
RECENT ECONOMIC DEVELOPMENTS*

Main Developments

The main theme running through the period from October 1999 to March 2000 (henceforth—the period reviewed) was the end of the millennium and concern—which turned out to be unfounded—at the implications of the Y2K bug on the global economy. Domestically, the recovery in the level of activity in Israel's economy continued, albeit at a lower rate than that of the previous two quarters, and the budget for the year 2000 was passed. In international capital markets, technology and internet shares rose strongly and continuously, resulting in new peaks of capital raising and values of firms regarded as being related to the "new economy." The sharp downward correction to the prices of these shares which occurred at the end of the period reviewed halted these trends, and their current high volatility may have a negative effect on global economic activity later in the year.

In the second and third quarters of 1999, after three years of recession in Israel's economy, reflected in negative *per capita* growth rates and continuous rises in the rate of unemployment, the main economic indicators started showing that the trend was changing and that the economy may be about to recover from the recession: the growth rate surged, inflation declined and came close to the target set by the government, and some features of the labor market also pointed to an improvement. These trends continued in the last quarter of 1999: growth persisted at a relatively high rate, the rate of inflation went down to about 2 percent, annual rate, and average unemployment fell slightly. Activity in that quarter, and particularly in November and December, was affected by preparations for dealing with the millennium bug, which were reflected in reduced tourism, imports being brought forward, increased investment, and a rapid rise in the money supply. Although preliminary data for January–February 2000 point to a significant slowdown in the increases in the main indicators of economic activity, data for March generally corrected the weak trend indicated. The main indicators suggesting continued expansion of economic activity in 2000:1 include the impressive rise in exports and tourism, and a sharp increase in tax revenues. On

the other hand, the rate of unemployment in 2000:1 remained at the peak level of 1999, the recession in the construction industry continued and may even have deteriorated further, and prices actually fell. Throughout the six months of the period reviewed, the state-of-the-economy index calculated by the Bank of Israel did not rise (after rising at an annual rate of more than 8 percent in the previous six months), and the seasonally adjusted rate of increase of the index of industrial production declined to below 2 percent, annual rate, after rising by more than 15 percent a year between March and September 1999.

The weakness in expansion of economic activity in January–February 2000 shown by the main indicators, the persistence of unemployment at a high level since the middle of 1999, and the development of prices in the last few months raise questions regarding the robustness of the recovery in economic activity and the expected emergence from the recession. Although growth is expected to be 4–5 percent in 2000, some of this expected growth reflects the rapid growth in the last three quarters of 1999, and there is still uncertainty regarding the rate of growth actually taking shape in 2000 (see page 12).¹

It will therefore be appropriate to examine the factors acting for and against rapid growth in 2000. Two of the major factors which supported a high level of activity in the period reviewed are a) the high level of demand for Israel's exports, mainly in high-tech industries and tourism, which are supported by the accelerated rise expected (according to IMF predictions) in the rates of growth in the industrialized countries and in the level of world trade, and b) the recovery in private consumption against the background of the "bullish" capital market and accelerated immigration to Israel which started at the end of 1999. These two factors are expected to continue pulling Israel's economy forward during the year, but it is unclear how strong their effect will be, as the profitability

¹ The rapid growth in the last three quarters of 1999 resulted in GDP at the beginning of 2000 being 2.2 percent higher than its average level in 1999. This growth rate will therefore be part of the annual growth rate for 2000, as annual rates are calculated by comparing average levels in consecutive years. The rate of growth which will occur in 2000 itself will affect the rate for 2001 in the same way.

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

Table 1. Indicators of Business Activity, 1998–2000
(all data excluding construction are seasonally adjusted)

	1998	1999	1999				2000	Oct–Mar ^a		*
			I	II	III	IV		1999	2000	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	3.1	2.9	-1.3	2.4	14.8	-3.3	2.8	2.3	3.7	3
Large-scale retail trade	6.6	4.3	8.4	-3.0	11.8	-1.3	7.7	6.2	3.7	3
Manufacturing production (excl. diamonds)	2.7	1.2	-7.2	2.9	19.2	0.1	5.7	1.9	4.8	2
Business-sector consumption of electricity	2.5	2.8	-1.5	-0.7	16.4	16.4	8.5	6.3	8.6	2
Index of revenue in commerce	0.8	3.6	-2.7	8.7	20.5	8.1	1.6	-1.5	9.7	2
Index of total revenue	3.5	5.0	-5.1	9.8	16.9	13.8	3.1	2.2	10.1	2
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	-5.7	16.4	3.9	2.4	10.0	4.8	0.5	2.4	23.2	2
Immigrant arrivals	-15.4	21.3	-16.8	9.8	45.7					9
Residential starts	-21.2	-7.3	-18.3	2.2	16.0	-10.5		1.0	-13.3	12
of which:										
Government-initiated	-44.4	3.0	16.9	13.9	38.0	-36.4		-53.9	16.9	12
Residential completions	-21.6	-13.4	-3.5	-7.0	13.8	2.0		-37.6	4.2	12
of which:										
Government-initiated	-22.7	-4.7	39.4	-23.2	7.6	-6.3		-29.4	7.9	12
Survey of companies (percent) ^b										
Net output of manufacturing firms (original)	-8	9	-8	7	18	20 ^c	2 ^c			3
Net output of manufacturing firms (adjusted)	-8	9	2 ^c	7	10	14 ^c	15			3
Net sales by commercial firms (original)	-13 ^c	12 ^c	3 ^c	8 ^c	26	9	4 ^c			3
Net sales by commercial firms (adjusted)	-14 ^c	12 ^c	13 ^c	7 ^c	5 ^c	23 ^c	3 ^c			3

* Last month for which data available.

