
RECENT ECONOMIC DEVELOPMENTS, 106*

First Half of 2004

Main developments

In the first half 2004 (the period reviewed) the trend of expansion in economic activity evident since the second half of 2003 became more firmly established. Nonetheless, according to the composite State-of-the-Economy index, the Bank's Companies Survey, and other indicators of economic activity, two sub-periods may be discerned in the first half of 2004: acceleration in the rate of growth of business-sector activity in the first quarter of the year, followed by a slowdown in the second quarter.

The background to the expansion of business-sector activity in the first half of 2004, the effect of which spread into the labor market, was the acceleration of economic activity throughout the world, the relative calm in the security situation, the recovery in high-tech industries, and a sharp improvement in companies' profitability (due to increased productivity and streamlining). In addition to the above, fiscal and monetary together helped to reduce Israel's risk premium and to gradually lower long-term interest rates. One result of the tight fiscal policy was a slowdown in the rate of public expenditure in the period reviewed, but the fact that the government achieved the deficit target boosted its credibility and enabled the Bank of Israel to reduce the interest rate to its lowest level for several years. Growth in 2004:I was based on a steep rise in goods and services exports, increased investment and continued growth of private consumption.

The rise in exports derived mainly from increased trade in international markets and in particular the recovery in high-tech industries, but all manufacturing industries showed increased exports in the first quarter. In the second quarter exports declined, probably an adjustment to the too rapid increase in the first quarter. Fixed investment, on the other hand, expanded faster in 2004:II than in 2004:I, especially investment in machinery and equipment. The latter reflects manufacturers' expectations of more lively economic activity and a rapid increase in demand. Private consumption, that started rising in 2003:II, continued its rise in 2004:II, with the assistance of a rise in the real wage, reductions in taxation on labor

and consumption (that increased individuals' income) and the reductions in interest rates at home and abroad.

In the second quarter there were indications of some possible recovery in the construction industry, that had wallowed in a recession for the last three years. Apartment sales and prices rose, after a sharp rise in construction investment in the last quarter of 2003. In 2004:II the picture changed, when investment in residential construction fell steeply, indicating a slowdown in activity as the year progresses, and responses of construction companies to the questionnaire of the Companies Survey for the second quarter reflect pessimism regarding the extent of activity in the third quarter.

The labor market reacted relatively rapidly to the economic recovery. The rate of employment rose to 49.2 percent in 2004:I, apparently due to greater elasticity of this market than in the past, reflected by a decline in wages in the years of the recession, and the replacement of non-Israeli employees by Israelis in the traditional industries (construction, agriculture, and domestic services). The unemployment rate dipped by 0.1 of a percentage point to 10.8 percent. The main reason for this modest drop was the sharp rise in the participation rate among both men and women, which led to the rapid increase in the civilian labor force.

Commerce and services industries were affected by the rise in private consumption and the expansion of economic activity, so that their output rose considerably in the period reviewed. At the top of the list were business services, wholesale and retail trade, and hotels and catering, which recovered following the easing of international tension with the end of the war in Iraq. Incoming and domestic tourism and the number of hotel bed nights rose markedly in the first half of 2004 from their level in the first half of 2003. In contrast, the contraction of public consumption served to slow down the increase in the turnover of education, health and welfare service companies.

Manufacturers' expectations, reflected by a steep rise in investment in machinery and equipment, and by the responses of participants in the Companies Survey, indicate their optimism regarding the continuation of the recovery in 2004:III, albeit it at a slower pace than in 2004:I. The exception were companies in the construction industry, which did not expect a turnaround in the near

* For diagrams (bilingual) please turn to the end.

future. Manufacturers' optimism was expressed in labor input: the number of business-sector employees and the real wage rose, in the wake of companies streamlining and the rise in labor productivity in the last few years.

The budget performance in the first half-year was consistent with the achievement of the deficit target of 4 percent of GDP. This was made possible by the cuts in transfer payments—child allowances, unemployment benefits and income maintenance—that started in 2003 as part of the economic recovery package, and by the under-spending (relative to the budget path) of government ministries. Some of the latter was offset by cuts in direct and indirect taxes (in the second quarter) that reduced tax revenues.

With the rise in economic activity and the acceleration of consumer goods imports, tax collection also accelerated. As a result real tax revenues increased sharply in the first quarter, but went down in the second. Total tax revenues were 5.8 percent higher in the first half of 2004 than in the first half of 2003. Revenues from both direct and indirect taxes accelerated in the first quarter and derived from the rise in private consumption, the import of consumer durables, the increase in the number of employed persons, and the collection of capital gains tax due to the boom in the financial markets. Some of the rise in tax revenue was due to the postponement of some wage payments from 2003 to January 2004 (the jubilee grant and vacation supplement), but for the most part it resulted from the recovery in economic activity.

The Consumer Price Index (CPI) rose rapidly, by 1.4 percent, after a long period of low indices. Most of the rise in the CPI in the period reviewed occurred in the second quarter, with a rise of 1.1 percent in April alone, mainly due to seasonal factors and a rise in fuel and electricity prices. At the same time the path of expected inflation for 2004 reached around the middle of the price stability range of between 1 and 3 percent.

The fact that inflation expectations stabilized within the target range enabled the Bank of Israel to continue lowering the interest rate at a steady pace during the first quarter, by a cumulative 0.7 of a percentage point to 4.1 percent. The cuts in the interest rate was reflected by the decline of short-term real interest to its lowest level for a long time (2.0 percent on average in 2004:II). The stability of the dollar exchange rate and the stabilization of inflation expectations at around the middle of the target range meant that the Bank of Israel could leave the interest rate unchanged during the second quarter. The reduction in the interest rate during the first quarter and its stability in the second, combined with the surge in economic activity, led to a 26.9 percent rise in the M1 money supply

in the period reviewed. The increase in the share of liquid assets in the assets portfolio reflects the effect of the reduction in the interest rate and the rise in activity.

The General Share Price Index, which reflects the public's expectations regarding future economic developments, rose by 15.5 percent in the period reviewed, with a drop in its volatility to its lowest level in the last four years; this was in contrast to the trend in the rest of the world, where volatility is rising and yields falling. The rise in the index is an expression of the public's confidence in economic policy and the stabilization of alternative yields at a slump level.

Although business-sector product expanded very rapidly in 2004:I, the future rate of growth depends on several factors: a continuation of the global recovery, calm prevailing in the security situation, and the return of public debt to a downward path. In the period reviewed the government showed consistency in implementing fiscal policy. This helped its credibility and thus also contributed to the lowering of Israel's risk premium in the international markets, and to the creation of conditions that enabled short-term and long-term interest rates to come down to relatively low levels. One necessary condition for the realization of potential growth is that macroeconomic policy limit the increase of public expenditure, thereby enabling the public-debt/GDP ratio to be reduced relatively rapidly, and that it be reflected in relatively low long-term interest rates. This will make it possible to maintain price stability at relatively low interest rates.

The National Accounts and the principal industries

GDP increased by 5.1 percent in 2004:I in annual terms.¹ This follows increases of 2.3 percent in the previous quarter, and 1.3 percent in the whole of 2003 (Table 1). Business-sector product rose by 7.2 percent, and excluding start-up companies, by 7.8 percent. These figures indicate the very rapid acceleration in the expansion of economic activity in the first quarter. This is reflected also by the composite State of the Economy Index, the Companies Survey of the Bank of Israel's Research Department, and other indicators of economic activity.

The backdrop to the accelerated growth in the first quarter, and the more moderate pace in the second, was provided

¹ Henceforth, in this review all rates of change will be in annual terms, unless stated otherwise.

Table 1. National Accounts,^a 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^b	Last month for which data available
		II	III	IV	I	II		
GDP	1.3	-0.5	2.5	2.3	5.1		2.3	Mar
Business-sector product	1.7	0.1	2.2	4.5	7.2		3.5	Mar
Business-sector product excl. start-ups	2.1	0.4	1.6	4.2	7.8		3.5	Mar
Private consumption	1.3	12.4	7.1	4.1	4.3		6.9	Mar
Gross domestic investment	-10.7	-9.6	17.9	-23.4	24.2		0.4	Mar
Fixed investment	-4.9	-3.5	-15.8	3.6	7.8		-2.4	Mar
Goods and services exports	6.2	-2.3	26.4	2.9	25.6		12.4	Mar
Goods and services exports excl. start-ups and diamonds	6.2	-11.9	39.6	5.6	33.5		14.8	Mar
Goods and services imports	-1.8	2.4	22.9	-4.0	25.3		10.9	Mar
Goods and services imports excl. diamonds	-1.6	10.0	15.0	-0.4	25.9		12.2	Mar
Public-sector consumption	-2.0	-9.5	-0.1	-9.2	-4.9		-6.0	Mar
Public-sector consumption excl. defense imports	-0.7	-4.3	0.8	-8.0	-4.1		-4.0	Mar

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

^b Compared with January-June 2003.

SOURCE: Central Bureau of Statistics.

by the rapid recovery in the global economy and world trade, and in particular the recovery in the US economy, that led to a considerable rise in exports (Figure 8), the rallying of the high-tech industries after a three-year slump, a fiscal policy that boosted the credibility of the government's policy. These, together with a slow rate of price increases and a decline in inflation expectations, enabled the Bank of Israel to continue reducing the interest rate gradually. The rapid expansion in the first quarter was based on the rise in goods and services exports, investments, and private consumption.

