

Recent Economic Developments 131

May - August 2011

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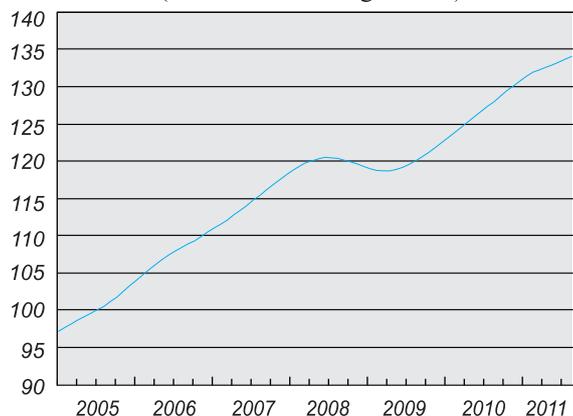
Part 1: Review of Recent Economic Developments, May to August 2011

Main developments¹

During the period being surveyed, May–August 2011, there was a slowing in the rate of growth in Israel and an increase in uncertainty. This occurred against the background of debt crises in Europe and volatility in the financial markets, the fear of a major slowdown in global growth, continuing geopolitical instability in our region and the effects of the social protests in Israel. GDP grew by 3.5 percent in the second quarter, while the product of the business sector grew by only 2.4 percent (both figures are expressed in annual terms) and the Bank of Israel’s State-of-the-Economy Index rose by only a moderate amount (Figure 1.1).

Figure 1.1

The level of economic activity,^a
2005–August 2011
(index: 2005 average = 100)



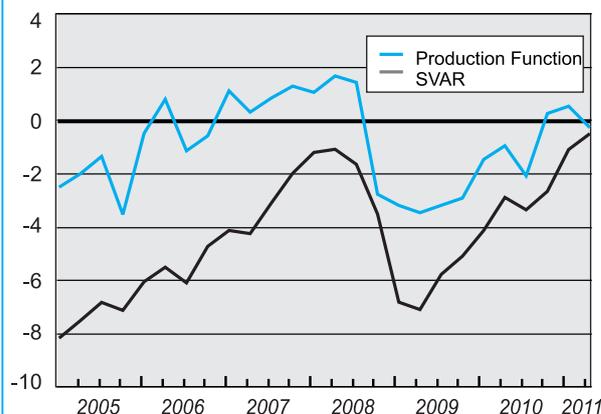
^a The Bank of Israel composite index, including the change in economic activity trend growth.

The output gap narrowed (Figure 1.2) and together with the slowdown in the rate of growth and the drop in the rate of unemployment to historically low levels this is perhaps a sign that the economy is at a point beyond the peak of the business cycle. With regard to uses, the export of goods declined against a background of slow global demand; the growth in private consumption slowed and consumer confidence declined; and the accelerated upward trend in investment began to level off. This may be evidence that

producers feel that there is no longer any need for major expansions in production capacity in view of the expected slowdown in economic activity.

Figure 1.2

Output gap^a
2005–June 2011



^a For a discussion of various methods of calculating the output gap, see Bank of Israel Annual Report 2009, pages 52–53.

The developments by specific industry were mixed: activity in manufacturing stabilized overall, with a slowdown in export-oriented sub-industries and in tourism; in contrast, there was continued rapid growth in commerce although at a slower rate than in the previous period. The momentum in the construction industry continued though there are signs that there is declining interest in the purchase of housing. During the period being reviewed, a number of major policy measures were adopted in the area of housing. The goal of these steps, which were partly motivated by the social protest, is to make it easier to buy or rent a home.

Improvement continued in the labor market. The rate of unemployment fell to 5.5 percent, which is lower than prior to the 2008 crisis and is one of the lowest levels reached in recent decades. Employment expanded, primarily in the business sector, though at a slow rate, accompanied by a large increase in the number of those employed in part-time positions and a drop in the number of those employed in full-time positions. The low rate of unemployment and the slowing of the rate of expansion in employment are indications that the economy is approaching full employment. Despite this, there are still no major signs of pressure on wages, perhaps

¹ The survey uses data that was available up until September 27, 2011.

due to the entry of a large number of workers in low-paid jobs and in part-time positions.

The export of goods from Israel slowed, due to the dampening of global demand, which was particularly noticeable in the hi-tech industries. Exports to the US fell significantly and exports to Europe were stagnant. The rate of increase in the import of goods started to level off and this encompassed all categories, i.e. consumption goods, raw materials and investment assets. The deficit in the current account grew during the second quarter of 2011 and this included all of the sub-accounts: in the goods account, primarily due to the increase in expenditure on the import of fuel, a worsening of the terms of trade and, as mentioned, a slowdown in exports relative to a moderate increase in imports; in the services account, due to the increased expenditure of Israeli tourists abroad; and in the financial account due to an increase in the income of foreign investors in Israel.

Tax revenues grew moderately and are below the forecasted seasonally-adjusted path, particularly with respect to the collection of indirect taxes. Domestic expenditure (excluding credit) was also below the seasonally-adjusted path, primarily due to the low rate of utilization by government ministries. Based on the fiscal developments so far, the forecasted budget deficit will stand at close to 3 percent of GDP, which is within the budget deficit ceiling.

Prices rose at a moderate rate during the period being surveyed, with slower growth in owner occupied dwellings (which is not included in the CPI) and an end to the prolonged increase in food and energy prices in Israel and worldwide. Inflation during the last twelve months was above the upper boundary of the inflation target range though expectations for the year fell significantly during the period to within the target range. The prices of financial assets fell sharply towards the end of the period being surveyed, simultaneous with the crash in markets worldwide, and the level of risk in the local capital market grew.

The Bank of Israel interest rate was raised by 0.25 percentage points to 3.25 percent in May and during the period being surveyed was left unchanged.² The average nominal effective exchange rate for the period being surveyed appreciated slightly relative to the previous period and there was less intervention in the foreign currency market by the Bank of Israel.

There was a slowdown in global growth, especially in Europe, and in the rate of expansion in global trade. The fears that the debt crises would spread to key countries on

the European continent and the downgrading of the US credit rating as a result of the difficulties it is experiencing in reducing its budget deficit led to increased volatility in the financial markets and an increase in uncertainty. The forecasts for world growth were revised downward.

During the period being surveyed, a large-scale social protest sprung up in Israel. It began in June with a consumer boycott of milk products, which led to a reduction in their prices, and continued during July-August with the creation of tent cities, the main one located on Rothschild Street in Tel Aviv. The demonstrations were attended by hundreds of thousands of people who demanded a reduction in the cost of living and in particular housing prices and the cost of childcare. There was also a multitude of additional demands on various socioeconomic issues. As a result of the protests, the Prime Minister appointed a committee to examine directions for socioeconomic change, headed by Professor Manuel Trajtenberg. The government approved the committee's recommendations after the period surveyed.

Real aggregate activity³

The national accounts data for the second quarter of 2011 indicate a slowdown in the rate of growth in each of the various uses (Table 1.1). GDP grew by 3.5 percent (1.8 percent per capita), which is a continuation of the high growth rate in the first quarter (4.7 percent). Business sector product expanded by only 2.4 percent, following rapid rates of growth in each of the quarters during the period of the recovery from the crisis in 2008.