^a Compared with same period in preceding year.

^b Difference between the number of firms reporting a rise and those reporting a fall, as a percentage of all reporting firms.

^c Denotes non-significant result at 5 percent level.

of exports has been adversely affected by the appreciation of the NIS, and the rate of increase of private consumption is likely to slow down during the year in the light of the erosion of their wealth which Israeli investors in shares of technology firms experienced when the prices of these shares plunged in April.

As well as the rise in exports, the recovery in domestic demand also has a major role to play in placing the economy back on a path closer to its potential growth. It is assessed that private consumption, the main component of this demand, continued to expand rapidly in 2000:I, although most indicators of consumption

suggest a marked rise in consumption of imports, with no hard evidence as yet of a similar rise in consumption of domestic production. Likewise, in investment, especially in construction, no signs of increased domestic demand have been discerned as yet. Factors continuing to act in the short term against the rise in domestic demand include monetary and fiscal restraint—intended to ensure the attainment of the deficit and inflation targets set by the government, while preserving the stability of the financial sector—and the slow rate of progress in structural reform of the economy and in privatization. Questions have also arisen in connection with the expected development of domestic investment

Table 2. National Accounts, 1998–2000
(seasonally adjusted)

	1998	1999	1999				2000	Oct–Mar ^a		*
			I	II	III	IV		1999	2000	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	2.2	2.2	-3.7	8.0	5.1	5.8		2.5	3.7	12
Business-sector product	2.2	1.8	-6.5	9.5	7.1	6.5		2.5	4.0	12
Private consumption	3.6	3.3	6.0	1.7	12.1	1.3		2.6	5.2	12
Gross domestic investment	-8.0	9.8	5.1	36.6	-9.6	7.5		-4.2	8.7	12
Goods and services exports	6.3	9.7	7.4	17.1	24.1	17.3		6.1	16.3	12
Goods and services imports	1.7	14.4	18.5	30.5	21.2	13.7		1.6	20.8	12
General government product	2.0	3.9	-2.0	20.5	7.0	5.2		0.5	7.4	12

* Last month for which data available.

^a Compared with same period in preceding year.

due to difficulties in the peace process. The steep decline in the prices of shares of high-tech companies in general, and of Israeli firms traded in the US in particular, also call into question the continued ready availability of foreign investment in Israel's high-tech industry.

Exports, then, which continued to grow very fast in the period reviewed (as did imports), but slightly slower than in 1999:II and 1999:III, were a major factor in the recovery of economic activity. The rise in exports, despite significant appreciation in the period, points to the continued strong demand for the products of Israel's advanced industries, such as electronic components, computers, and communications, and control, medical, and scientific equipment whose increased exports were at the forefront of export growth. Some traditional industries also recorded good increases in 2000:I, such as food and beverages, rubber and plastic, and textile and clothing. The rising trend of capital goods imports slowed, but imports of consumer goods surged, rising by 23 percent annual rate, against the background of appreciation of the NIS.

In 1999:IV, demand for labor rose markedly, particularly in the business sector. Employment rose rapidly, but as the labor force rose even faster (reflecting a rise in the rate of participation) the number of people unemployed still increased. The rate of unemployment fell slightly in 1999:IV, but rose again in January–February 2000 (using trend data) to the peak level it had reached in the last few years, 9.1 percent. The steady rate of unemployment despite the expansion of economic activity derives from the segmentation of the manufacturing labor force into industries of the “old economy” and the “new economy”, the latter consisting of the skill- and

technology-intensive industries which are leading the economy towards growth, and which are short of skilled labor. Given this process, the rate of unemployment can only fall if there is an increase in demand for labor in non-manufacturing industries, such as trade and services which can absorb the workers who are no longer employed in manufacturing. The period reviewed was characterized by unrest in labor relations, and especially towards the end of the period there were many token work disruptions and instances of working-to-rule as the time to renew wage agreements approached.

With the boom in the US in prices of the shares of technology and internet companies, the extent of public offerings by Israeli companies in these areas soared. In addition, a new channel for raising capital abroad was developed in 2000:I—the issue of convertible bonds. At the same time, capital outflow by Israelis increased, mainly via the accumulation of deposits abroad. The main source of this latter rise is money raised abroad and left there. Total net foreign capital inflow in 1999:IV was about \$ 900 million, while in 2000:I it spurted to \$ 1.7 billion. The Bank of Israel's foreign reserves reached a peak of \$ 23 billion towards the end of the period reviewed, as a result of capital raised by the government on the international markets in March.

The large capital inflow, which derived from nonresidents' investment in Israel's economy, exerted strong downward pressure on the NIS exchange rate. The Bank of Israel refrained from intervening in trade in the foreign-currency market, allowing the exchange rate to respond freely to market forces. Thus, the exchange rate of the NIS against the currency basket fell by 7 percent in the period reviewed, and against the dollar by 5 percent. In the third

week of March, the exchange rate reached just 4 percent above the lower limit of the exchange-rate band. Until the end of the period the exchange rate was 4–5 percent above the band's lower limit, and towards the end of the period it actually rose slightly.

At the end of 1999 the Knesset (Parliament) passed the budget submitted by the government for the year 2000, in which the total government deficit was set at a maximum of 2.5 percent of GDP, 0.3 percentage points higher than the actual deficit recorded for 1999 (when the budget was set, it was estimated that the deficit for 1999 would be higher). The most notable fiscal feature of the period reviewed was the sharp and unexpected rise in tax revenues. As a result, the government's total deficit for 1999 contracted markedly from earlier estimates, and for the first time in several years there was a budget surplus in government activity in 2000:I, which rose further in April. Some of the rise in tax revenues, however, is of a non-recurring nature, and is related to changes in real estate taxation and to the bullish capital markets. According to current estimates, the budget deficit for 2000 is expected to be below the top end of the target.