Israel's exports were boosted by the global economic recovery and the expansion of world trade, especially the rapid increase in trade with the US (Figure 8). Thus goods exports went up by 12.5 percent in 2004:I, following their 7.5 percent increase in the previous quarter. The 11.6 percent increase in manufacturing exports in the first quarter (foreign trade data, Figure 4) encompassed all manufacturing industries, with the high-tech industries featuring most prominently, with a rise of 13.5 percent. The second quarter featured some adjustment correcting the rapid expansion of the first quarter: goods exports dropped by 1.7 percent from their first-quarter level. Those most affected were the traditional industries (with their profitability suffering) and the high-tech industries, which declined by 1.5 percent.

Goods and services imports (excluding diamond) rose by 25.3 percent in 2004:I, having fallen by 4 percent in the previous quarter; imports of intermediate goods went up by 9.2 percent (Table 4), and imports of capital goods by 13.1 percent. Goods imports continued to increase in the second quarter too, but more slowly, by 4.1 percent. Imports of intermediate goods rose by 6.9 percent, and of capital goods by 2.6 percent. The slowdown in goods imports in the second quarter encompassed all industries, and may have been a correction to the steep rise in the first quarter. Manufacturers' expectations for the third quarter of 2004, derived from the Companies Survey, indicate optimism regarding the level of economic activity.

Private consumption rose by 4.3 percent in 2004:I, equivalent to a per capita increase of 2.7 percent, following a 4.1 percent rise in the previous quarter (Table 1). There was a marked rise of 12.9 percent in expenditure on consumer durables, following an increase of 1.8 percent in 2003:IV. There were several reasons for this increase: optimism regarding economic activity, a rise in the number of employed persons and a 6 percent increase in the average wage² (reflecting payment of vacation

² The average wage per employee post, excluding foreign workers, seasonally adjusted.

supplement and the jubilee grant in January 2004). Two exogenous factors added their weight to the above: the wealth effect, deriving from the rise in value of financial assets in 2003, and the relative calm in the security situation vis-à-vis the Palestinians, that raised private consumption in the first quarter.

The increase in private consumption was reflected in the rise in the turnover in the commerce and services industries, which rose by 9.4 percent in the first four months of the year, after rising by 12.1 percent in 2003:IV (Table 2) Topping the list were business services (12.5 percent increase), hotel and catering services (11.4 percent), and wholesale and retail trade (7 percent). Turnover in education and health rose slowly (by 3.7 percent and 2.5 percent respectively). Sales in the retail chain stores rose by 15.1 percent in the period reviewed compared with the equivalent period in 2003.

Public consumption went down by 4.9 percent in 2004:I (Table 1). This was the outcome of fiscal policy that was directed towards reducing the domestic deficit as it reverted to the target path. Cuts in expenditure by government ministries on wages and purchases (under-performance), combined with cuts in transfer payments acted directly to slow down growth, but increased the confidence in government policy, thereby contributing to sustainable GDP growth.

The recovery of economic activity and companies' expectations³ that the trend would persist served to encourage a faster rise in fixed investment: in 2004:I it rose by a steep 7.8 percent, following a rise of 3.6 percent in 2003:IV. There was a very marked 19.5 percent surge in investment in machinery and equipment. On the other hand investment in residential construction fell by 7 percent in the first quarter, after rising by 10.4 in the previous quarter. The acceleration in fixed investment points to expectations that activity will continue to expand.

The acceleration in activity, particularly that in the first quarter, was evident in other indices too: the composite index rose by 7.1 percent in 2004:I and by 2.1 percent in 2004:II (Table 2 and Figure 1). Most of the index's components accelerated in the first quarter, and in particular the turnover index in the commerce industries, which went up by 13.9 percent. The other components

of the index also rose, with the exception of the index of large-scale retail trade. In the second quarter the index shows a slower rate of economic expansion, due to a decline in Israel's foreign trade. In addition the index of turnover in the commerce industry went down by 1.1 percent, and manufacturing production (excluding diamonds) dropped by 1.6 percent, all these combining to reduce the rate at which the composite index rose.

The Companies Survey supports the above findings: companies' responses show that in the second quarter economic activity continued expanding (except for the construction industry), but more slowly than in the first quarter. Companies in almost all the principal industries reported increased activity, and in most they expected that domestic activity and exports would increase in the following quarter too. In contrast, the reductions in building and infrastructure construction intensified, and companies expected further falls in the next quarter. In the report on severity of constraints in performing activity, the decline in supply side constraints, especially the constraint of financing difficulties, was notable.

Manufacturing production (excluding diamonds) went up by 8.9 percent in 2004:I and by 5.2 percent compared with the first quarter of 2003 (Table 2). Production in the high-tech industries rose by 11.5 percent above the level in 2003:I. The mixed-traditional industries also rose rapidly (by 4.4 percent compared with 2003:I, while the traditional industries went up by a slower 2.8 percent. As manufacturing production accelerated, so did exports, especially high-tech exports, which was a main catalyst to growth. In 2004:II manufacturing production declined by 1.6 percent, and exports by 0.9 percent. This stabilization of the rate of expansion at below the level in the first quarter occurred against the background of the erosion of profitability in the traditional industries due to the rise in wages, and maybe also the appreciation of the NIS.

With the increase in manufacturing production and exports, the number of hours worked per manufacturing employee also rose, by 0.3 percent compared with 2003:IV (seasonally adjusted), and the number of employees went up by 1.4 percent. The modest increase in labor input relative to the rapid rise of manufacturing production indicates that the rise in production was mainly the outcome of increased labor productivity.

After a long period of sluggishness, with a low level of activity, the construction industry gave first signs of some possible improvement (the index of housing prices rose by 2.2 percent in the quarter, and the number of sales was 3 percent higher than the average in 2003), but

³ According to the Bank of Israel Companies Survey for second quarter of 2004.

Table 2. Indicators of Business Activity,^a 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^b	Last month for which data available
		II	III	IV	I	II		
Composite state-of-the-economy index	–2.0	–2.2	1.2	4.4	7.1	2.2	3.2	Jun
Large-scale retail trade	–2.5	–1.1	4.9	10.0	1.3	4.0	4.4	Jun
Manufacturing production (excl. diamonds)	–0.4	–1.0	1.7	12.2	8.9	–1.6	5.2	May
Business-sector consumption of electricity	4.2	14.0	5.3	–5.8	14.0	–9.5	4.0	May
Index of revenue in commerce	0.2	9.6	2.3	11.1	13.9	–1.1	8.3	May
Index of commerce and services revenue	–0.7	7.3	9.8	12.1	10.5	0.8	9.6	May
Tourist arrivals	21.7	27.2	25.2	8.4	1.6	12.6	63.9	Jun
Construction (change from equivalent period in previous year)								
Residential starts	–7.7	–12.5	–7.3	6.7	–11.4		–10.4	Apr
of which: Government-initiated	–4.3	–22.4	4.5	–12.3	–55.2		–56.8	Apr
Residential completions	–12.4	–12.7	–23.0	–0.2	–15.0		–17.3	Apr
of which: Government-initiated	–15.2	–10.5	–32.2	–1.5	–21.2		–19.7	Apr
Survey of companies (net balance, percent) ^b								
Output of manufacturing firms	–3 ^d	–9 ^d	4 ^d	9 ^d	29 ^d	20 ^d		Jun
Sales by commercial firms	7 ^d	31 ^d	12 ^d	14 ^d	53 ^d	15 ^d		Jun

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

^b Compared with January–June 2003.

^c 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.

^d Not significant at 5% level.

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

contractors are pessimistic in their expectations for the future (according to the Companies Survey for the second quarter of 2004), and this is reflected in the steep decline in construction investment in 2004:II. Activity remained at a very low level, and in 2004:I the supply of finished apartments and of building starts continued to fall (Table 2 and Figure 3). Government initiated building starts fell by 55.2 percent from the level in the equivalent period in 2003, as part of the government's policy of reducing public expenditure. It seems that most of the activity was in the market for second-hand apartments, which does not contribute directly to economic activity.

Strenuous measures taken to replace foreign workers in the construction industry with Israelis led to an increase of 1.6 percent in the number of Israelis from the number in 2003:IV to 129,800, while the number of non-Israelis fell. The number of foreign workers dropped by 2.7 percent to 49,600, and the number of Palestinians (with

permits) went down by 2.5 percent to 19,500. The average real wage per Israeli employee post in 2004:I was 5 percent above the average for the year 2003.

The recovery in incoming tourism which started in 2003:II continued in the first half of 2004, but at a slower pace. In January–June the number of tourist entries into Israel was 63.9 percent above the number in the equivalent period in 2003 (Table 2 and Figure 4). (The number of tourist entries in 2003:I, particularly in March, was very low because of the war in Iraq, so that in the comparison of figures with that period very large changes are obtained.) In April and May the trend intensified; the number of tourist entries went up by 12 percent, and the number of hotel bed nights, seasonally adjusted, rose by 15.5 percent from the level in 2004:I. As inbound tourism rose, so did domestic tourism, and the number of hotel bed nights of Israelis was 12 percent higher than in April and May 2003, seasonally adjusted.

Box 1 Macroeconomic forecast for 2005

The macroeconomic forecast for 2005 reflects a continuation of the recovery process that took place in 2004. The assumptions underlying the forecast are that world trade will grow, relative calm will be preserved in the security situation, and that economic policy will be consistent with the targets set by the government. In the forecast business-sector is expected to rise by 4.8 percent in 2005, and GDP by 3.5 percent, due to a slight drop in the public services product in accordance with economic policy, and a slow increase in housing services product, reflecting very gradual recovery in housing investment. The expansion of business activity and the continued reduction in the number of foreign workers will be accompanied by a faster increase in employment; nevertheless, the rise in productivity and the stabilization of the rate of participation in the labor force at a high rate will moderate the reduction in the unemployment rate, which will reach 10 percent, after rising steadily in the last few years.