Private consumption expenditure increased in the first quarter by 3.2 percent and expenditure on current consumption rose by a relatively rapid rate, while the expenditure on durables (particularly private transportation vehicles) declined. The Globes consumer confidence index is on a downward trend while the parallel index of the Central Bureau of Statistics (CBS), which has been published since last March, has also reflected pessimism among consumers ever since. The expenditure on public consumption (apart from defense imports) dropped by 5.3 percent, following a prolonged upward trend, primarily due to a decline in local defense consumption, while civilian public expenditure expanded at a rapid rate.

Investment in fixed assets continued to expand, at a rate of 9.9 percent, which was slower than previously. The investment

² The interest rate for October was reduced by 0.25 percentage points.

³ National Accounts data in this survey are expressed in annual quantitative terms and are seasonally adjusted. Export and import data refer to the export of goods and services excluding diamonds and the import of goods and services excluding defense imports, ships, planes and diamonds.

in the various industries of the economy grew somewhat, following sharp increases during the previous year and at the beginning of the current year. The rate of investment in machinery and equipment slowed while investment in land transportation vehicles fell sharply. These developments may be indicators that following a prolonged period of major investment in the industries of the economy and the growth in productive capacity, producers now believe that the rate of expansion in economic activity will become more moderate. Thus, they do not see any further need for a rapid expansion of capacity. This is despite slower growth in the supply of local manpower with the drop in the rate of unemployment to a low level. There was momentum in investment in residential (and non-residential) construction, which is consistent with the high level of activity in the industry.

The export of goods and services grew during the second quarter of 2011 by 5.2 percent. Thus, the expansion in the export of goods continued at a relatively high rate,⁴ despite the slowdown in global trade and particularly the slowdown in demand in the US, while the export of services remained almost unchanged. The import of goods and services grew by 8.3 percent, which was slower than the rates of growth during previous quarters and was particularly evident in the import of goods.

Output prices grew rapidly at 6.4 percent in annual terms (0.8 percent in terms of business sector output prices). This was led by the rapid increase in prices of expenditure on civilian public consumption and private consumption. In contrast, the prices of investment in fixed assets and export prices fell while import prices rose somewhat, such that the overall terms of trade worsened.

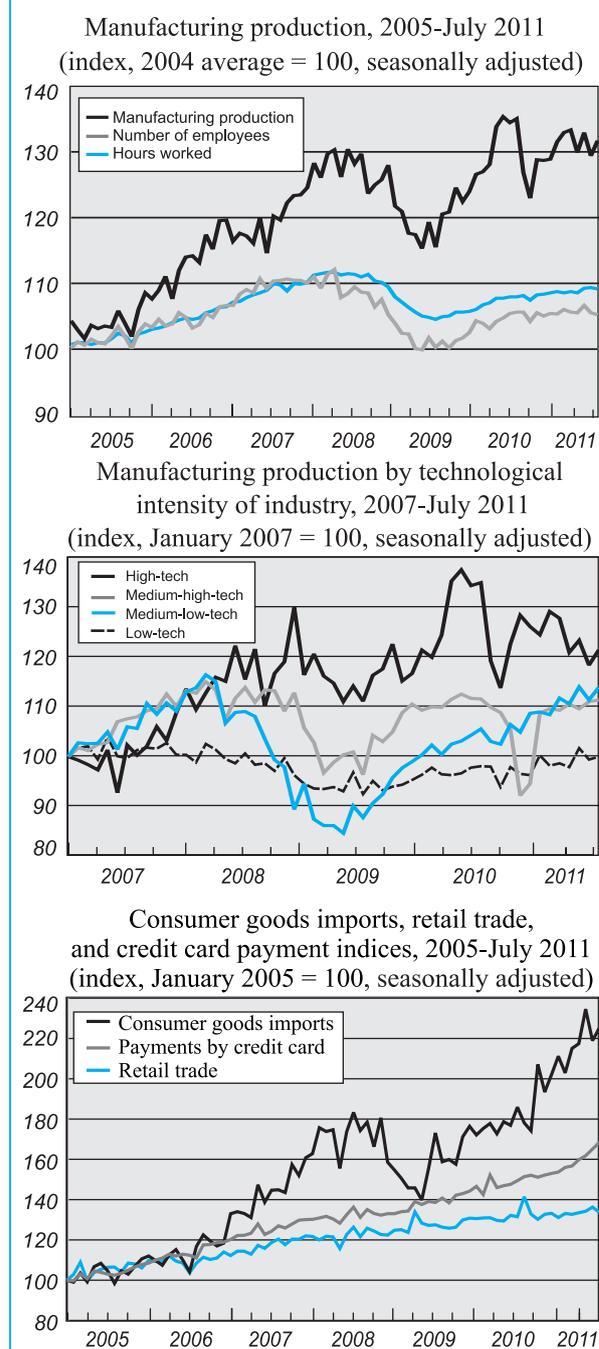
Real activity by industry⁵

The rate of expansion in the activity of the business sector slowed during the period being surveyed, at least in some industries (Table 1.2). The Bank of Israel's Companies Survey for the second quarter shows a positive net balance in the activity of the business sector but smaller than in previous periods and the CBS's Survey of Business Trends for the period being surveyed points to a reduction in activity. The Bank of Israel's State-of-the-Economy Index grew moderately but slower than previously. The two surveys indicate that three-month expectations are for a continuation of the improvement in economic activity although to less

of an extent than the expectations in the previous period surveyed.

The indices point to stability and even a slowdown in the manufacturing industries in general and the export-oriented industries in particular (Figure 1.3). Manufacturing production grew during the months May-July, according to

Figure 1.3



⁴ The export of goods, in dollar terms, fell during the period being surveyed; see the section on foreign trade below.

⁵ In annual terms, seasonally adjusted.

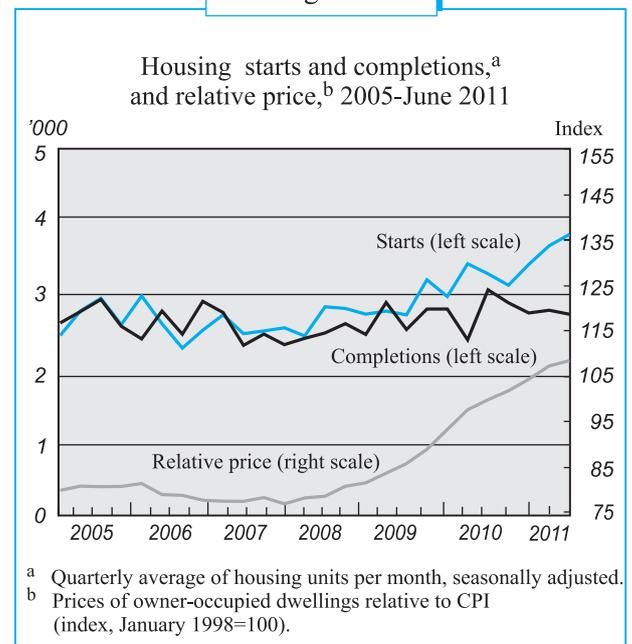
trend data, by only 0.6 percent. This was the result of the significant decline in production in the hi-tech industries, together with the slower rate of growth in the other industries. The output of the industry fell during the second quarter of the year. Sales in the local market continued to grow during the period being surveyed but exports, in real terms, were stagnant, primarily due to the lack of change in hi-tech exports and the shrinking of exports in the traditional industries. The number of workers employed fell somewhat in the second quarter and the number of salaried positions rose somewhat during the period being surveyed; while work hours fell somewhat, as did the rate of utilization of the factors of production. The purchasing managers index points to stability in manufacturing activity. The moderation of growth in manufacturing activity is confirmed by the Bank of Israel's Companies Survey and the parallel CBS survey. The surveys, together with the Manufacturers Association of Israel survey of expectations in manufacturing, indicate that manufacturers expect an expansion of sales in the local market and stagnation to moderate expansion of exports during the third and fourth quarters of the year, together with a significant decline in the output of the hi-tech industries.