Tight monetary policy (expressed in a relatively high real rate of interest), the appreciation of the NIS, the slowdown in the rate of increase of domestic demand, the recession in the construction industry, and continued fiscal discipline, all these led to a significant fall in inflation, which even prior to the period reviewed had come within the target range set by the government, 3–4 percent. The Consumer Price Index (CPI) declined in four of the six months of the period, and the rate of inflation for the period reviewed became negative, at –4.5 percent a year. The fall in prices was especially severe in the housing index, which fell by 17 percent in the period reviewed, essentially due to the close short-term indexation of the industry's prices to the exchange rate. Concurrently, all indices of inflation expectations went down markedly (those derived from the capital market, from the Companies Survey, and from private forecasters), and are currently close to or even below the lower limit of the government's target range.

In the light of the decline in expected inflation for 2000 and 2001, monetary policy continued with the gradual reduction of the nominal rate of interest on the Bank of Israel's sources. In the period reviewed, the rate was cut five times giving a cumulative reduction of 2 percentage points. Inflation expectations declined faster, so that expected short-term real interest rose to 7.8 percent in March, before changing direction and falling slightly in April. As a result of negative inflation, short-term real ex

post interest rose even faster. The rate of interest reductions was affected by the very swift contraction of the interest spread between Israel and abroad (following hikes in interest rates abroad, and mainly in the US) and its implications for the public's assets and liabilities portfolio, and by the desire to ensure that the inflation environment towards the end of the year would be consistent with the target set by the government for 2001.

The stock market was very buoyant, rising by an impressive 34 percent in the period reviewed, in line with the international burgeoning of technology and internet shares. The upward trend reversed in March, when the general share-price index plunged by almost 9 percent, in the wake of falling prices of technology and internet shares traded in the US. The reductions in these shares became far more severe in April.

The principal industries

GDP (seasonally adjusted) rose at an annual rate of 5.8 percent in 1999:IV, continuing the rapid growth of the previous two quarters. The rapid rise derived mainly from high rates of growth of exports, gross domestic investment, and public consumption. Most GDP components, however, and imports, increased more slowly in that quarter than in the previous one. In particular, the increase in private consumption fell sharply to just 1.2 percent (Table 2).

Several indicators show that there was a setback to the strength of the recovery in economic activity in 2000:I. In the Bank of Israel's Companies Survey for the first quarter of 2000, companies in transport, communications, hotels, business services, and trade reported continued growth of activity, but in construction there were renewed reports of a decline in activity and of demand constraints preventing output from rising. Companies in manufacturing industries reported an increase based on continued export growth, with a fall in domestic sales. The trends indicated in manufacturing and trade, however, are not statistically significant (see the Bank of Israel's Companies Survey, April 2000).

The Bank of Israel's state-of-the-economy index showed a 2.9 percent rise in 1999, 0.7 percentage points more than the rise in GDP. In contrast, in the period reviewed the index fell in each month in 1999:IV, rose in January–February 2000, and fell slightly again in March. Taking all the fluctuations into account, the index at the end of the period reviewed was a little below its level at the beginning, having exhibited great volatility.

The index of industrial production (seasonally adjusted data) rose at an annual rate of 2 percent in the period from October 1999 to February 2000, after rising at an annual rate of 16 percent in the previous six months. The high volatility of the index from month to month makes it very difficult to assess the trend of manufacturing, but the trend data calculated by the Central Bureau of statistics (CBS) indicate a continued rise at an annual rate of 7 percent. The number of hours worked per employee in manufacturing (trend data) in January–February showed a rise of 2 percent a year, compared with a one percent rise in 1999:IV.

The total revenue index in trade and services industries (based on VAT data) continue to expand in 1999:IV at the buoyant rate of 15 percent per year which it had reached in 1999:III, but it slowed to 9 percent per year in January–February 2000.² A similar trend was evident in the revenue of wholesale and retail trade, which expanded at 10 percent a year in January and February, down from 13 percent a year in 1999:IV.

The deep recession in the construction industry continued in the period reviewed, with a fall in the area and number of residential starts, which have declined since 1986, and a fall for the second year in succession in the area and number of residential completions. Although there were signs during 1999 of some small upward movement in the level of activity in the second and third quarters, the negative trend returned in 1999:IV, and residential starts and completions (seasonally adjusted) fell by more than 7.5 percent. Other indicators of further contraction in the construction industry include the 2.1 percent reduction in investment in residential housing in 1999:IV (following continuous reductions in the seven previous quarters), a 16 percent decline in non-residential investment, an 11 percent fall in the number of those taking out housing loans, and a 7 percent decline in cement sales in that quarter. Although there was a sudden surge in the number of transactions carried out in December (both in new and second-hand apartments), this represented activity being brought forward due to changes in taxation (mainly sales tax and purchase tax) which were becoming effective in January 2000, and did not reflect a permanently higher level of housing demand. This can be seen most clearly in the data on housing loans (mortgages) taken up, which rose from about 3,500 in November to 4,500 in December, and then went back down to 3,200 in January 2000.

² This index covers the revenue of wholesale and retail trade industries, hotel and catering services, business services and personal services.

The number of tourist entries, which had fallen in 1997 and 1998, rose by more than 17 percent in 1999. The inward flow of tourists surged markedly in 1999:III, and reached a peak in October. Activity by Israelis also showed a similar development, and in 1999 the total number of bed nights in tourist hotels increased by 17.4 percent. There was a marked slowdown in the rate of tourist entries and bed nights in tourist hotels in November and December, partly seasonal, and partly apparently related to concern regarding the millennium bug. In January–February 2000, however, the trend reversed again, due to the number of tourists who came to be in Israel at the time of the Pope's visit in March. The average monthly total number of tourist entries and bed nights in tourist hotels were more than 5 percent higher than in 1999:III.