Exports: A slight slowdown in the rate of increase of world trade from 2004 to 2005, and in particular a decline in the industrialized countries' share of world trade, will act to hold back export growth. This effect will be slightly lessened if Israel's terms of trade improve as expected.

Private consumption will grow rapidly due to the increase in disposable income and wage income, the result of accelerated growth during the recovery from the recession and the lowering of taxes, and the shortened cycle in consumption of durables.

Investment in the principal industries is expected to rise faster in 2005 following the firmer growth pattern and the backlog of investment after the turnaround in the business cycle. Despite the increase in disposable

Indicators of Economic Development, 2003–2005

	2003	2004 estimate	2005 forecast
Sources and uses		Volume change, percent	
GDP	1.3	3.7	3.5
Business-sector product	1.7	5.2	4.8
Private consumption per capita	-0.5	2.4	2.2
Public consumption excluding defense imports	-0.8	-0.9	-0.8
of which Civilian consumption	0.3	-1.1	-0.8
Fixed investment	-4.9	3.8	7.1
Domestic uses (excluding defense imports)	-1.3	4.0	3.4
Goods and services exports	6.2	9.1	7.4
Civilian imports	-1.0	9.3	6.6
		percent change	
Average population	1.8	1.8	1.8
Unemployment rate (percent of labor force)	10.7	10.6	9.9
Total number of Israelis employed	2.0	3.2	2.5
of which In the business sector	2.5	4.7	3.7

income, it was assumed that investment in residential construction will expand gradually, as hitherto there are no signs of recovery in that area.

Public consumption: The government decision setting a ceiling on the increase in public expenditure and the wage rise expected in the public sector with the ending of the “growth support” deduction from wages in mid-2005 make a reduction of about 1 percent in public expenditure necessary.

The labor market: it is assumed that the participation rate will settle at 55.1 percent, which it reached in 2004. The assumption is that the reduction in the number of foreign workers (including Palestinians) will continue more slowly. Against the background of economic growth, these two factors will lead to a rise of 2.5 percent in the number of employed persons (3.7 percent in the business sector). The average unemployment rate in 2005 is likely to dip below 10 percent.

The real wage will rise slowly, because of the relatively slow increase in labor demand and the rise in the participation rate. A reduction in unit labor cost will improve companies’ profitability, which will be reflected in a steep rise in income tax revenues. The increase in the real wage is expected to match the rise in labor productivity.

The NIS is expected to show real appreciation as a result of greater demand for output relative to supply factors, particularly of capital stock, which has contracted in the last few years because of the decline in investment. The increase in the deficit on the current account in 2004 and 2005 are not likely to ease these pressures, as was the case in the business cycles in Israel following the economic stabilization program: boom periods are accompanied by real appreciation with a rise in the current-account deficit and capital flows to the economy.

The labor market

The rise in employment in the business sector was almost marched in step with the recovery in economic activity (Figure 5). In 2004:1 the employment rate rose to 49.2 percent. This was due to the greater elasticity of the labor market than in the past—expressed by the reduction in the real wage during the recession years—the building of the security fence that prevents Palestinians from entering Israel, and the substitution of Israelis for foreign workers. In the public sector employment went up by about one percent, lower than the rise in the working age population. The number of public-sector employees was 1.2 percent below the number in 2003:1.

The two-digit industries which showed the greatest increase in employment were manufacturing, hotel and catering services and banking, all of which by about one percent from the level in the previous period (seasonally adjusted). The increase in employment in manufacturing

followed a reduction in the number of employees in the industry in 2003. Other prominent rises were those in the number of Israelis employed in domestic services (1.9 percent), and in security and cleaning services (1.7 percent). In total these industries absorbed 14,400 new employees. The rise in the employment of Israelis in construction and household services was partly due to the government’s policy of reducing the employment of foreign workers (by about 17,000), and the erection of the security fence which created an obstacle to the entry of Palestinian workers into Israel.

As the number of employed persons increased, the average number of hours worked per Israeli employee went up by 0.5 percent, having declined by 0.5 percent in the previous quarter (Table 3). This indicates that employers are waiting for the rate of increase in activity to stabilize.

The rate of unemployment dipped fractionally by one-tenth of a percentage point to 10.8 percent (Table 3), after reaching 10.9 percent in the second half of 2003.

Table 3. Indicators of Labor Market Developments, 2003–2004

(seasonally adjusted data)

	2004	2004	2003			2004		Jan–Jun 2004 ^a	Last month for which data available
	I	II	II	III	IV	I	II		
	('000s)		percent change from previous quarter						
1. Civilian labor force	2,671		-0.3	0.9	1.6	0.7		3.1	Mar
2. Total employees ^b	2,383		-0.1	0.5	1.6	0.9		3.0	Mar
of which: General government	721		1.4	0.2	-1.1	-0.1		0.0	Mar
Business sector	1,662		-0.3	0.7	2.4	1.4		4.4	Mar
of which: Israelis	1,648		0.6	1.9	1.4	0.5		4.4	Mar
Non-Israelis ^c	223		-2.0	-1.8	-2.9	-2.5		-8.8	Mar
3. Average hours worked weekly per employee	37.1		-1.6	0.5	-0.3	0.5		-0.5	Mar
4. Labor input in business sector (incl. foreign workers)	78,428		-1.5	0.2	1.6	1.0		1.4	Mar
of which: Israelis	68,409		-1.3	0.6	2.4	1.7		3.8	Mar
5. Labor input in general government (Israelis)	20,137		-1.4	2.4	-1.7	-0.5		-1.1	Mar
6. Israeli employees (total)	2,379		0.4	0.6	1.4	0.7		3.0	Mar
7. Unemployed	288		-1.7	4.5	1.9	-0.6		3.6	Mar
8. Work seekers	231	228	2.1	11.6	5.7	-0.8	-1.3	17.4	Jun
9. Claims for unemployment benefit	84	75	-4.0	0.7	-0.6	-3.5	-11.1	-10.6	Jun
	Nominal NIS, (unadjusted)								
10. Wage per employee post ^c	7,148	6,859	-2.5	2.6	-0.1	4.5	-4.5	3.3	Apr
General government	7,049	6,315	-5.4	5.1	1.4	6.4	-7.3	5.7	Apr
Business sector	7,102	7,003	-0.4	1.0	-0.7	2.7	-1.9	2.1	Apr
			percent						
11. Participation rate			54.1	54.4	55.0	55.1		1.2	Mar
12. Employment rate			48.4	48.4	49.0	49.2		1.1	Mar
13. Unemployment rate ^e			10.5	10.9	10.9	10.8		1.0	Mar
14. Depth of unemployment ^f			39.9	35.5	35.2	38.7		10.3	Mar

^a Compared with January–June 2003 (unadjusted).^b Including Israelis and an estimate of foreign workers.^c Foreign workers and Palestinians.^d Excluding Palestinians.^e Unemployed (Row 7) divided by civilian labor force (Row 1).^f Percent of unemployed seeking work for more than six months.

SOURCE: Central Bureau of Statistics, Labor Force Survey, except for data on Israelis, non-Israelis, and labor input in the business sector, and total Israelis employed, which are the Central Bureau of Statistics' National Accounts estimates.

The main reason for this small decline in the rate was the rise in the participation rate of both men and women, which increased the civilian labor force. One explanation for this increase is the return of discouraged workers to the labor market; the cuts in transfer payments and the stricter criteria for obtaining them may have encouraged the participation in the labor market. As unemployment

dipped, labor input in the business sector rose by 3.2 percent. On the other hand, the depth of unemployment deteriorated: the number of those seeking work for more than half a year increased by 3.5 percent in 2004:I, and the share of those who had not worked in the previous year went up by 1.5 percentage points.

The average wage per employee post rose in January–April by 3.3 percent from its level in those months in 2003. The change in the wage in the public sector was due to a non-recurring cause: the postponement of payment of the jubilee grant and vacation supplement from 2003 to January 2004, which created a high fluctuation (Table 3 and Figure 6). Despite the fluctuation, an upward turn is evident in what was a downward wage trend during the previous three years. A comparison of average wage in February–April 2004 with the average in the last quarter of 2003, thus removing the effect of the one-off rise paid in January, shows that the average wage in the business sector, seasonally adjusted, rose by one percent.

The problem of delays in payment of wages in the municipalities persisted in the period reviewed. In some, wages had not been paid for a year! This problem arose as a result of the cut of about 40 percent in the balancing grant to municipalities and another 6-percent across-the-board cut in the education, health and welfare grants. Most of the municipalities withholding their staff's wages are classified in the lower socioeconomic range, whose

main income (64 percent) is derived from government transfers; the rate of unemployment in these areas is high. Withholding wage payments, which continued in the first half of 2004, as a means of applying pressure, had very serious effects on the workers, who have not received the wages to which they are legally entitled, and also on the residents who do not receive the proper municipal services.

The balance of payments

The more firmly based growth was expressed by the acceleration of international trade. In the first half of 2004 imports of capital goods and intermediate goods (excluding ships, aircraft, diamonds and fuel) rose by 24.7 percent compared to the first half of 2003. This increased Israel's goods imports by 21.2 percent over the equivalent period in 2003 (Table 4). This increase reflects the rise in domestic demand, which was boosted by, among other things, the rise in disposable income and expectations that the economic recovery would persist.

