal indicators, i.e., contraction in 2002:IV and expansion since the beginning of 2003. This was accompanied by switching between different

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

			2002				2003	Jan–Mar		
	2001	2002	I	II	III	IV	I	2002	2003	*
Nominal interest on:										
Nondirected local-currency credit	10.0	9.9	7.4	8.5	11.9	11.8		9.2	11.8	12
Average monetary loan	6.7	6.7	3.7	4.9	9.1	9.1	8.9	4.8	9.0	3
SRO deposits	5.6	5.8	3.1	4.3	7.9	7.9		4.7	7.9	12
3-month Eurodollar	3.7	1.7	1.8	1.8	1.7	1.4	1.2	1.9	1.3	3
Yield to maturity on Treasury bills	6.5	7.4	4.8	7.2	8.9	8.7	8.5	5.2	8.6	3
10-year bonds	4.9	5.2	4.1	5.3	5.6	5.8	5.8	4.4	5.8	3
5-year bonds	4.9	4.8	3.2	4.4	5.8	5.9	5.6	3.9	5.7	3
General Share-Price Index (points)	197.5	183.7	199.6	183.4	177.8	174.1	171.7	197.8	172.9	3
Expected inflation (gross)	1.9	3.3	2.8	4.3	2.6	3.5	4.0	2.3	3.7	3
Interest derived from expected inflation (gross)	4.3	4.1	2.2	3.3	6.1	4.8	4.1	2.9	4.5	3

* Last month for which data available.

components of the aggregate: a reduction in the M1 money supply and deposits in or indexed to foreign currency and a rise in local-currency deposits in October to December, and the opposite in January and February. In March, however, M1 rose while both local-currency and foreign-currency deposits fell, apparently reflecting the public's desire to make its financial assets more liquid with the war in Iraq imminent. With the liquidation of short-term assets, long-term deposits at nominal rates of interest increased. This trend may well express the moderation of longer-term inflation expectations, especially as the total of the indexed assets (CPI-indexed deposits and savings schemes) showed a decline. Total nondirected credit fell by 0.5 percent (annual terms) in the period reviewed, with a change in its composition: CPI-indexed credit fell, while local-currency and foreign-currency credit rose. During 2002 the real rise in business credit was only 1 percent, while credit to households surged by 6 percent. The slowdown in the growth of credit in the economy probably indicates a lack of sources in the banks, and a fall in demand from companies due to the recession in real activity. The difference between the rise in business credit and that in credit to households may be partly due to the significant rise in the share of business-sector problem credit in the sector's total credit, while the share of problem credit in credit to households remained stable.

Trade in the stock market from October 2002 to January 2003 took place with falling prices, continuing the trend that started in 2000:IV, and the Share Price Index fell by 2.6 percent. The trend reversed, however, and from February to April the index rose by 15 percent. The different trading sector indices for 2003:I show that prices rose in most of the sectors. Steep rises occurred in this period in oil and gas exploration companies (28.7 percent), in the share price index of manufacturing companies (9.7 percent), and in the share price index of mortgage banks and industry financial institutions (9.3 percent). The positive trends in the capital market in general and in the stock market in particular were supported by the reduction in the country risk premium that resulted from expectations of an improvement in the security and economic situation.