The momentum in the activity of the construction industry continued during the period being surveyed. The trend of rapid growth in the number of housing starts continued, while the number of building completions remained almost unchanged (Figure 1.4). Thus, the number of housing units under construction increased significantly and investment in residential (and non-residential) construction and the output of the construction industry grew during the second quarter of the year. The quantity of land (in terms of building units) marketed by the Israel Land Administration grew during the course of the year, which was a continuation of a similar trend that began in 2010; in addition the number of permits for private construction of housing grew significantly. The number of workers employed in the industry continued to grow as did the number of vacancies. The sharp downward trend continued in housing sales (new and second-hand), which included "investment housing" (a second or higher-order apartment) and those sold by foreign residents. The revenue of the construction industry also fell. Recently, there has been a slowdown in the volume of new mortgages provided, in contrast to the positive seasonality that characterizes the summer months.⁶ These developments can be explained by the increase in the interest rate on mortgages at the beginning of the period being surveyed, by the restrictions imposed by the Bank of Israel on mortgages

⁶ The proportion of variable-interest mortgages fell during the period being surveyed, due to, among other things, the limiting of the variable-interest component of housing loans to one-third. The restriction was imposed by the Bank of Israel and went into effect at the beginning of May.

and on the belief among buyers that housing prices will decline in the near future. These beliefs are reinforced by the continuing decline in the willingness of the public to purchase housing, as revealed by the Globes consumer confidence index, and the drop in the number of searches on Google for an apartment to purchase. As a result, the prices of resident-owned housing rose more moderately and the growth in the inventory of new housing for sale continued. The number of months it took to sell a new house also increased.

Figure 1.4



The expectations regarding the construction industry during the third quarter are positive according to the Survey of Companies but less so than during the previous period. The observable risk of the real estate companies, which is captured by the differences in yield between the industry's bonds and government bonds, has risen (Figure 1.14).

During the period being surveyed, a number of major policy measures were implemented with the goal of making it easier to purchase or rent an apartment (see also the Table of Events at the end of this survey): (a) In June, the government approved benefits to young couples who purchase their first house in the periphery. (b) In July, after the start of the social protest, the Prime Minister presented a program that included: a 50 percent discount on the price of land in designated tenders; the distribution of free land to contractors building apartments for long-term rental; and the distribution of free land for the building of 10,000 housing units for student

housing. (c) Following the cancellation of the land tax on a second or higher-order apartment starting from February 2011, a law canceling the 20 percent exemption from land tax on the sale of a second or higher-order apartment within eight years of a previous sale (instead of four years prior to the cancellation of the exemption) was approved on August 1st and will go into effect in 2013. The goal is to encourage the sale of these apartments in the near future.⁷ At the same time, an exemption from land tax was granted on the sale of a non-residential apartment that was converted to residential use, which went into effect from the day the law was approved until the end of June 2013 (for further details, see Part II). (d) On August 3rd, the Knesset approved the National Housing Committees Law, according to which planning committees will be created to process building plans involving the construction of more than 200 housing units on State land. The goal is to speed up the planning and construction processes.

Retail and wholesale activity in the commerce and services industry continued to grow at a relative high rate, as can be seen from the data on VAT revenue and data on sales of the retail chains and credit card purchases. Employment and number of salaried positions in both industries also continued to grow. This development is consistent with the continuing expansion of expenditure on current consumption during the second quarter and the data on the import of consumption goods in dollar terms during the period being surveyed. The CBS Survey of Business Trends (for August) indicates that expectations are for a relatively slow rate of

expansion of activity in the commerce industries during the coming three months. There was a dampening of growth in the hotel industry where the number of nights stayed by tourists contracted while there was a significant increase in the number of nights stayed by Israelis (Figure 1.5), which paralleled the continuing increase in trips abroad by Israelis. The revenue of food and catering services declined as did the number of salaried positions in the industry. The Companies Survey indicates expectations of a drop in hotel reservations, particularly those of tourists, perhaps due to concerns of a worsening in the security situation. Expansion continued in business services, as reflected in the data on revenue, exports (which constitute about two-thirds of the total export of services), and employment. Companies expect a dampening in the expansion of activity during the third quarter.

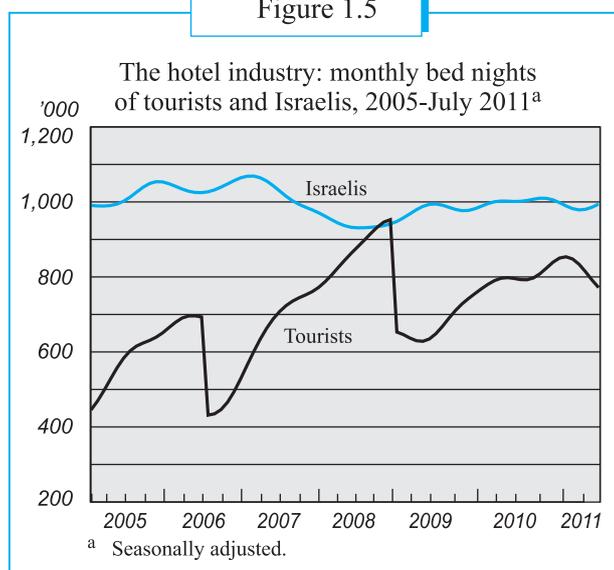
The labor market

The developments in the labor market indicate continuing improvement (Table 1.3 and Figure 1.6) and that the economy is approaching full employment. The rate of unemployment declined to a level of 5.5 percent during the second quarter, which is lower than its level prior to the crisis in 2008 and is near the lowest levels reached in recent decades. The decline in the unemployment rate is also reflected in depth of unemployment (i.e., the shortening of the duration of job search) and the continuing decline in the number of job seekers, while the number of new applications for unemployment benefits rose somewhat.

The rate of participation in the workforce grew somewhat and the rate of employment rose to 54.3 percent. The employment of Israelis continued to increase, primarily in the business sector, as did the employment of non-Israelis, primarily Palestinians. The number of salaried positions rose somewhat and at a slower rate than during 2010 and at the start of the current year. Full-time employment fell during the second quarter relative to the first quarter while part-time employment grew substantially (both among men and women). This is due to, among other things, the relatively rapid expansion of employment in the service industries, where part-time positions are common, such that average weekly work hours per employed worker fell somewhat. According to the Survey of Business Trends, the rate of expansion in employment will slow in coming months relative to the past, particularly in the hi-tech and traditional industries and in the hotel industry.