Table 4. Balance of Payments, Foreign Trade, and the Reserves,^a 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^b	Last month for which data available
		II	III	IV	I	II		
percent change from previous period								
Goods imports	0.4	6.0	0.1	4.8	10.0	4.1	21.2	Jun
of which: Consumer goods	–1.8	7.5	5.7	2.9	9.1	–2.8	21.3	Jun
Capital goods	–4.1	9.4	–7.5	1.3	13.1	2.6	12.0	Jun
Intermediates	3.1	4.2	1.6	6.8	9.2	6.9	25.2	Jun
Goods exports	7.2	–4.5	0.1	7.5	12.5	–1.7	17.3	Jun
Manufacturing	6.8	–4.3	0.2	7.5	11.6	–0.9	17.0	Jun
High-tech	3.3	–10.8	1.6	7.3	13.5	–1.5	15.8	Jun
quarterly averages, \$ million								
Trade deficit	203	257	257	225	205	327	266	Jun
Current account, net	24	36	–1,078	747	587			Mar
Financial account (excl. foreign exchange reserves)	–154	–218	1,168	–8	–1,968			Mar
Nonresidents' direct investment	918	1,628	530	719	609			Mar
Nonresidents' portfolio investment	573	–66	1,064	1,555	2,189			Mar
Residents' direct and portfolio investment abroad	879	710	512	2,226	3,177			Mar
Net foreign debt (percent of GDP)	–4.33	–4.58	–4.70	–4.35	–6.12			Mar
Bank of Israel reserves, end-period	25,788	24,089	24,767	25,788	26,162	25,712	25,712	Jun

^a At current prices, seasonally adjusted. Foreign trade data do not include ships, aircraft, diamonds, or fuel.

^b Compared with January–June 2003.

SOURCE: Central Bureau of Statistics.

Goods exports also accelerated in this period, rising by 17.3 percent from their level in the first half of 2003 (Table 4), with most of the rise in the first quarter—a rise of 12.5 percent from 2003:IV, in contrast to a decline in 2004:II. In the forefront of goods exports were those of the high-tech industries, and to a lesser degree, of the traditional industries, whose profitability improved greatly in 2003. As a result of the fast expansion of exports in 2004:I, the trade deficit fell by 8.8 percent (average), but the decline in exports in the second quarter pushed it up again by 60 percent⁴ (Table 4 and figure 7). This brought the trade deficit in 2004:II to its highest level since the beginning of the recession, despite the slowdown in goods imports.

Manufacturing exports, which were one of the main forces propelling growth forward, rose by 11.2 percent in the first quarter. One of the major components of this increase was the steep rise of 13.4 percent in high-tech exports. Among the prime reasons for the expansion of exports in 2004:I were the streamlining that firms implemented in the second half of 2003, the sharp rise in labor productivity, and the persistent real depreciation. The relative quiet on the security front also contributed to export growth. In the second quarter there was a reversal, and manufacturing exports fell by 2.5 percent. This was due inter alia to the rise in wages, which adversely affected the profitability of the traditional industries, and to a reverse reaction to the acceleration in exports in the first quarter.

In 2004:I the trend of a widening gap in trade prices (relative to GDP prices) continued: import prices (excluding ships, aircraft and diamonds) rose by 2.8 percent, and export prices by 2.2 percent. Prices of imported intermediate goods went up by 4.6 percent during the quarter, and fuel prices by 5.9 percent. The widening of the gap between import and export prices was partly due to the rise in energy prices from the time of the war in Iraq in 2003. Prices of manufactured exports rose by a sharp 8.1 percent in the first quarter, which may act to increase exports in the future.

There was a surplus of NIS 100 million in the services account, seasonally adjusted, with a rise in the deficit on transport services and a rise in the surplus on the account of other services, which include computerization and software services. Imports and exports of tourist services were at similar levels to those in 2003:IV. The surplus in the services account and current transfers offset the deficit in the trade account and the increase in the payments to factors abroad (which derived from a rise in nonresidents' income from their investments in Israel and a reduction

in their interest income abroad due to the lowering of world interest rates), but to a lesser extent than in the previous quarter. Thus the net surplus on the current account declined in 2004:I (Table 5), although it is still 50 percent higher than the surplus in the equivalent period in 2003.

Low yields in the international markets combined with a reduction in Israel's risk premium and the stabilization of the security situation in the confrontation with the Palestinians at a relatively calm level made investment in Israel more worthwhile for nonresidents. As a result, nonresidents' portfolio investments rose steeply in 2004:I, continuing the trend of the previous two quarters but increasing its pace (Table 5) Israelis' investment abroad, and mainly banks' investments, rose considerably in the last quarter of 2003 and even more in the first quarter of 2004 due to the opening of a new investment channel—structured deposits ('structures') in markets abroad that enables risks to be spread, and due to the sharp rise in issues abroad. This may have been affected by the expected removal of discriminatory taxation on Israeli assets abroad. The steep increase in Israelis' investments abroad offset the rise in nonresidents' investment in Israel in the period reviewed. Thus the financial account showed a net deficit of about NIS 2 billion in 2004:I.

The general government

In the context of the economic recovery package introduced in mid-2003 that acted to reduce government expenditure, several legislative changes were made to encourage employment and demand, by means of tax reductions. VAT was brought back down to 17 percent, and it was decided to lower income tax on low-wage earners and the companies tax.⁵ The expansion of economic activity in 2004:I seems to have served to offset the effect of the tax reductions on tax revenues, so that tax revenues after the reductions were equal to the original forecast, and the performance of the budget in the first half of the year was consistent with the achievement of the deficit target of 4 percent of GDP (Table 6 and Figure 9). The domestic cash deficit⁶ (excluding net credit granted) was about NIS 6 billion, down from NIS 15 billion in the first half of 2003 (and an average deficit of NIS 5.5 billion in 2001 and 2002, when the annual deficit was 4 percent of GDP).

⁵ See the Timetable of Events at the end of this review.

⁶ The domestic deficit is reviewed due to the seasonal fluctuations in the deficit abroad.

⁴ In this section data are in current terms.

Table 5. Government Budget Performance vis-à-vis Deficit Target, 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^a	Last month for which data available
		II	III	IV	I	II		
Domestic deficit as percent of GDP	0.5	2.9	1.1	2.1	0.3	NC	2.3	Jun
		deviation from path ^b (NIS billion)						
Government revenue	–3.9	–7.5	–5.0	–2.7	0.5	–2.5	9.1	Jun
Government expenditure	–5.1	–0.3	–2.5	–2.9	0.1	–2.2	–2.2	Jun
Domestic deficit	1.3	–7.2	–2.5	0.2	0.4	–0.3	–59.5	Jun
Total government deficit (excl. credit extended)	–18.7	–9.9	–5.4	–8.0	0.1	–7.4	–0.7	Jun
		percent change from same period in previous year						
Government tax revenue	–1.9	–4.9	–2.3	1.1	8.7	4.9	6.9	Jun
of which: Income tax, gross	–8.2	–12.9	–4.4	–2.3	11.6	2.7	7.3	Jun
VAT, gross	2.0	–0.3	–1.9	2.3	3.4	6.1	4.7	Jun
Government expenditure	2.6	1.3	2.4	–0.6	–2.2	–5.2	–3.7	Jun
National Insurance allowances	–5.1	–3.3	–3.7	–11.2	–6.5	–8.6	–6.5	May
of which: Unemployment benefit	–31.3	–35.5	–24.8	–25.9	–7.8	–15.3	–8.9	May
Income support	–18.9	–27.1	–20.2	–25.8	–15.9	–19.7	–18.5	May
National Insurance contributions received from public	3.4	9.8	–0.4	–4.4	2.7	0.1	1.4	Jun

^a Compared with January–June 2003.

^b The path was determined on the basis of a deficit of 3 percent of GDP in 2003, and 4 percent of GDP in 2004.

SOURCE: Ministry of Finance.

Government expenditure in the period reviewed was 3.1 percent lower than that in the equivalent period in 2003, and NIS 2 billion below the budget path. The reduction in government expenditure started in the last quarter of 2003, but most of it occurred in 2004:II, when the expenditure fell by 9.5 percent. The cut in child allowances and imposition of stricter criteria for entitlement to unemployment benefits reduced the National Insurance allowances by 6.5 percent from their level in the equivalent period in 2003. Expenditure on income maintenance went down by 17.1 percent in the same period (Table 6)

As economic activity increased and imports of durables accelerated, tax receipts also accelerated. Thus tax revenues in 2004:I rose steeply, by 8.7 percent compared with 2003:I, and by 9.8 percent in 2004:II compared with 2003:II (Table 6). Comparing the first two quarters of 2004, however, shows that in the first quarter tax revenues were 11.3 percent higher than in 2003:IV, and then declined by 4 percent in the second quarter.

The upturn in tax revenue during the first quarter was recorded in both direct and indirect taxes. Net government revenue from income tax rose by 11.6 percent in the first quarter compared with the same

quarter of 2003, and by 8.7 percent in the second quarter following a long period of continued decline in revenue (Table 6). The increase is attributed mainly to a rise in nominal wages per employee post and to a rise in the number of employed persons in the economy. It should be noted that part of the upturn in tax receipts during the first quarter derived from the postponement of wage payments to January 2004 (vacation allowance and seniority bonus), and from an upsurge in tax receipts in respect of capital gains. But most of the upturn during the first quarter reflected the rebound in activity in the economy. However, the slower pace of growth in the economy during the second quarter led to a slower pace of tax receipts in that quarter, including revenue from VAT and (net) revenue from income tax.

Revenue from VAT rose by 4.7 percent in the first half of 2004 compared with the same period of 2003 (Table 6). The growth in VAT revenue was recorded in the first quarter of the year, due to the rapid expansion of private consumption and imports of consumer durables. In the second quarter, the one percent cut in VAT (back down to 17 percent) and the slower pace of expansion in private consumption and economic activity led to a decline in VAT receipts.