The labor market

In 1999:IV the labor-force participation rate (seasonally-adjusted data) continued to rise, to stand at 54.3 percent—the highest rate in the last four years. This rise appears to stem from a combination of assessments or hopes regarding an improvement in the employment situation (the re-employment of the 'discouraged worker') and growing economic distress, causing workers who had not found it necessary to participate in the labor force in the past to change their attitude ('the incremental worker'). Most of the rise in the civilian labor force—44,000—was absorbed in the labor market, so that the number of unemployed persons remained unchanged at 213,500. About three-quarters of the new employees entered the business sector, most of them in full-time positions, while the average number of hours per employed person did not change in 1999:IV after rising in the previous two quarters. These developments may be regarded as evidence of employers' expectations that economic activity would expand, although they were also influenced by events unique to 1999:IV (preparations for contending with Y2K-associated problems).

In spite of the positive data regarding the absorption in employment of the incremental civilian labor force in 1999:IV, the upward trend in the unemployment rate has not yet been reversed. Although the unemployment rate (defined as the proportion of the civilian labor force not employed) declined from 9.1 to 8.9 percent because of the stability in the number of unemployed persons and concomitant increase in the labor supply, this decline did not affect the unemployment trend as calculated by the Central Bureau of Statistics (CBS), and this remained at the same level—9.1 percent—as at the end of 1999:III.

Table 3. Indicators of Labor Market Developments, 1998–2000
(seasonally adjusted)

	1998	1999	1999				2000	Oct-Mar ^a		*
			I	II	III	IV	I	1999	2000	
	('000s)									
Civilian labor force	2,266	2,344	2,308	2,325	2,349	2,394		2.6	4.9	12
Israelis employed	2,072	2,136	2,108	2,118	2,136	2,181		2.0	4.1	12
Business sector ^b	1,446	1,491	1,473	1,479	1,489	1,522		-0.3	5.0	12
General government ^b	626	646	638	640	646	659		7.7	2.0	12
Average hours worked per employee ^b	37	37	37	37	38	38		-1.1	2.2	12
Claims for unemployment benefit	108	108	107	109	107	108	111	1.2	3.0	3
Work seekers	156	158	157	160	150	164	163	0.9	6.4	2
Real wage per employee post (NIS)	4,488	4,615	4,514	4,590	4,603	4,754	4,727	-0.4	6.8	1
of which: Business sector	4,548	4,697	4,594	4,678	4,683	4,832	4,887	0.4	7.6	1
Unemployment rate (%)	8.6	8.9	8.7	8.9	9.1	8.9				12

* Last month for which data available.

^a Percent change compared with same period in preceding year.

^b Not seasonally adjusted.

Data for the unemployment trend in 2000:I indicate that this has not changed. In February the number of unemployment black spots as defined by the Employment Service increased by three, to 31 (22 of them Arab population centers).

The average wage per employee post (seasonally-adjusted data) was NIS 6,600 in January 2000. In the business sector it was NIS 6,730 and in general government it was approximately NIS 6,120. In real terms the wage per employee post in 1999:IV was 3 percent higher than its level one year earlier: 2.7 percent in the business sector and 5.4 percent in general government. The latter reflects the 4.8 percent rise granted to the intermediate grades in general government in November.

Labor relations were characterized by unrest during the period reviewed, especially towards its end. The labor disputes, with their attendant disruptions and sanctions, persisted until mid-April 2000 in the Medical Association, the hospitals' administrative and housekeeping staff, the X-ray technicians, the employees of the Employment Service, the National Insurance Institute, the Ports Authority, Bezeq (Israel Telecommunication Corporation), the oil refineries, and the research workers at Rafael (Armaments Development Authority). On the other hand, in November, as stated, the wage agreements signed in May 1999 with the

intermediate grades in general government were implemented, and new agreements were signed with teachers, and employees of Mekorot (the Water Authority) and non-specialized office workers (in April). The backdrop to the labor disputes was the difficulty in adjusting the new wage agreements to the new low-inflation environment, requiring acceptance of lower nominal wage-increments than were customary in the past, especially given the automatic 3–5 percent (nominal) wage drift that has existed in the long term and which in the present inflation environment constitutes a significant real wage hike.

With regard to labor legislation, the debate in the Knesset continued regarding the proposal to increase the minimum wage in Israel to \$ 1,000. At the end of April it was agreed to appoint a committee comprising representatives of the government, the employers and the Histadrut (General Federation of Labor) to examine the subject.

Preliminary data on immigrant arrivals published by the Ministry of Housing indicate that immigration increased by 74,000 persons in the course of 1999—up by 31 percent over 1998. The immigration rate accelerated greatly from July, and despite the fact that to date no final figures have been received for 1999:IV, the rising trend evident in the preceding quarter appears to have persisted then too. The immigrants' participation rate in

the domestic labor market declined in 1999:IV from 56.5 percent to 55.8 percent—albeit still higher than it was in the past. Immigrants continued to account for 17.4 percent of the civilian labor force in 1999:IV, as they had in 1999:III, and their unemployment rate declined to 10.9 percent in 1999:IV, after soaring to 13.5 percent in 1999:III.

According to preliminary data for January and February, immigration rates fell to those evident in the equivalent period in 1998/99—a monthly average of about 4,500 new arrivals, compared with the 1999 monthly average of 6,200.