The number of vacant positions remained almost unchanged during the period being surveyed. This was true of all industries in the business sector (apart from the construction industry where there was a sharp increase) and there was

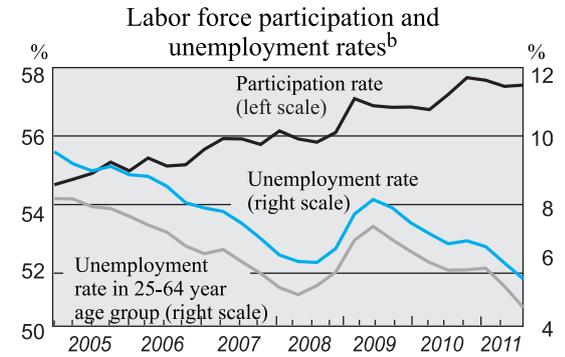
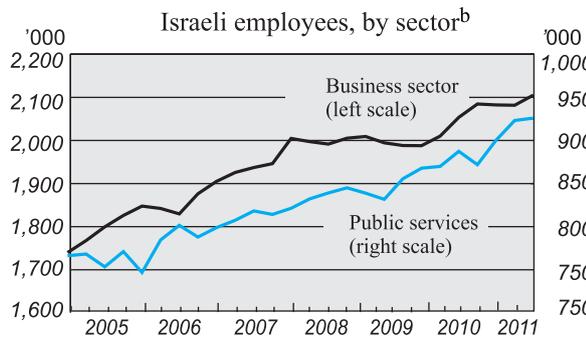
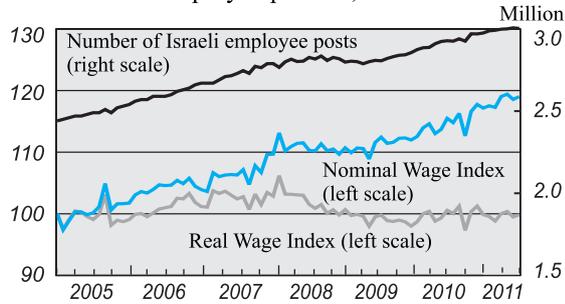
Figure 1.5



⁷ Discussions to cancel the exemption from the land tax took place already in the second quarter, during which there was a high level of sales of apartments of this type.

Figure 1.6

Indices of the nominal and real wage^{a,b}, and the number of employee posts^{a,b}, 2005-June 2011



^a January 2005=100. Includes Israeli, Palestinian, and foreign workers.

^b Seasonally adjusted.

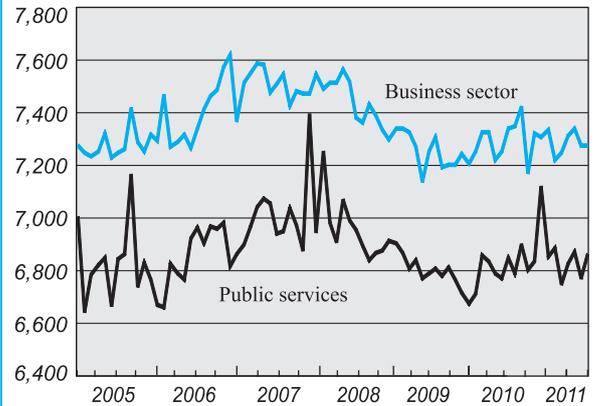
even a decline during the second quarter in seasonally-adjusted terms. The ratio of number of unemployed to number of vacant positions in the business sector (according to the survey of the Ministry of Industry, Commerce and Employment) continued to decline and reached a level in the vicinity of that prior to the last crisis. This development is also an indication of labor market tightness. Furthermore, the Survey of Employers indicates that the balance of employment (number of positions filled less number of workers laid off) was positive, with the number of positions filled decreasing and the number of workers laid off

decreasing even more, although since mid-2010 the balance became less positive.

The nominal wage per salaried position remained almost unchanged in both the business sector and in public services (Figure 1.7), perhaps due to the high rate of entry of relatively low-paid workers and the rise in the proportion of part-time workers. The real wage fell somewhat and the cost of labor per unit of business sector output stabilized during the

Figure 1.7

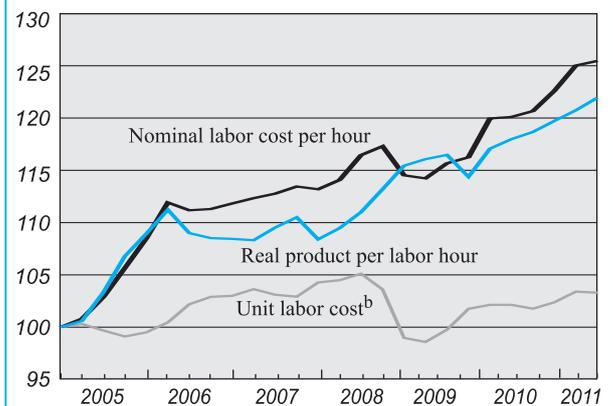
Real wage per employee post^a, 2005-June 2011 (NIS, 2004 prices)



^a Seasonally adjusted. Includes Israeli, Palestinian, and foreign workers.

Figure 1.8

Index of nominal unit labor costs (gross) in the business sector, 2005-June 2011^a (2005:Q1=100)



^a Quarterly data. Seasonally adjusted.

^b Total hourly labor costs divided by hourly GDP.

second quarter, following a decline in the previous quarter (Figure 1.8). In light of the decline in unemployment to such a low level, there is a possibility of pressure on wages and an increase in the cost of labor. At the beginning of July, the minimum wage was raised to NIS 4,100 per month (NIS 22.04 per hour) after being raised to NIS 3,890 in April.

During the period being surveyed, a number of major wage agreements were signed (see also the Table of Events at the end of the Survey). As part of the Oz Letmura reform in the high schools, which will be implemented gradually starting from the current school year, a number changes will be implemented: teachers' wages will be raised significantly,⁸ there will be a transition to a 40-hour work week and the promotion and compensation of teachers will be based on merit as well as on other factors. The cost of the reform is more than NIS 3 billion (when implemented in its entirety). Following a lengthy strike, a wage agreement was signed with physicians for a period of eight years with a total cost of more than NIS 2.5 billion (when implemented in its entirety). According to the agreement, the following changes will be implemented: physicians' wages will be raised significantly;⁹ a limit will be placed on the number of shifts for interns; it will be possible to have specialists work shifts (for higher payment); a large one-time grant will be paid to physicians who move to the periphery and to interns in fields where physicians are in short supply; and physicians will be obligated to punch in on a time clock. In addition, about one thousand positions will be added for physicians in the public hospitals, primarily in order to reduce the number of shifts for interns and to give more time for the meeting between physician and patient in clinics in the community. A large number of interns resigned after the signing of the agreement. Finally, an agreement was signed to significantly improve the wages of policemen and prison workers starting from the September salary.