Table 6. Indicators of Economic Development in Advanced and Developing Countries,^a and Forecast for 2005^b

	2002	2003	2004	Forecast 2005
World GDP	3.0	3.9	4.6	4.4
Advanced countries	1.7	2.1	3.5	3.1
Developing countries	4.6	6.1	6.0	5.9
World trade	3.1	4.5	6.8	6.6
Advanced countries				
Imports	2.3	3.5	5.7	5.4
Exports	1.9	2.7	6.3	6.1
Developing countries				
Imports	6.2	8.9	10.2	9.4
Exports	6.5	8.7	8.1	8.7
Inflation (CPI)				
Advanced countries	1.5	1.8	1.7	1.7
Developing countries	6.0	6.1	5.7	5.0
Countries in transition				
Prices of unprocessed goods (US\$)				
Oil ^c	2.5	15.8	3.8	-10.0
Other	0.5	7.1	7.6	-0.8
Short-term interest ^d (%)				
Dollar deposits	1.9	1.2	1.3	3.5
Euro deposits	3.3	2.3	2.1	2.6
Unemployment rate in advanced countries	6.4	6.6	6.4	6.3

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

^b Annual rate of change, percent, except for unemployment and interest rates.

^c Average price per barrel in 2003 was \$28.89; estimated price in 2004 is \$30.00, and the estimate for 2005 is \$27.00.

^d Six-month Libor rate.

SOURCE: "World Economic Outlook" (IMF), April 2004.

Global developments

Following a period of slowdown, the global economy is undergoing a steady recovery. Forecasts of global growth by the IMF for 2004 were raised in April to 4.6 percent,⁷ compared to a growth rate of 3.9 percent in 2003. The rise in the rate of growth was expressed by the optimism in the financial markets and National Accounts data on

the US economy, and to some extent also on the EU. Thus, for example, the growth forecast for the US was raised to 4.7 percent, the highest since 1985; the forecast in Japan was raised to 3.4 percent; and in China, to 8.5 percent. The forecast for the EU, on the other hand, was reduced to 1.7 percent. The forecast of the rise in world trade in 2004 was increased to 6.8 percent, following rises of 3.1 percent in 2002 and 4.5 percent in 2003 (Table 6). According to this forecast, the growth in world trade will be led by the US and Asia, and in particular, by China (see Box 2).

⁷ IMF World Economic Outlook, April 2004.

The sharp rise of 15.8 percent in world oil prices in 2003 pushed up prices in the advanced countries, but these increases are considered, worldwide and in Israel, to be of a temporary nature, without exerting inflationary pressure that derives from excess demand.

As stated, the IMF forecasts 4.7 percent for the US in 2004, after its 3.1 percent rise in 2003. This forecast is based on indicators from most of the principal industries. In the first quarter of 2004 total labor productivity in the US rose by 3.8 percent, and 300,000 jobs were created, after a long recession in the labor market. There are also data that indicate a rise in risks: the budget deficit climbed in 2004:1 and reached 6.8 percent of GDP. In response to an increase in inflationary pressure, the Federal Reserve raised its interest rate in June by 0.25 of a percentage point, to 1.25 percent, and further hikes are expected in the next few months.

In the EU, where the rate of growth slowed in 2003 to 0.4 percent—its lowest level in more than ten years—

the European economy started to revive. The rate of recovery in the European countries is slower than the global rate, due to weak demand and a high exchange rate. The growth forecast for 2004 went up to only 1.6 percent; this recovery could however be threatened by high unemployment, which rose in the last four months, and reached 9.0 percent in April, above the forecast.

In Japan, the accelerated rise in investment in the principle industries, in exports, and in private consumption propel growth (in May alone exports were 11 percent higher than in May 2003). As a result, assessments are becoming firmer that GDP, which rose by 2.7 in 2003, will go up by 3.4 percent in 2004 and 2005. Several important risks can be seen confronting Japan's economy, however: structural problems of the financial system, persistent deflation, activity to cut the deficit, and concern over a slower rate of exports due to a possible slower growth rate in China, one of Japan's major trading partners (see Box 2).

Box 2

The China Effect and its Impact on Israel

The rate of increase of China's foreign trade, both imports and exports, is very high. In the 1990s it was three times faster than the rise in world trade. In 2003 it rose steeply (Table B1), to reach a total value of imports and exports of \$ 851 billion, a jump of 37.1 percent from 2002. This has made China into the fourth in the world according to the size of foreign trade, taking the countries of the EU together as one. At the same time China's economy has shown high growth rates: 9.1 percent in 2003, a rise of 1.1 percentage points above its growth in 2002.

Like other countries, Israel is affected by China's stronger position in international trade. Israel's exports to China (machinery, diamonds, medical equipment and chemicals) went up by 44 percent in 2003, and reached \$ 631 million. High-tech industries' share of these exports increased to about 40 percent. At the same time, reflecting the policy of exposing Israel to foreign trade, imports from China rose too: in 2003 alone imports swelled by 27 percent to \$ 1,008 million (mainly textiles, machinery, iron, rubber, and electronics).

China's rapid development, especially the sharp rise in trade and some degree of opening its capital markets, are likely to affect other countries in general, and Israel in particular, in several ways:

- The increased supply of labor-intensive Chinese products lowers the relative price of such goods in world markets, to the benefit of consumers.
- China's rapid growth increases its domestic demand, which is likely to lead to increased exports to China, especially knowledge and capital-intensive goods, as well as services, energy, and raw materials for China's industry. The greater the trade in services, the greater the profit for Israeli companies (in particular in communications and financial services).
- These changes in terms of trade bring in their wake changes in the labor mix and the return to labor: the supply of unskilled labor in China is likely to raise the return on capital and on skilled labor, and at the same time reduce the relative return on unskilled labor. As a result, unskilled-labor-intensive industries will continue to suffer the effects of increased competition from China, and the unemployment rate of unskilled workers will rise.

Direct Trade between China and Selected Countries, 2003

	Percent of China's exports directed to	change from 2002 (%)	Percent of China's imports from	change from 2002 (%)
US	18	24.3	21	32.2
EU	22	37.7	16	49.7
Japan	41	38.7	14	22.7
Asia	52	51	12	30

SOURCE: China Council for the Promotion of International Trade, <http://www.ccpit.org>.

- Like other countries, Israel is likely to suffer the adverse effects of China's increased international trade in goods, particularly its increased exports to other countries in East Asia, due to Israel's reduced ability to compete in those markets (specially Japan and Korea) where China has a dominant influence.
- In the light of China's rapid growth and forecast inflation (4 percent in 2004 and 6 percent in 2005) world prices of Chinese goods may rise, but this is likely to have only a limited effect.

China's integration into the global economy is likely to affect Israel, like other countries, via the financial markets too: the lack of a mechanism for channeling foreign credit in China led to a rise in foreign direct investment there over the last twenty years, and these may crowd out such investment in other emerging countries, including Israel. A similar process occurred in Europe, where the closer association of East European countries with the EU crowded out foreign direct investment in Spain and Portugal.

Moreover, increased foreign investment in China, both direct and indirect, and its becoming the world's main target for foreign investment endangers China's continued trade expansion: the sharp surge in foreign investment in China raises concern that it will run into a currency crisis such as that which erupted in East Asia in 1997. According to the IMF, such a crisis would affect trade in two ways: one is the effect deriving from a reduction in the global growth rate, leading to lower demand from abroad, especially demand from Asian countries. The other is that a crisis such as that in East Asia in 1997 is likely to cause a sharp depreciation of the Chinese yuan, thereby seriously affecting the stability of the international, and Israel's, financial markets.

To prevent such a crisis the Chinese government has taken a number of steps to cool down its economy, including imposing restrictions on granting credit and importing capital. China's president also declared recently that he intends to float the yuan. As a result of these measures, the rate of growth of China's trade is expected to slow down, and thus contribute to a slower growth of world trade in the next few years.

Prices, monetary policy, and the money and capital markets

The consumer price index rose by 1.4 percent⁸ in the period reviewed, and the index excluding housing, seasonal items and price-controlled goods went up by 2 percent. The rise in the index was not consecutive: In the first quarter, the index fell to a moderate extent (by a tenth of a percent) while in the second quarter the trend changed, and the index rose by 1.5 percent. The index excluding seasonal factors rose by 1.8 percent in the

⁸ In this section the rates of change are not in annual terms, unless explicitly stated.

second quarter (Table 7). The price increase in the second quarter of the year derived mainly from one-time factors (rises in fuel and electricity prices) following the rise in world prices for oil; in April alone, the CPI rose by 1.1 percent. Also contributing to the rise in the index were a seasonal increase in the prices of clothing and footwear, and a seasonal increase in housing prices. The expansion of private consumption (via the rise in nominal wages) had the effect of raising the index from the demand side.

Gross inflation expectations derived from the capital market stabilized within the target inflation range during the period reviewed (Figure 11). Inflation expectations were not homogenous during the period: In the first quarter, as a result of the 3.4 percent depreciation of the dollar exchange rate and the rise in oil prices, inflation

Table 7. Selected Price Indices,^a 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^b	Last month for which data available
		II	III	IV	I	IV		
CPI	-1.9	-1.3	-1.0	-0.4	-0.1	1.5	2.8	Jun
CPI excl. housing, fruit and vegetables	-0.6	0.2	-1.3	-0.2	0.0	2.1	4.2	Jun
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	-0.4	-0.1	-0.3	-1.1	0.6	1.8	4.9	Jun
Index of housing prices	-6.7	-7.3	1.3	-1.5	0.0	1.4	2.8	Jun
Wholesale price index	3.3	-2.0	0.6	1.2	2.2	2.7	10.2	Jun
NIS/\$ exchange rate	-6.4	-8.4	2.0	-1.6	2.5	0.3	5.7	Jun
NIS/currency-basket rate	-0.5	-6.4	0.9	1.8	2.8	-0.1	5.3	Jun

^a Annual rates of change during period, compared with previous period, percent.