The balance of payments

Both imports and exports continued to expand at a good pace in the period reviewed, with some volatility in December and January, apparently due to the sanctions imposed at the ports for part of these months. Seasonally adjusted, the average monthly level of exports in 2000:I was 6 percent above its level in 1999:III, and that of imports 3.6 percent higher. A comparison of the data for

March 2000 with those for September 1999 shows that both imports and exports expanded by over 10 percent during the period reviewed. Notwithstanding, trend data calculated by the CBS indicate some slowing of the expansionary trend in 2000:I relative to 1999:IV: the export trend declined from an annual rate of 18 to 13 percent, and that of imports from 15 to 11 percent, despite the extremely high rate (23 percent) of consumer goods imports, apparently also due to the influence of local-currency appreciation.

Export data by principal industries indicate the continued expansion of high-tech exports. Exports of electronic components and computers grew at an annual rate of 18 percent in 2000:I, similar to their rate in the second half of 1999. Exports of communications, control, medical, and scientific equipment increased by an annual rate of 23 percent in 2000:I. Exports of the traditional industries also expanded: food and beverages grew by an annual rate of 16 percent in 2000:I, textiles by 7 percent, and rubber and plastics by 13 percent. Agricultural exports were up by 10 percent over the equivalent period in 1998/99. Imports of capital goods slowed, rising by an

Table 4. Balance of Payments, Foreign Trade, and the Reserves, 1998–2000
(\$ million, current prices)

	1998	1999	1999				2000	Oct–Mar ^a		*
			I	II	III	IV		1999	2000	
Monthly averages										
Trade deficit	362	373	400	365	367	362	343	385	352	3
Goods imports	1,769	1,855	1,766	1,826	1,906	1,924	1,975	1,765	1,949	3
Consumer goods	323	331	331	317	345	331	363	323	347	3
Capital goods	378	447	410	435	471	472	487	409	480	3
Intermediates	1,067	1,077	1,025	1,074	1,091	1,120	1,125	1,032	1,123	3
Goods exports	1,406	1,482	1,366	1,461	1,539	1,562	1,633	1,380	1,597	3
Manufacturing	1,337	1,415	1,304	1,392	1,473	1,491	1,560	1,317	1,526	3
Quarterly averages										
Net current account	-210	-650	-901	-1,007	-1,102	409		107		12
Financial account (excl. foreign-currency balances)	374	783	748	1,017	475	891		338		12
Nonresidents' direct and portfolio investments	589	931	1,012	1,028	746	936		863		12
Israeli residents' direct and portfolio investments	141	227	353	76	184	293		387		12
Net foreign debt (% of GNP)	12.42	10.86	12.13	11.60	11.74	10.86		12.27		12
End-period Bank of Israel reserves	21,828	22,071	21,984	21,931	21,854	22,515		22,329		12

* Last month for which data available.

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

annual rate of 7 percent in 2000:I, after 13 percent in the second half of 1999, while imports of raw materials and consumer goods continued to rise and even accelerated. According to Customs Authority data, durable goods imports soared in 2000:I to a level 29 percent above that of 1999:I.

Against the backdrop of the worldwide surge in share prices, capital inflow to Israel rose substantially in the period reviewed, creating new records for capital raised by Israeli companies abroad. Total capital raised through IPOs abroad rose to stand at \$ 2 billion, supplemented by another \$ 700 million raised (in 2000:I) through issuing convertible bonds. Parallel to this trend, capital outflow by residents continued to grow, and in 2000:I it amounted to \$ 1.6 billion, most of it in foreign-currency deposits abroad and originating from issues abroad by Israeli companies. Direct investment declined, on the other hand, and amounted to only \$ 400,000 in October–March (1999:IV was distinguished by a particularly large capital outflow transaction in which shares in Bezeq to the value of \$ 500 million were bought by an Israeli investor from a nonresident investor). In addition to these capital flows, in March the government's net foreign borrowing amounted to \$ 500 million through bonds at 1.44 percentage points above the yield on US T-bonds. Total net capital inflow into Israel amounted to \$ 2.6 billion in the period reviewed, \$ 900 million of it in 1999:IV and \$ 1.7 in 2000:I. For purposes of comparison, net capital inflow in 1999 as a whole was \$ 2.1 billion.

Capital continued to be raised at an accelerating pace even beyond the period reviewed, despite the shocks on the NASDAQ at the beginning of April; in the first week of April Israeli firms raised another \$ 330 million in four IPOs.

During the period reviewed the Bank of Israel's foreign-exchange reserves remained at between \$ 21.5 billion and \$ 22 billion in dollar terms. At the end of the period they rose to \$ 22.7 billion, after increasing by \$ 702 million in March. Most of the increase was from government issues, as the Bank of Israel continued to refrain from intervening in foreign-currency trading.

Prices

During the period reviewed, the CPI rose at a negative rate, amounting to an annual rate of –1.5 percent, compared with an annual increase of 4.7 percent in the preceding six months, and of 5.9 percent in the equivalent period in 1998/99. In the last five months of the period reviewed the inflation rate fell to –3.6 percent in annual terms. In the period reviewed, the rate of price increases over the previous 12 months remained the

lowest since the 1960s, reaching 1.5 percent in March, vis-à-vis 5.3 and 7.0 percent in the two previous six-month periods.

The rate of price increases of the indices of 'underlying inflation,' i.e., adjusted for certain CPI items, was also slow enough in the period reviewed to constitute stability. Thus, adjusted for the prices of housing, fruit and vegetables, and clothing and footwear, the CPI rose by an annual rate of 1.8 percent, while when also adjusted for goods whose prices are controlled by the government, the CPI rose by an annual rate of only 1.1 percent. The rate of increase of the index of wholesale goods produced for domestic uses slowed in the period reviewed to an annual rate of 2.5 percent, compared with 5.6 percent in the preceding six months (April–September 1999), alongside an annual –2.9 percent decline in the prices of nontradables and slow 0.7 percent annual increase in the prices of tradables.