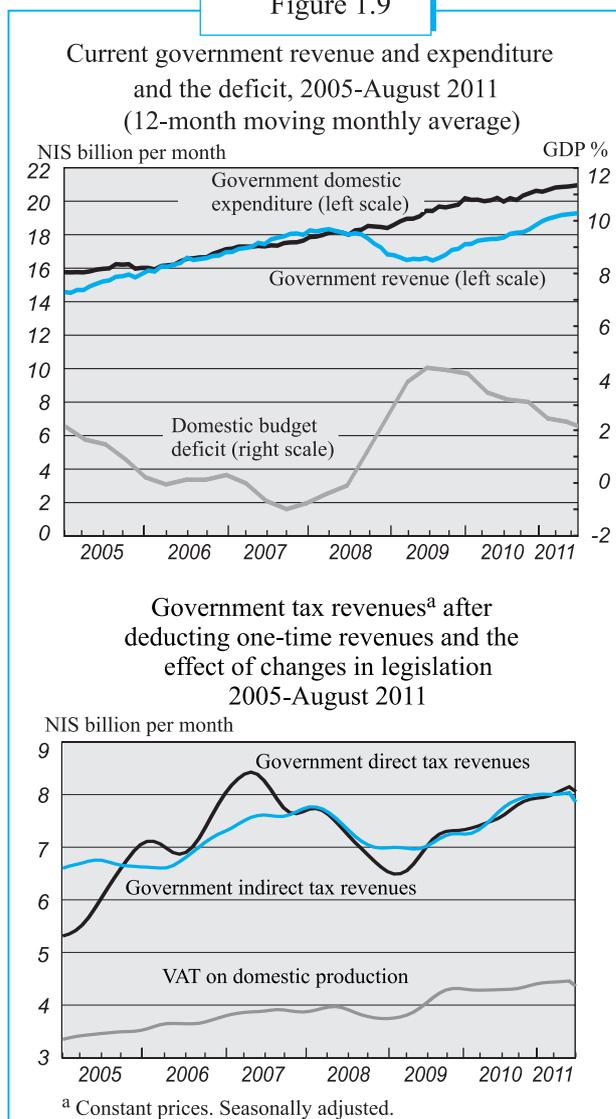
⁸ About 42 percent due to the reform and another about 9 percent due to the general agreement signed with the public sector workers and the erosion of wages.

⁹ A uniform 32-percent hike in the base wage and differential wage increases for physicians in the periphery, in specializations where physicians are in short supply, etc. (which on average add about 49 percent to physicians' wages). Most of the changes will be implemented in the first years of the agreement. It should be mentioned that if the CPI rises in any particular year by more than 5 percent, the increase in physicians' base wage will be equal to the difference between the increase in the CPI and 5 percent.

The government

Tax revenues fell by more than 2 percent relative to the previous period in seasonally-adjusted terms. Though they are below the forecasted seasonally-adjusted path, they are still significantly higher than during the same period in the previous year (Table 1.4 and Figure 1.9). This development is primarily a result of the significant slowdown in the collection of indirect taxes on local production and imports, following the rapid increase in the previous year. Meanwhile the collection of revenue from direct taxes continued to grow at a moderate rate. Since the beginning of the year, there has been a shortfall of about NIS 2.3 billion in tax revenues relative to the forecasted seasonally-adjusted path.

Figure 1.9



Local expenditure (not including credit) during the period being surveyed was lower by close to 4 percent than the seasonally-adjusted path that represents full usage of the budget. This is primarily due to under-utilization by the government ministries and relatively low expenditure on interest payments and in other items. Local expenditures (not including credit) since the beginning of the year are lower than the forecasted seasonally-adjusted path by about NIS 3.5 billion. It should be mentioned that the utilization of the defense budget exceeds the level that is consistent with the original budget.

Based on the fiscal developments until now, it appears that the budget deficit (not including credit) will this year be about 3 percent of GDP (the deficit ceiling according to law).

In August, the Government cancelled the planned hike of about NIS 0.31 (including VAT) in the price of a liter of gasoline following the rapid rise in global oil prices. This was done by reducing the gasoline tax by an identical amount. At the beginning of September, the gasoline tax was raised by about NIS 0.24 per liter while the markup of the gasoline companies was reduced by about NIS 0.19 per liter (both including VAT). The measures to reduce the gasoline tax and the markup of gasoline, as well as their timing, are related to, among other things, the social protest, which was partly motivated by the high price of gasoline.

Foreign trade¹⁰

The weakening of global demand during the period being surveyed led to a slowdown in the import of goods into Israel, which was a continuation of the downward trend in the rate of growth in imports since the beginning of 2011 (Table 1.5 and Figure 1.10). There was a sizable drop in exports of the hi-tech industries (including pharmaceuticals) together with stagnation in the Tech Pulse Index, and the growth rate in exports of other industries also weakened or even became negative. Exports to the US declined and exports to Europe remained unchanged. The shift of Israeli exports to Asia continued and led to a reduction in the risk to exporters from possible economic crises in key countries worldwide.

The rate of increase in the import of goods weakened relative to the period following the recovery from the 2008 crisis. This phenomenon encompassed all types of goods (Figure 1.11): consumption goods (and in particular goods for

Figure 1.10

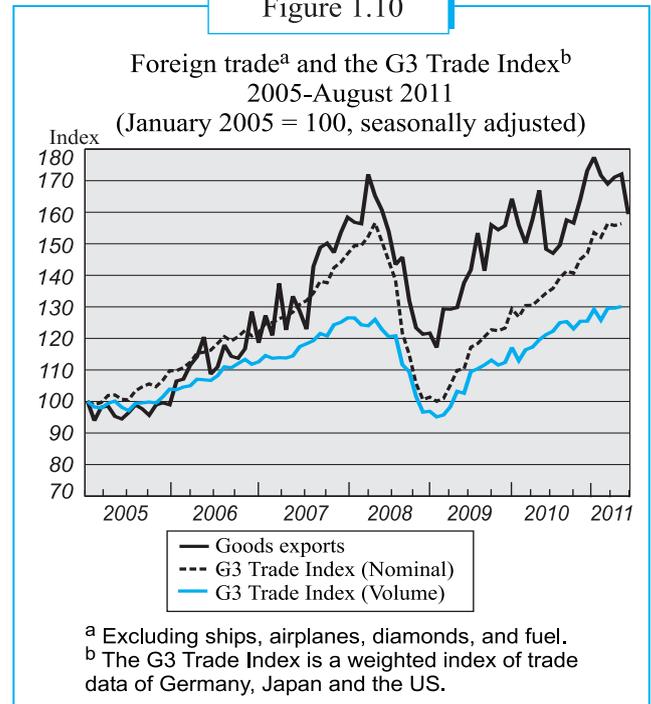
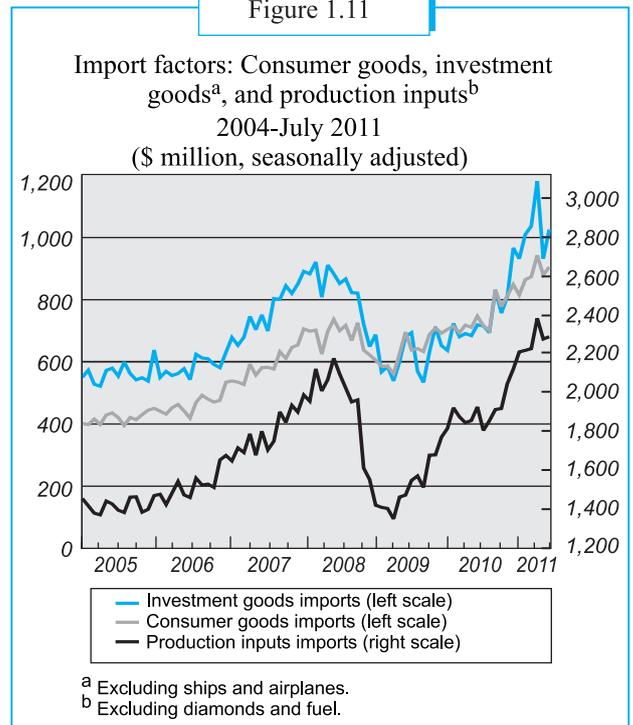


Figure 1.11



¹⁰ The foreign trade data is denominated in dollars and is seasonally adjusted; it does not include ships, planes, diamonds and energy.

current consumption), raw materials and investment assets (including machinery and equipment). The weakening in the rate of growth in the import of investment assets is consistent with the sharp increase during the period following the recovery from the crisis and the expectations that economic activity will not continue to expand as in the past.