^b Compared with January–June 2003.

SOURCE: Central Bureau of Statistics.

expectations increased and stabilized in the upper part of the target range (2.6 percent). In the second quarter, expectations fell due to the appreciation of the shekel against the dollar and the low indices.⁹

In view of the convergence of prices and inflation expectations to the center of the target inflation range, the Bank of Israel reduced the interest rate by a cumulative 0.7 percentage points in the first quarter of the year, and left it unchanged in the second quarter (Table 9 and Figure 11). As a result, the Bank of Israel's interest rate was 4.4 percentage points lower than in the same period of 2003. The reduction in the interest rate together with the stabilization of inflation expectations at the center of the target range in the second quarter had the effect of reducing the short-term real interest rate to an average of 2.0 percent in the second quarter.

Concurrent with the reduction in the Bank of Israel's interest rate and the decrease in the risk premium, the downtrend in 3-6 month Treasury bill yields continued during the first quarter of 2004 (Table 9 and Figure 14), reflecting the decline in the interest rate. In the second quarter, 3-6 month Treasury bill yields remained static compared with the previous quarter due to the halt to the reduction in the interest rate. However, the yields on Treasury bills for periods of six months to one year rose during the second quarter, a development indicative of

⁹ The large price increase recorded in April (1.1 percent) appears to have been seasonal (due to the Passover holiday and fuel prices) and the capital market perceived it as such, rather than as evidence of demand surpluses.

the public's expectations that the Bank of Israel would raise the interest rate in the second half of the year in order to attain the inflation target. The future real yield curve of long-term (5 to 9 year) government bonds, which reflects the percent of the risk inherent in the government debt, rose during the period reviewed (and fell slightly towards the end of the period). This was in contrast to the downtrend that prevailed in 2003.

The proportion of liquid assets rose considerably during the period reviewed. The M1 money supply expanded by 7.2 percent in the first quarter and by 6.6 percent in the second quarter in current terms. As a result, the money supply increased by 26.9 percent in annual terms during that period (Table 8), compared with an average rate of increase of 13.3 percent during the years 1997-1999 and 9.4 percent during the years 2000-2002. The reduction in the interest rate and the imposition of tax on capital gains made investment less worthwhile. Since total deposits therefore decreased, the rate of increase in the M2 aggregate¹⁰ – 2.9 percent – was less than that in the M1 money supply. The M3 aggregate rose by 1.7 percent in the period reviewed, which was slightly more than the forecast inflation rate. The gradual process of liquidation of the financial asset portfolio has continued since the beginning of 2003 and increased greatly during the period reviewed, reflecting the impact of the interest rate reduction on the composition of the portfolio and the growth in activity in the economy.

¹⁰ M1 plus unindexed time deposits (up to one year) plus self-renewing overnight deposits.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2003–2004
(annual terms, percent)

	2003 Average	2003 Change from preceding quarter			2004 Change from preceding quarter		Cumulative change over previous 12 months	Jan–Jun 2004	Last month for which data available
		II	III	IV	I	II ^a			
Rates of change		During period							
M1 ^b	0.5	-1.6	9.7	10.5	32.1	25.1	21.6	26.9	Jun
M2 ^c	1.7	-4.0	6.0	8.4	3.6	-0.5	5.3	2.9	Jun
M3 ^d	2.2	-5.2	3.2	5.0	7.0	3.9	5.7	6.2	Jun
Nondirected bank credit	1.7	-5.9	-3.7	0.1	7.3	1.0	1.5	3.7	Jun
Unindexed local-currency credit	7.1	10.0	3.0	-1.6	8.5	5.4	2.7	5.2	Jun
CPI-indexed credit	-1.1	-2.9	-7.8	-5.1	16.4	-3.8	0.5	7.2	Jun
Credit in and indexed to foreign currency	-0.9	-26.1	-6.4	10.5	-5.7	2.2	1.2	-2.8	Jun

^a Some of the data for 2004:II are based on preliminary figures.

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

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

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

SOURCE: Bank of Israel.

Total nondirected credit expanded by 3.7 percent during the period reviewed (Table 8) after contracting by 2.4 percent in 2004. This was against the background of price stability and forecasts of increased growth, which will reduce borrowers' risk premium. The moderate increase in unrestricted credit following a continued decrease in real unrestricted credit since 2000 (Figure 12) is attributed mainly to the raising of capital in the USA (NIS 8.5 billion during the first five months of the year). The increase reflects *inter alia* the large increase in stock issues in the primary market (NIS 12.1 billion in the first five months of the year) and the raising of capital outside of the banking system, via the issue of corporate bonds. The growth in unrestricted credit during the first half of the year was notable for a 6.5 percent expansion in CPI-indexed and unindexed local currency credit, while foreign currency and foreign currency indexed credit contracted by 8.1 percent.

The General Share Price Index rose by 15.5 percent in the period review; by 9.2 percent in the first quarter and by 5.8 percent in the second quarter (Table 9), concurrent with a decrease in volatility to the lowest level for the past four years, in contrast to the worldwide trend of

increased volatility. The rise in the index reflects the public's confidence in economic policy, and the stabilization of alternative yields at a low ebb. The rise in the index also reflects the expectations of a continued recovery in the economy, although at a slower pace than in the first quarter of the year. Supporting a continuation of this trend are the high P/E ratio (an average of 14 for the Maof index) and a high level of profitability. The US share indices fell to a moderate extent during the period reviewed. (The high-tech shares index dropped by 4 percent). Companies notable for a rise in their share prices and a growth in profit during the first quarter of 2004 were in the real estate industry, the manufacturing industries and the electronics industry. The most notable sector in this respect during the second quarter was the mortgage bank sector. In contrast to the positive trend in the market, the shares in the Tel-Tech Index were notable for a decrease of 0.9 percent and the shares of the real estate industry were notable for a decrease of 0.5 percent. The large rise in the share indices during the previous year had the effect of expanding the public's financial asset portfolio during the first quarter of 2004. As a result, activity in the financial markets increased to a significant extent.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2003–2004

	2003	2003			2004		Jan–Jun 2004 ^a	Last month for which data available
		II	III	IV	I	II		
Nominal interest	percent change over previous period, annual terms							
Marginal interest on monetary loan	7.8	8.7	7.3	5.8	4.6	4.2	4.4	Jun
SRO deposits	6.2	7.1	5.7	4.4	3.4	3.0	3.3	May
Nondirected local-currency credit	10.6	11.4	10.2	8.9	7.9	7.4	7.7	May
3-month Eurodollar	1.1	1.1	1.0	1.0	1.0	1.2	1.1	Jun
Yield to maturity on:								
Treasury bills	7.0	7.6	6.5	5.4	4.8	5.0	4.9	Jun
10-year bonds	4.8	4.8	4.6	4.2	4.1	4.3	4.2	Jun
5-year bonds	4.9	5.2	4.5	4.2	3.8	3.9	3.9	Jun
Expected inflation (gross)	2.7	1.9	2.7	2.2	1.8	2.2	2.0	Jun
Interest derived from expected inflation (gross)								
General Share-Price Index (change)	55.7	31.0	–3.5	18.2	9.2	5.8	15.5	Jun

^a Compared with January–June 2003.

SOURCE: Bank of Israel.

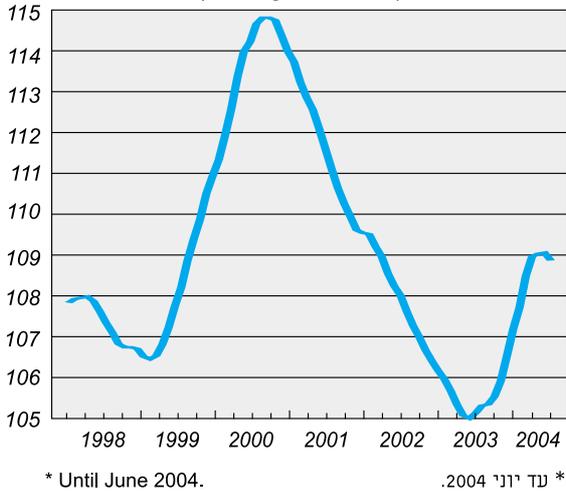
Timetable of Events: January–June, 2004

Month	Date	Event	Details
January	1	Income tax brackets and credit points were downward adjusted.	By 1.95 percent; under the automatic annual adjustment,
	5	An agreement signed between the Treasury and the Histadrut, ending 100 days of disruptions in the general government sector.	It was decided <i>inter alia</i> under the agreement: <ol style="list-style-type: none"> 1. There will be no unilateral dismissals in the general government sector in 2004. 2. Part of the structural changes in the civil service that the Treasury proposed will be deferred or canceled. 3. Part of the principles of the program for saving the old pension funds were changed.
	7	The State Budget in the amount of NIS 255 billion was approved.	
	8	The Knesset passed the Retirement Age Law.	The retirement age will be gradually raised by 4 months a year, to 64 for women and 67 for men.
	25	The State's share in the Zim Navigation company was sold.	In the amount of NIS 125 million.
February	1	The changes in child allowances under the economic program for 2003 went into effect.	<ol style="list-style-type: none"> 1. The child allowances were cut by NIS 24 per child. 2. A mechanism for reducing the allowance for children born from 1 June 2003 to 2006 was determined. 3. The allowance for each child born from 1 June 2003 was set at a uniform amount of NIS 144.
	1-18	Local authority employees went on strike due to the non-payment of salaries. (The 15 largest authorities were not hit by the strike).	Under an agreement signed on 18 February 2004, it was decided to reduce the impact of cutbacks on the authorities, and to reinstate part of the grants that were cut.
	11	A 1 percent cut in VAT from 1 March was announced and the purchase taxes on certain electrical appliances were cut immediately.	For example, the taxes on fridges were cut by NIS 900, on cooking stoves by NIS 400, on washing machines by NIS 360 and on TV sets by NIS 500.
	25	An agreement for structural change in the Mekorot water carrier was signed.	Under the agreement, a separation will be made between (monopolistic) water supply activity and activity in competitive sectors.
March	1	The tax cuts announced in February went into effect.	<ol style="list-style-type: none"> 1. VAT fell from 18 percent to 17 percent. 2. Prices of milk and eggs under control were reduced by 1 percent. 3. The customs duty on basic food products was abolished.