Housing, which has a large share in the CPI, fell steeply, declining in each of the six months of the period reviewed, and in cumulative terms by 7.3 percent; this represents an annual price fall of –15 percent, compared with a persistent increase, accumulating to 8 percent, in the five months before the period reviewed. In 2000:I housing prices plummeted at an annual rate of –19 percent; this rate being very close to the rate of local-currency depreciation against the dollar, and expressing the close link between the exchange rate and the housing index, in view of the continuation and possibly even intensification of the slump in real estate.

As was the case with the exchange rate and the housing index, 12-month inflation expectations (as derived from the capital market) also declined monotonically each month during the period reviewed, from an annual rate of close to 6 percent in September 1999 to 2.5 percent in March 2000. There was a parallel decline in the inflation expectations of private forecasters, and these fell to an average of 3.5 percent annually at the end of March. Note that throughout the period reviewed private forecasters' estimates of the monthly indices were (on average) higher than those actually published, so that as a result of these forecasting errors the previous forecasts were revised downwards on a monthly basis. A similar picture is obtained from the Survey of Companies undertaken by the Bank of Israel's Research Department, which indicates that inflation assessments for the next twelve months declined to an average of 3.2 percent—the lowest assessment since the Survey was begun at the beginning of 1997.

The slow rate of increase of the principal price indices and the low level of inflation expectations on the part of the public are explained mainly by sharp local-currency

Table 5. Selected Price Indices, 1998–2000
(annual rates of change during period, percent)

	1998	1999	1999				2000	Oct–Mar		*
			I	II	III	IV		1999	2000	
CPI	8.6	1.3	-5.5	4.3	5.1	1.9	-4.8	5.9	-1.5	3
CPI excl. housing, fruit and vegetables	8.5	1.7	-1.4	2.7	1.1	4.6	-0.4	10.5	2.1	3
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	8.8	2.4	2.9	2.2	3.7	0.7	1.6	12.3	1.1	3
Index of housing prices	8.8	-0.9	-17.9	8.3	23.5	-12.1	-17.0	-3.5	-14.6	3
Wholesale price index	8.2	3.5	-3.4	4.1	7.3	6.3	-1.1	12.8	2.5	3
NIS/\$ exchange rate	18.2	0.4	-13.2	5.9	16.3	-5.0	-16.8	9.9	-11.1	3
NIS/currency-basket rate	20.6	-2.5	-20.2	0.6	21.5	-7.4	-21.4	7.9	-14.7	3

* Last month for which data available.

appreciation and the moderate level of economic activity—especially in housing—in the context of adherence to both monetary restraint and the government's budgetary framework.

General government

In 1999:IV the rate of expansion of public consumption continued to decline to 5.2 percent a year, after falling by an annual rate of 7 percent in 1999:III and reaching a peak of 20 percent in 1999:II. After adjusting for defense

imports, public consumption grew by a negative -3.2 percent a year in 1999:IV. By contrast, the rate of expansion of transfer payments to households via National Insurance (excluding military reserve service payments) soared, and these were 10 percent higher in real terms in 1999:IV than in 1998:IV. Transfer payments continued to rise in January and stood at NIS 3.1 billion—9.4 percent higher in real terms than in January 1998.

The government's total tax receipts were higher in real terms by 10.7 percent in 1999:IV than in 1998:IV, indicating a marked increase in tax-collection over the

Table 6. The Budget and its Financing, 1998–2000
(cash flows, as percent of GDP)

	1998	1999	1999				2000	Oct–Mar		*
			I	II	III	IV		1999	2000	
1. Government domestic expenditure	38.8	38.0	39.1	36.6	36.8	39.4	39.1	40.7	39.3	3
2. Government receipts	35.5	35.0	37.4	32.7	34.9	35.0	40.7	36.0	37.9	3
3. Domestic budget deficit (1 – 2)	3.2	3.0	1.7	3.9	1.9	4.5	-1.7	4.7	1.4	3
4. General government domestic deficit ^a (5 + 6)	3.6	3.6	2.5	3.3	1.2	7.2	-3.7	5.3	1.8	3
5. Government net borrowing from the public	2.7	2.1	0.7	2.8	2.4	2.5	2.1	3.1	2.3	3
6. General government injection (9 – 8 – 7)	0.9	1.5	1.8	0.5	-1.1	4.7	-5.7	2.2	-0.5	3
7. Bank of Israel injection	-1.1	-0.4	1.7	-2.3	0.4	-1.4	5.0	-1.1	1.8	3
8. Private-sector foreign-currency conversions	0.3	-0.1	-0.4	0.1	-0.1	-0.0	-0.3	-0.2	-0.1	3
9. Change in monetary base	0.1	1.0	3.2	-1.7	-0.8	3.3	-1.0	0.9	1.1	3

* Last month for which data available.

^a Budget deficit, plus Jewish Agency injection, plus non-budgetary injection.

previous quarters of 1999. The increase in revenues encompassed all tax categories: direct taxes and National Insurance payments were up by 9.7 percent in real terms in 1999:IV over 1998:IV, total indirect taxes on domestic production rose by 9.3 percent, and total taxes on imports increased by 9.5 percent. All-in-all, tax receipts during 1999 grew by 4.8 percent in real terms.

The expansionary trend of tax collection continued in 2000:I, when receipts reached a record NIS 37 billion—up by 25 percent over the average path of the last few years. The total surplus (excluding net credit extended) in the government's domestic account in 2000:I was NIS 1.8 billion, i.e., 1.7 percent of (quarterly) GDP. According to the State Revenue Administration, the steep rise in tax receipts stemmed from the combination of the general acceleration of economic activity and nonrecurring features connected with the bullish capital market, as well as from tax plans arising from legislative changes, and from the expansion of high-tax spheres such as private consumption and real estate. On the other hand, tax receipts from the traditional industries continued to be low. The Accountant-General's estimate, based on cash data, indicates that for the two quarters reviewed the government's domestic deficit was 1.4 percent of GDP—3 percent of GDP below its level in the equivalent period in 1998/99 (Table 6).