The commercial deficit (including energy) expanded to about \$1.6 billion per month according to trend data. This was due to the decline in exports and the continuing growth in all categories of imports (despite the drop in global energy prices). Export prices of goods rose during the second quarter by 2.6 percent and the import prices of goods rose by 3.4 percent, such that the terms of trade worsened by 0.7 percent, following an improvement during the first quarter.

The forecasted slowdown in economic activity worldwide is expected to adversely affect Israeli exports. The deterioration in relations with Turkey is expected to have only a limited negative effect on commercial ties, as long as the problem does not spread to other countries. The export of goods to Turkey totaled about \$1.3 billion in 2010 and constituted about 3.1 percent of the total export of Israeli goods.¹¹ Exports were mainly composed of commodities (mainly raw materials and intermediate goods such as chemicals) which are traded through multinational companies. These factors will make it easier to shift trade to other markets and to continue selling goods to Turkey through third parties.

Inflation and monetary policy¹²

The CPI increased during the months May–August 2011 by 1.1 percent (Table 1.6) and by a seasonally-adjusted rate of 0.2 percent. Leading the rise in the CPI were the housing and health components.¹³ Housing prices (which primarily reflect rentals) rose by 3.3 percent, such that without the housing component the CPI rose during the period being surveyed by only 0.3 percent. The rise in the CPI was moderated by the seasonal drop in prices of fruits and vegetables and shoes and clothing. The prolonged increase in food and energy prices in Israel and world wide came to an end. During the months July–August there was, for the first time this year, a significant drop in food prices in Israel.

¹¹ In several sub-industries, such as poisons for agriculture and iron waste, exports to Turkey are a significant proportion of total exports.

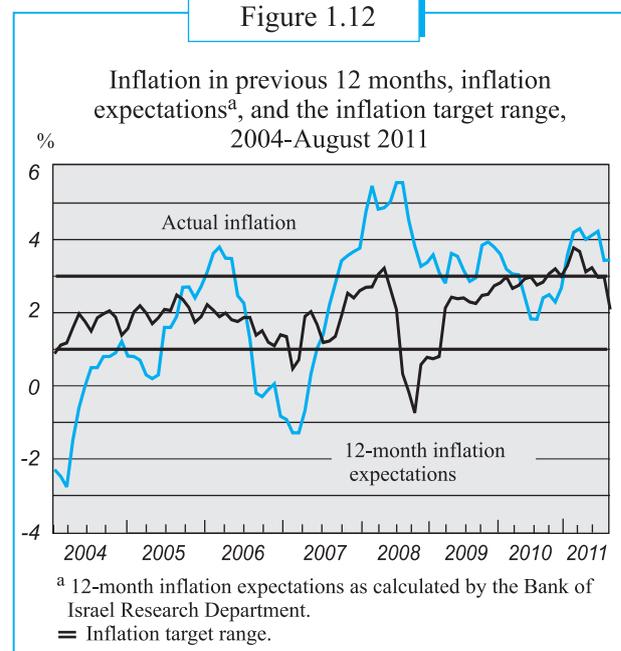
¹² For further details, see Bank of Israel (2011) *Monetary Policy Report (Inflation Report)*, Second half of 2011, August.

¹³ In July, the prices of health insurance services from the health funds and the insurance companies were raised by 5.2 percent, which is a higher rate than in previous years.

This is likely to have been connected not only to the drop in global food prices but also the reduced markups of the retail chains as a result of the social protest.

During the period being surveyed, the rate of inflation during the preceding 12 months exceeded the inflation target range (1–3 percent; Figure 1.12). Inflation expectations for one year, derived from the capital market, were somewhat above the target range at the beginning of the period being surveyed and subsequently declined to within the range. The CBS Survey of Business Trends indicates that towards the end of the period being surveyed, companies' inflation expectations for the year fell significantly, to a level of about 3.0 percent. Data from the capital market indicates that the inflation expectations curve for periods of more than one year shifted downward markedly in the short term, and to a more moderate extent in longer terms; in any case, it is within the inflation target range.

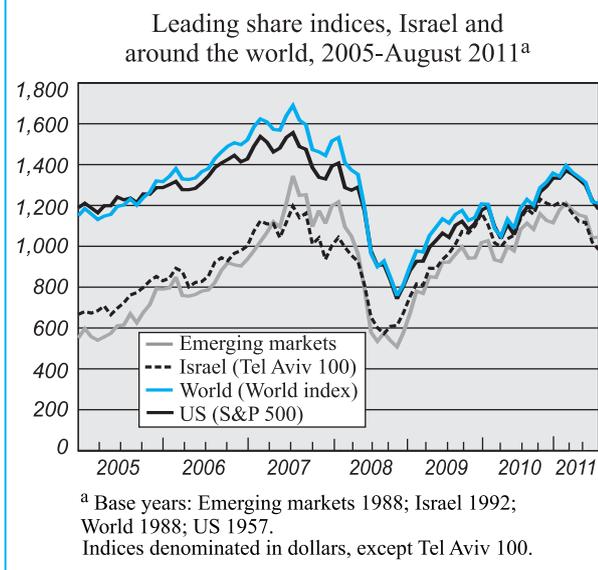
Figure 1.12



During the period being surveyed, the rate of increase in prices of owner occupied dwellings continued to weaken, a trend which began in early 2011; nonetheless the rate is still high. Housing prices increased during the period being surveyed by 1.4 percent (June–July prices relative to March–April) and are higher by 12.3 percent (8.8 percent in real terms) than during the corresponding period in the previous year. The ratio of home prices to the average wage in a salaried position continued to rise at a moderate rate and is currently at historically high levels.

The capital markets in Israel and worldwide (Figure 1.13) were affected by several negative factors: the debt crisis in Europe, the fiscal crisis in the US, the downgrading of the US credit rating by Standard & Poor's and the signs of a weakening in the rate of growth worldwide. During the month of August, share prices on the Tel Aviv Stock Exchange fell sharply, such that by the end of the month the Tel Aviv 100 Index was about 17 percent lower than at the end of April. Corporate bond prices also fell sharply, particularly those of companies belonging to business groups. As a result, the value of the public's portfolio of financial assets fell during the period being surveyed by about 2.1 percent. The level of risk in the capital market grew, as can be seen in the sharp rise in the implied volatility of prices of Tel Aviv share index options and in the widening of the gap between the yields on CPI-indexed corporate bonds and those on government bonds (Figure 1.14). The issuing of shares in Israel declined and mutual funds recorded a net outflow due to large redemptions, primarily in the funds that specialize in corporate bonds and shares.