Month	Date	Event	Details
April	4	The Ministerial Committee for Social and Economic Affairs approved the changes in the Law for the Encouragement of Capital Investments.	<p>The tax benefits track will be transferred to the auspices of the income tax authorities.</p> <p>Two tax benefit tracks were added for investments in national preference areas and for large investments.</p> <p>In the grants track a criterion was added whereby the grant will only be awarded to companies that export at least 25 percent of their sales.</p>
	15	The Ministerial Committee for Legislative Affairs approved the proposed amendment to the Labor Disputes Implementation Law, limiting the right to strike.	
May	4	The railway company's methods of operation in the areas of development, land and subsidization were subjected to regulatory procedures.	<p>Under the agreement, development expenses will be within the framework of the budget.</p> <p>The cost in the 2004 budget is estimated at NIS 1.9 billion.</p>
June	29	The Knesset approved the Finance Minister's proposal to reduce income tax rates for individuals with low and medium income, and to reduce corporation tax.	<ol style="list-style-type: none"> 1. Corporation tax will be gradually reduced from 36 percent to 20 percent over the next five years. The budget cost of a 1 percent cut in the rate of corporation tax is NIS 400 million a year. 2. From 1 July 2004, the tax for low and middle-income earners will be reduced, and the tax bracket for those The tax benefits track will be transferred to earning between NIS 7,500 and NIS 11,040 a year will be raised. The budget cost of reducing the taxes is NIS 1.3 billion per full tax year, and half of this for 2004. 3. The purchase tax on building materials was abolished.
	30	The period of validity of the Law for the Encouragement of Capital Investments was extended.	The period of validity of the Law in its present format was extended until 30 October 2004.

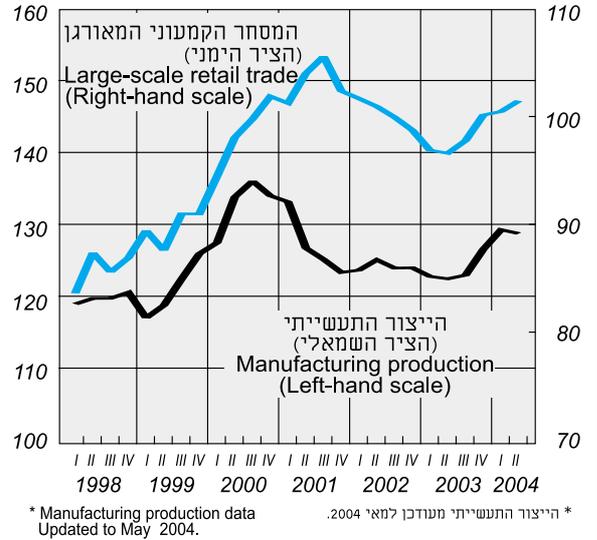
דיאגרמה Figure 1

המדד המשולב לחצב המשק, 1998 עד 2004*
(100 = 1994)
State-of-the-economy index, 1998-2004*
(average 1994=100)



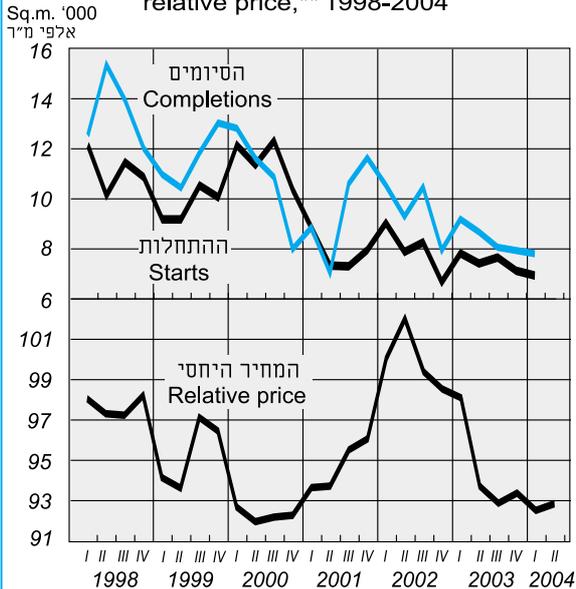
דיאגרמה Figure 2

הייצור התעשייתי* (מדד, ממוצע 1994=100) והמסחר הקמעוני המאורגן (מדד, ממוצע 2002=100), 1998 עד 2004
Manufacturing production* (index, average 1994=100) and large-scale retail trade (index, average 2002=100), 1998-2004



דיאגרמה Figure 3

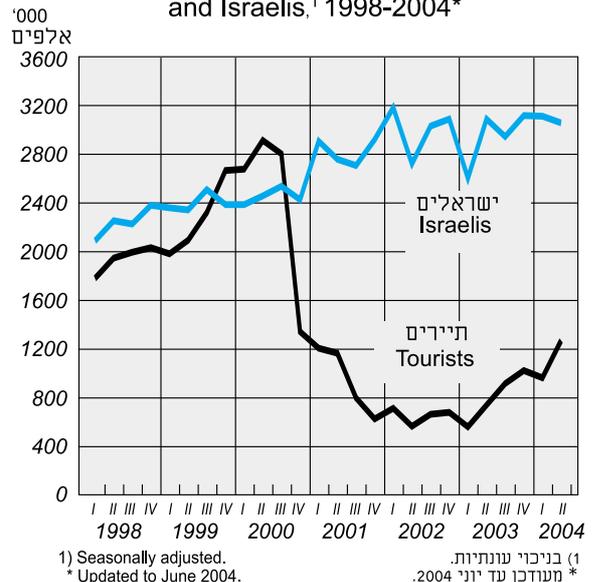
מספר ההתחלות והסיומים* של יחידות דיור והמחיר היחסי של הדיור**, 1998 עד 2004
Housing units: starts and completions,* and relative price,** 1998-2004



* Original data, Updated to March 2004. * הנתונים מקוריים, מעודכן עד מארס 2004.
** Relative to CPI, Updated to June 2004. ** במונחי מדד המחירים לצרכן, מעודכן עד יוני 2004.

דיאגרמה Figure 4

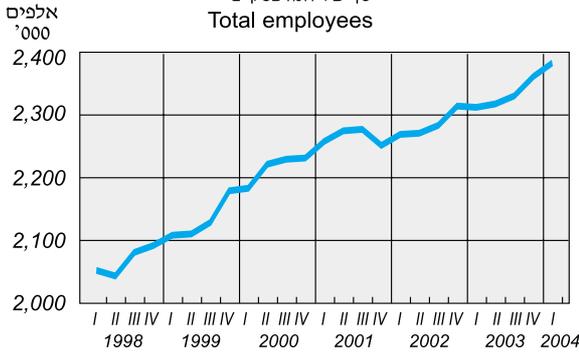
ענף המלונאות - לינות תיירים וישראלים¹, 1998 עד 2004*
The hotel industry: bed nights of tourists and Israelis,¹ 1998-2004*



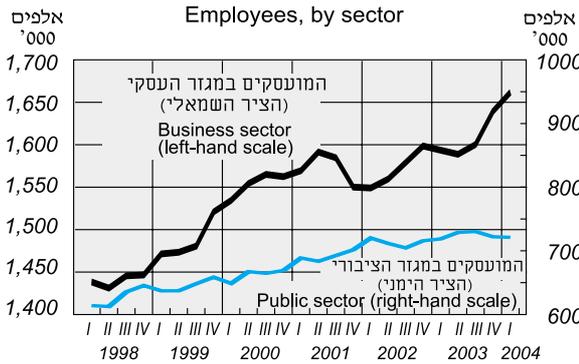
דיאגרמה 5 Figure 5

שוק העבודה¹, 1998 עד 2004*
The Labor Market¹, 1998-2004*

סך כל המועסקים
Total employees



המועסקים במגזר העסקי והציבורי
Employees, by sector



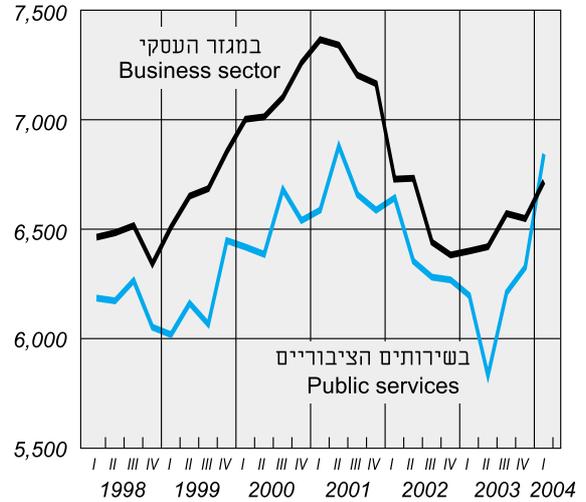
שיעורי האבטלה והתעסוקה
Unemployment and employment rates



1) Seasonally adjusted. * עד מארס 2004.