At the beginning of the year several statutory tax changes approved by the Knesset under the Economic Arrangements Law went into effect. The National Insurance and 'health tax' ceiling was raised from four to five times the average wage. Proposals for more far-reaching changes were submitted at the beginning of

March to the Minister of Finance by the tax reform committee (the Ben-Bassat Committee) and focused mainly on taxing all categories of income from labor and capital, while reducing taxes on labor.

The money and capital markets

During the period reviewed the Bank of Israel continued to gradually reduce the nominal interest rate on its sources, in order to consolidate the inflation environment in accordance with the government's target for the years 2000 and 2001, while keeping an eye on the narrowing interest-rate spread between local and foreign currency—primarily the dollar—with reference to its implications for capital flows and the composition of the public's asset and credit portfolio. The Bank of Israel's key interest rate was lowered in five stages during the period reviewed, accumulating to a 2 percentage-point reduction. The average nominal interest rate during the period reviewed was an annual 11 percent, after declining from 11.6 percent in September to 10 percent in March. Concurrently, the public's twelve-month inflation expectations fell, declining from close to 6 percent in September to 2.5 percent in March. Thus, the expected short-term real interest rate implicit in the Bank of Israel's auctions continued to rise from an average of 6.8 percent in 1999:III to 7.9 percent in 1999:IV and 2000:I, in spite of consecutive reductions of the nominal interest rate. Because of the negative inflation rate in the period reviewed (an annual rate of -1.5 percent), real *ex post* interest, i.e., nominal interest adjusted for actual inflation, reached an annual rate of 12.5 percent. In

Table 7. Monetary Indicators and Nondirected Bank Credit, 1998–2000
(annual terms, percent)

	1998	1999	1999				2000	Oct-Mar		*
			I	II	III	IV		1999	2000	
Rates of change	(average)		(compared with preceding quarter)					(during period)		
M1 ^a	12.1	11.4	-4.9	11.1	28.9	9.3	34.7	0.8	26.7	3
M2 ^b	22.6	21.0	32.7	22.5	17.8	19.6	29.3	21.4	24.8	3
M3 ^c	22.1	21.8	25.5	19.6	19.2	20.4	26.1	23.0	20.9	3
Nondirected bank credit	15.9	17.9	12.3	11.9	15.1	20.5	14.8	19.6	15.5	3
Unindexed local-currency	16.3	18.0	20.7	13.8	5.3	20.2	53.2	23.0	42.3	3
CPI-indexed	14.1	18.3	22.9	10.2	18.4	17.8	-1.3	21.7	3.4	3
Foreign-currency-indexed and denominated	17.9	17.3	-8.0	11.6	23.7	24.4	-3.6	12.9	2.0	3

* Last month for which data available.

^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.

Table 8. Interest Rates, Yields, and the Share-Price Index, 1998–2000

	1998	1999	1999				2000	Oct–Mar		*
			I	II	III	IV		1999	2000	
Nominal interest rate										
Nondirected										
local-currency credit	16.2	16.4	17.6	16.5	15.9	15.5	14.3	16.8	15.0	2
Average monetary loan	12.0	12.4	13.6	12.5	12.0	11.5	10.4	12.8	11.0	3
SROs	10.2	10.7	11.9	10.7	10.2	10.1	9.2	11.1	9.7	2
3-month Eurodollar	5.4	5.3	4.9	4.9	5.3	6.0	6.0	5.0	6.0	3
Yield to maturity on										
Treasury bills	11.3	11.4	12.0	11.5	11.3	10.9	9.1	12.2	10.0	3
10-year government bonds	4.9	5.2	5.2	5.1	5.2	5.3	5.3	5.1	5.3	3
5-year government bonds	5.1	5.6	5.6	5.4	5.6	5.9	5.8	5.2	5.9	3
General Share-Price										
Index (points)	137.7	181.4	146.3	181.2	187.7	210.4	254.8	140.7	232.6	3
Expected inflation (gross)	6.1	5.1	5.5	6.0	5.5	3.6	2.8	6.3	3.2	3
Interest derived from										
expected inflation (gross)	4.9	5.9	6.1	5.1	5.5	6.7	6.0	5.5	6.3	3

* Last month for which data available.

April, following the continued reduction of interest and a slight rise in inflation expectations, real expected short-term interest fell to 7.2 percent.

Extensive capital inflow during the period reviewed contributed to local-currency appreciation; the Bank of Israel did not intervene in trading, so that the average exchange rates of the currency basket and the dollar declined by 7.6 and 5.7 percent respectively. The rate of appreciation was particularly high in 2000:I, when the exchange rate of the currency basket declined at an annual rate of 22 percent (quarterly average against preceding quarter), and that of the dollar by 17 percent (Table 5). The lowest point of the exchange rate was in the third week of March, when the currency basket fell to only 4 percent above the lower limit of the exchange-rate band. The exchange rate rallied somewhat subsequently.

The interest spread vis-à-vis abroad narrowed significantly and steadily during the period reviewed, in the wake of the reduction of interest rates in Israel and moderate interest-rate hikes in the EU and the USA. The spread from the average LIBOR of the currency-basket currencies to the Bank of Israel's effective interest rate narrowed from 5.7 percent in September 1999 to 3.4 percent in March 2000, and is currently at its lowest for the last two years. The narrowing of the interest-rate spread has not yet led to a slowing of the rate of capital inflow.