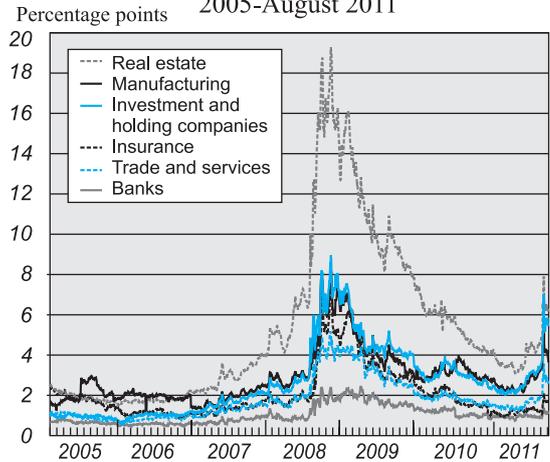
Figure 1.13



The Bank of Israel interest rate for May was raised by 0.25 percent points to 3.25 percent and during the period being surveyed was left unchanged. The considerations behind this decision included, among others: the decline in the expectations of inflation towards the target, the assessments that the growth in activity in Israel will weaken, a fear that major debt crises would appear in key countries in the West, the volatility in capital markets worldwide and the weakening of global demand. These factors, together with the geo-political turbulence in our region, also increased uncertainty with respect to the economic environment

Figure 1.14

The gap between the weighted average yield of CPI-indexed corporate bonds and Galil government bonds, by industry, 2005-August 2011



in Israel.¹⁴ Also contributing to the decision to leave the interest rate unchanged was the lowering of expectations for an increase in interest rates by central banks worldwide, due to the less than encouraging economic developments there,¹⁵ and also the housing policy measures and expansion of activity in the construction industry, which are likely to lead to a further moderation in the rate of increase in housing prices. The one-year-ahead expectations of the interest rate (according to the one-year forward interest rate in the Telbor market) fell in August by a percentage point to about 3 percent and the trend in the one year ahead interest rate derived from makam was similar.

The average nominal effective exchange rate for the period surveyed appreciated by about one percent relative to the previous period. Since the first quarter of the year, there has been an appreciation in the NIS/\$ and the NIS/€ rates and in late July, the shekel weakened significantly against the other currencies (Figure 1.15) and to a greater extent than the major currencies. This was due to, among other things, the change in expectations regarding the path of the Bank of Israel interest rate from an upward trend to no change and perhaps also geopolitical instability and the escalation of tension in the region. The uncertainty in the foreign currency market rose significantly at the end of the period being surveyed, which was reflected in an increase in the standard deviation

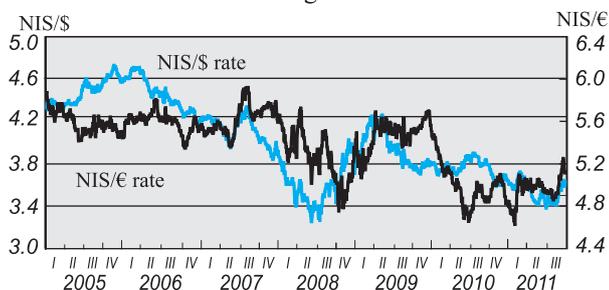
¹⁴ Israel's risk premium, as measured by the five-year CDS spreads, rose during the period being surveyed by about 7 basis points and at the end of the period stood at close to 150.

¹⁵ The Fed decided at the end of August to leave the interest rate at its current low level at least until mid-2013.

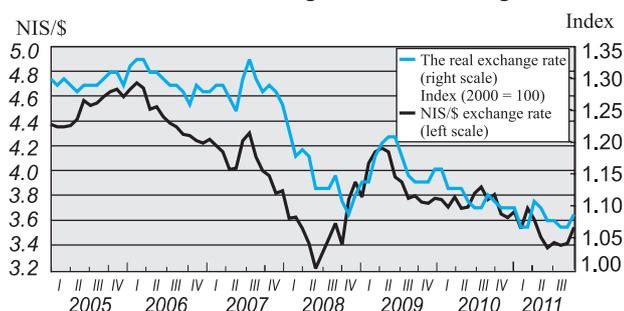
of NIS/\$ option prices and in the increasing probability of a sharp depreciation. The intervention of the Bank of Israel in the foreign currency market was on a smaller scale during the period being surveyed and the Bank of Israel purchased only about \$900 million. By the end of the period, foreign exchange reserves totaled about \$78 billion.

Figure 1.15

The nominal NIS/\$ and NIS/€ exchange rates, 2005-August 2011



The nominal NIS/\$ exchange rate and the real effective exchange rate,^a 2005-August 2011



^a The real effective exchange rate is the trade-weighted geometrical average exchange rate of the shekel against the 28 currencies of Israel's 38 main trading partners, adjusted for the difference between inflation in Israel and in those countries.

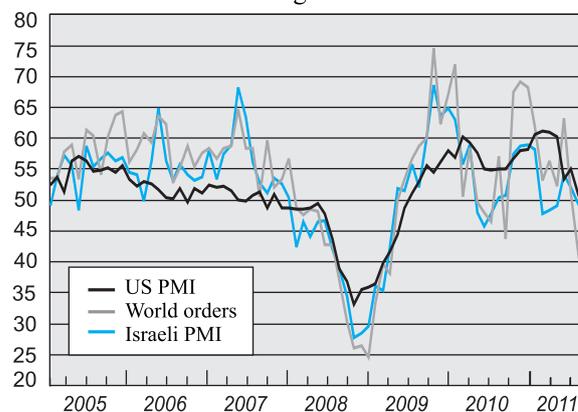
The global economy

The expansion of global economic activity slowed during the period being surveyed, primarily in the European countries. There was also a high level of volatility in the financial markets, due to fears that the debt crises in Europe would spread and due to the fiscal crisis in the US. GDP of the developed countries grew by only 0.7 percent in annual terms during the second quarter (0.6 percent in the euro bloc, with no growth in key European countries, and 1.0 percent in the US) while the gross product of the developing countries grew by about 5.6 percent. The rate of unemployment in the OECD countries remained high. The expansion in global trade slowed, as did the rate of growth in the imports of the developed countries. The

indices of consumer confidence in Europe and the US are on a downward trend, although the balance is still positive. The global purchasing managers index continued to decline (Figure 1.16). The OECD Composite Leading Indicators, which are indices that predict the status of the business cycle, indicate a continuation of the slowdown in growth in the OECD and in other key countries. The fiscal restraint in Europe is liable to exacerbate the slowdown there. The IMF announced a major downward revision of its forecast of global growth for the second half of 2011. The forecast for growth in 2012 was reduced to 4.0 percent and the forecast for global imports to 5.8 percent (Table 1.7).