דיאגרמה 6 Figure 6

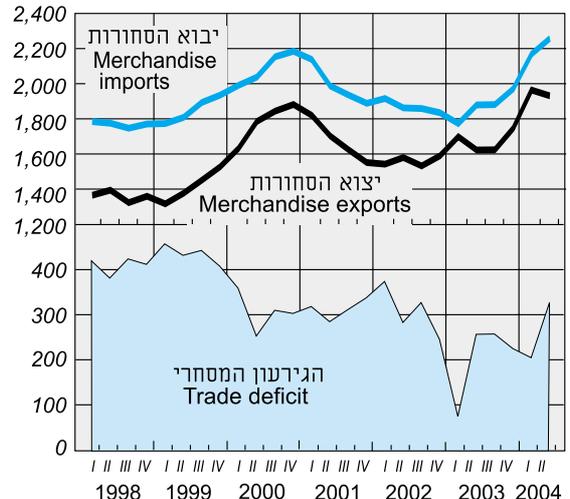
השכר הריאלי למשרת שכיר* 1998 עד 2004
(ש"ח, במחירי 2001)
Real wage per employee post*, 1998-2004
(NIS, 2001 prices)



* Updated to March 2004. * מעודכן למארס 2004.

דיאגרמה 7 Figure 7

סחר החוץ¹, 1998 עד 2004*
(מיליוני דולרים לחודש)
Foreign trade¹, 1998-2004*
(\$ million per month)

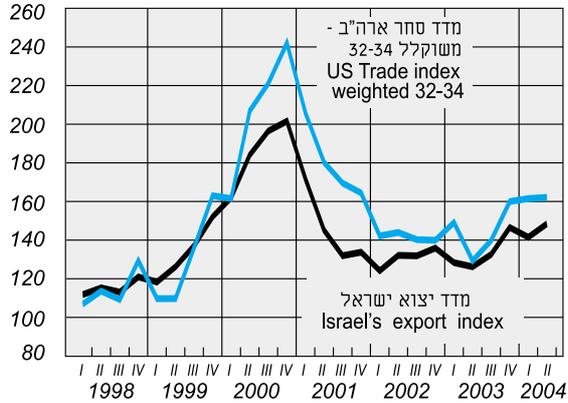


* עד יוני 2004. * עד יוני 2004.
1) Excluding ships, aircraft, diamonds, and fuel. 1) ללא אניות ומטוסים, יהלומים ודלק. Seasonally adjusted. נתונים מונכי עונתיות.

דיאגרמה Figure 8

היצוא מישראל¹ והסחר של ארה"ב² - רכיבים אלקטרוניים, ציוד תקשורת אלקטרוני, ציוד לבקרה ולפיקוח וציוד מדעי, 1998 עד 2004

Israel's exports¹ and US Trade²: electronic components, electronic communications equipment, and scientific and monitoring equipment, 1998-2004

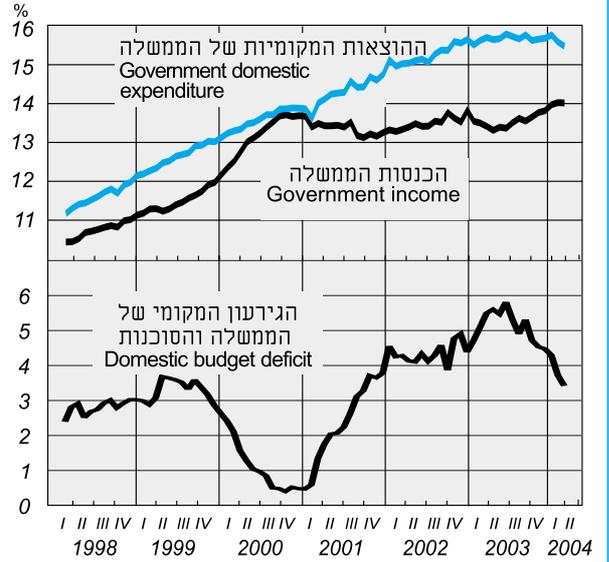


1) Until June 2004. (1) עד יוני 2004.
2) Until May 2004. (2) עד מאי 2004, מנופח עד יוני.
extrapolated until June.

דיאגרמה Figure 9

ההכנסות וההוצאות השוטפות של הממשלה, *1998 עד 2004 (מיליוני ש"ח, ממוצע נע של 12 חודשים, באחוזי תוצר)

Government cash flows, 1998-2004* (NIS million, 12-month moving average, percent of GDP)

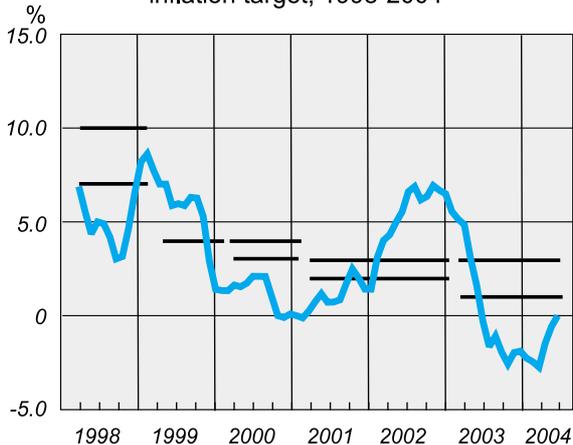


* Until June 2004. * עד יוני 2004.

דיאגרמה Figure 10

האינפלציה ב-12 החודשים האחרונים ויעד האינפלציה, *1998 עד 2004

Inflation in previous 12 months and the inflation target, 1998-2004*

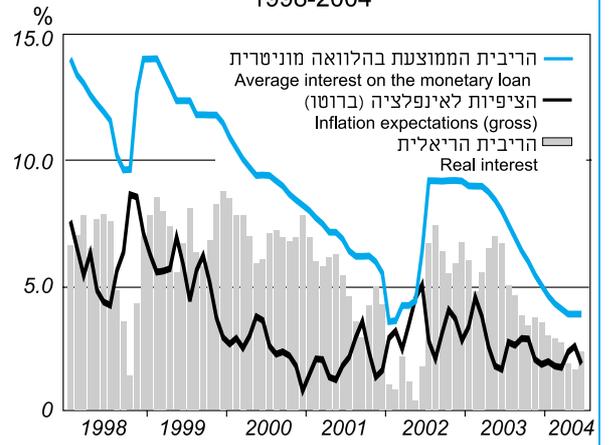


* Updated to June 2004. * מעודכן ליוני 2004.

דיאגרמה Figure 11

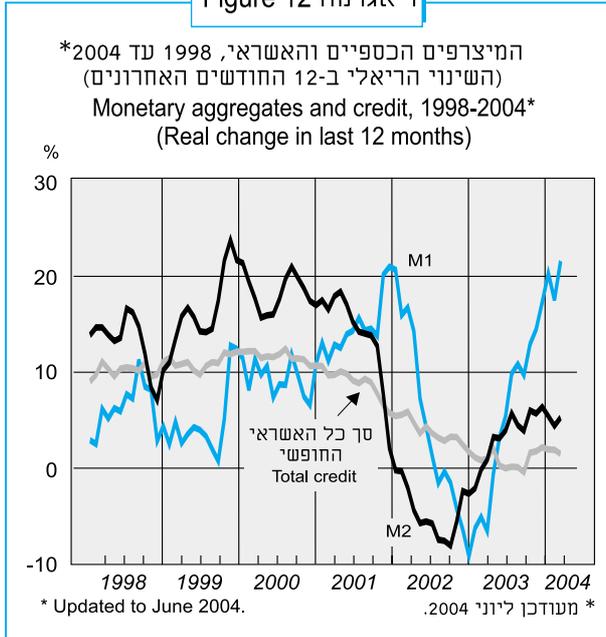
הריבית והציפיות לאינפלציה, *1998 עד 2004

Interest and inflation expectations, 1998-2004*

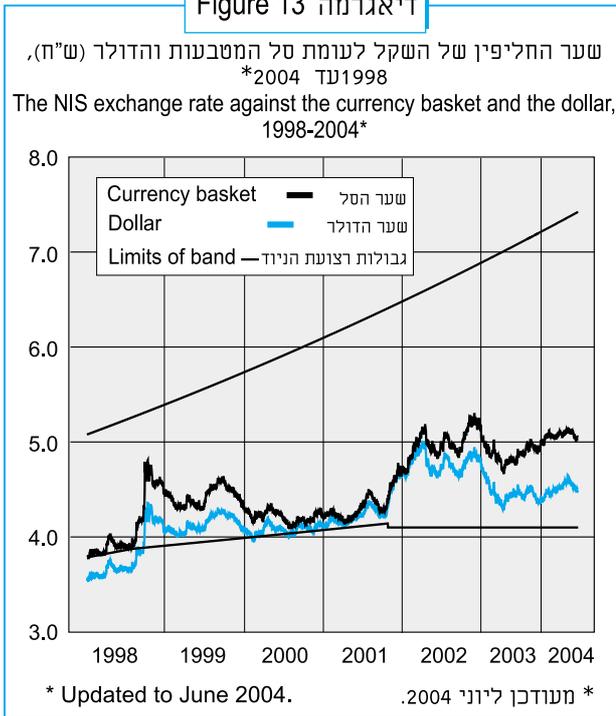


* Updated to June 2004. * מעודכן ליוני 2004.

דיאגרמה Figure 12



דיאגרמה Figure 13



דיאגרמה Figure 14