The monetary base expanded by 5.5 percent during the period reviewed, constituting an 11 percent annual increase; the M1 aggregate increased substantially—by

12.5 percent—representing an annual rate of expansion of 25 percent. As expected, the largest increases occurred in December 1999 due to preparations for Y2K-associated problems, when firms and households increased their liquid assets and wage payments were brought forward, but in contrast to expectations, the money supply did not contract markedly after the beginning of the year. Part of the increase in the money supply appears to have been connected with increased activity in the capital market and part with the fact that some interest-bearing liquid deposits were classified as part of the money supply. Preliminary data for April indicate that the money supply declined by about one percent in that month.

The other monetary aggregates also expanded very rapidly in the period reviewed: local-currency deposits for up to three months grew at an annual rate of 17 percent, while those for between three months and a year rose by 24 percent—a similar rate to that of the M2 aggregate. The extent of the banks' deposits in the Bank of Israel expanded by NIS 3 billion in the period reviewed, after a sharp rise in December and decline during 2000:I, and stood at NIS 52.7 billion at the end of March.

Notable among the monetary aggregates during the period reviewed was the expansion of unindexed local-currency credit, which rose in real terms at an annual rate of over 40 percent. In contrast to this, the other kinds of credit expanded far more slowly, with a particularly slow rate of expansion of foreign-currency-indexed credit

(which contracted by 11 percent in the period reviewed) and of foreign-currency credit, which rose by less than 1 percent in real terms, apparently in view of the narrowing of the interest-rate spread vis-à-vis abroad. Total nondirected foreign-currency credit (of all kinds) expanded by some 7 percent in the period reviewed.

Share prices rose by an impressive 34 percent in the period reviewed, parallel to the worldwide surge on stock

markets. During this trend the public flocked back to share-based mutual funds, which reached a record level in February. The rising trend of technology stocks reversed in March, when the general share-price index fell by about 9 percent in the wake of plummeting technology and internet stocks in the US. The decline in these share prices intensified greatly in April. The index of bond prices in Israel rose by 2.8 percent in the period reviewed.

The Research Department's Forecast of Economic Activity in 2000

According to the Research Department's updated forecast, GDP will grow by 4 percent, in contrast with the 3 percent forecast in October 1999 in the National Budget.

The acceleration of economic growth will be concentrated in the business sector, primarily in manufacturing, software services, and tourism. Business-sector product is expected to expand by 4.5 percent in the year 2000, compared with an annual average of 2 percent in the last two years. In construction and agriculture activity is expected to continue declining, although the moderating effect of construction will abate. The acceleration of GDP growth, after a period of recession, is due to a rise in measured total factor productivity, in the wake of the improved utilization of factors of production, as well as of structural changes that are increasing the share of high-tech industry; concurrently, employment will rise and the unemployment rate decline slightly during the year.

The factors behind the forecast of increased economic activity are those that led the recovery during the course of 1999: the expansion of world trade; structural changes in the direction of high-tech industry; and Christian tourism marking the end of the millennium. These factors should be expressed in a rise in exports and the adjustment of private consumption to increased GDP, and in 2000: I there has indeed been a rapid rise in exports (according to foreign-trade data). The persistence of the economic recovery, which is primarily export-led, depends on the continued expansion of world trade, and it is too early to tell whether and how this will be affected by the recent sharp fluctuations in global financial markets.

The forecast has been updated mainly because of the accelerated growth evident since 1999: II (especially in private consumption), as a result of which the level of GDP at the beginning of 2000 exceeds the forecasts made when the National Budget was prepared. This level is expressed in a faster average growth rate in 2000 than in 1999.

According to the forecast, the import surplus will contract in spite of the expected worsening of the terms of trade. This is because imports will rise more slowly due to the fall in the exceptional investments evident in 1999 (imports of equipment by Intel and imports of planes). The decline in the import surplus will also be expressed in the smaller current-account deficit in the balance of payments.

The forecast assumes a 2.5 percent rise in domestic public expenditure, and this is consistent with the assumptions underlying the 2000 budget approved by the Knesset. Note, however, that actual results may be higher as a result of the implementation of decisions made by the government during the year, principally with regard to defense expenditure.

Faster growth than forecast in the National Budget will be expressed in higher tax revenues than planned. It is important that the excess tax revenues are used to reduce the budget deficit and/or to ease the tax burden, thereby serving to stimulate growth, rather than to increase current public expenditure or for transfer payments.

Sources and Uses, 1998–2000

(rates of change, annual percentages)

	1998	1999	2000	
			National Budget	Updated Forecast
Sources				
GDP	2.2	2.2	3.0	4.0
Per capita GDP	-0.2	-0.2	0.7	1.6
of which: Business-sector product	2.2	1.8	3.3	4.5
Imports	1.4	14.7	4.8	7.5
Uses				
Private consumption	3.6	3.3	3.6	4.5
Public consumption	1.5	3.4	1.9	2.5
Investment	-0.8	9.8	-1.8	-1.6
Exports	6.3	9.7	9.5	11.5
of which: Exports excl. diamonds	9.9	8.7	8.5	11.0

Population, Labor Force, and Employment, 1998–2000

	1998	1999	2000		Change 1999–2000
			National Budget	Updated Forecast	
Working-age population	4,243	4,359	4,450	4,467	108
Civilian labor force	2,266	2,345	2,368	2,403	58
Business-sector employment ^a	1,659	1,710	1,693	1,757	47
Total Israelis employed	2,072	2,137	2,163	2,194	57
Number unemployed	194	208	205	209	1
Unemployment rate (percent)	8.6	8.9	8.7	8.7	-0.2

^a Including foreign and Palestinian workers.