Figure 1.16

Purchasing Managers Index, 2005-August 2011



There are concerns in Europe that the debt crisis will spread to key countries on the continent, despite the reinforcement of rescue plans in Greece,¹⁶ Ireland and Portugal and the budget cuts. The increasing weight of assessments that Italy (and also Spain) will experience a debt crisis was reflected in the gaps in yield to maturity between its government bonds and those of France and Germany. The European Central Bank (ECB) reacted by purchasing the bonds of governments that are experiencing a debt crisis or those that are approaching such a situation. Despite the compromise that raised the debt ceiling in the US, Standard & Poor's reduced the US credit rating for the first time ever and left it with a negative outlook. It estimates that the cuts in the US budget do not provide the solution needed to stabilize the dynamic of the debt in the medium term. As a result of the downgrading of the US credit rating and the debt crises in Europe, there were sharp declines in share prices, primarily

¹⁶ Even after the last rescue plan, Greece is in a situation of "selective default"; this means that it is expected that it will not be able to redeem its debts, and its credit rating is extremely low.

those of banks (including those in France and Germany) which are likely to be the most hurt by the debt crises and increased volatility in the financial markets. The level of uncertainty climbed and was reflected in sharp increases in CDS spreads and the gaps in government bond yields (Figure 1.18).

The prices of goods (energy, food and metals) declined to a large extent since May though they remained higher than at the end of last year (Figure 1.17). The price declines partly reflect the sharp price increases in the first quarter and the response to the weakening of growth in economic activity worldwide. Inflation in the OECD countries fell during the period being surveyed and the forecast of inflation for 2012 in the developed countries was revised downward to 1.4 percent.

In July, the ECB raised its interest rate by 0.25 percentage points to a level of 1.5 percent. Due to the growing indicators of a slowdown in European growth, the interest rate has been left unchanged since then. In August, the Fed made a commitment to maintain a low rate of interest at least until mid-2013.

Figure 1.18a

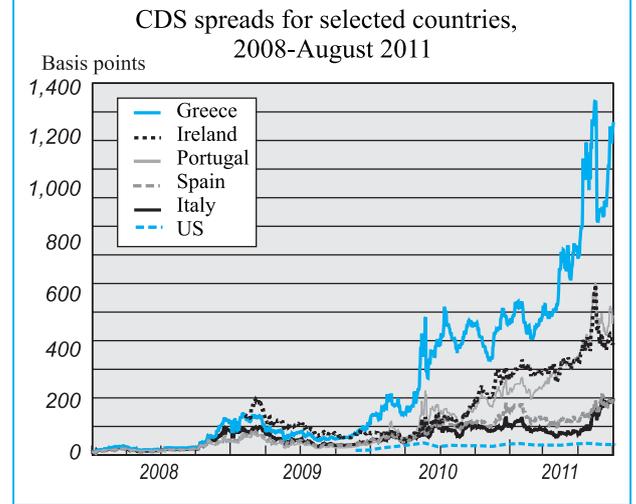


Figure 1.17

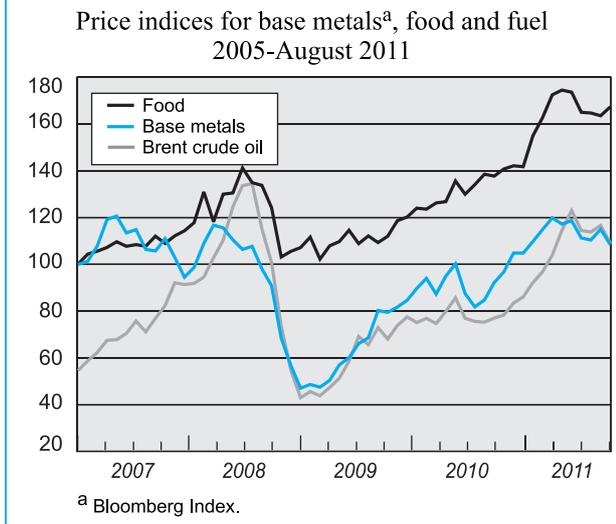


Figure 1.18b

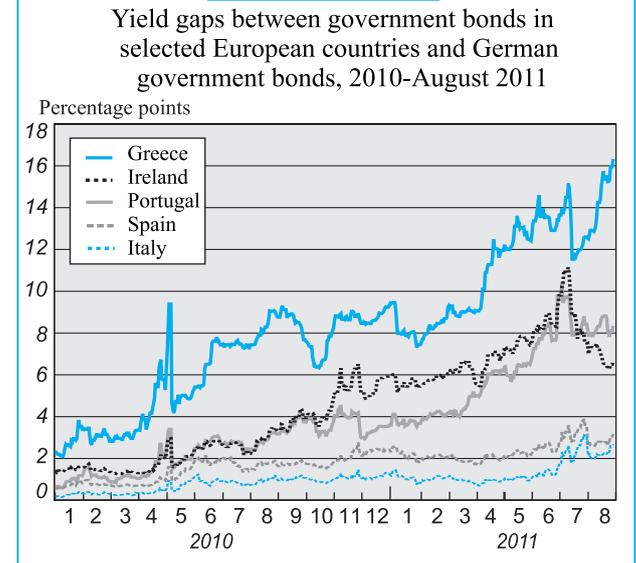


Table 1.1. National Accounts, 2010-2011

(percentage change in annual terms, at constant prices, seasonally adjusted)

| | 2010 ^{a,b} | Change from previous quarter | | | | | 2011/II | |
|--|---------------------|------------------------------|------|------|------|------|----------------------------------|-------------------------------------|
| | | 2010 | | | 2011 | | Year-on-year change ^a | Last month for which data available |
| | | II | III | IV | I | II | | |
| GDP | 4.8 | 6.1 | 4.6 | 7.5 | 4.7 | 3.5 | 3.5 | June |
| Business-sector product | 5.8 | 7.3 | 4.8 | 8.7 | 5.3 | 2.4 | 3.6 | June |
| Private consumption expenditure | 5.3 | 6.9 | 0.4 | 11.0 | 7.2 | 3.2 | 5.2 | June |
| Gross domestic investment | 4.0 | -17.2 | 11.4 | 26.8 | 56.9 | 11.6 | 20.6 | June |
| Fixed investment | 13.6 | 27.7 | 18.4 | 25.9 | 22.5 | 9.9 | 15.9 | June |
| Goods and services exports | | | | | | | | |
| excl. diamonds | 10.7 | 18.4 | 0.4 | 2.2 | 7.9 | 5.2 | 2.8 | June |
| Goods exports ^c | 16.6 | 20.3 | -4.7 | -2.9 | 17.5 | 6.6 | 1.8 | June |
| Services exports ^c | 6.4 | 12.9 | 17.1 | 20.1 | 2.1 | 1.5 | 8.7 | June |
| Goods and services imports | | | | | | | | |
| excl. diamonds ^d | 9.5 | 13.4 | -2.8 | 16.0 | 22.3 | 8.3 | 9.2 | June |
| Goods imports ^e | 18.6 | 7.3 | 7.5 | 16.1 | 42.1 | 3.3 | 13.8 | June |
| Services imports ^e | -2.4 | -7.9 | 3.7 | 1.8 | 10.6 | 31.4 | 9.5 | June |
| Public sector consumption | 2.5 | 2.0 | 7.3 | 4.5 | 1.4 | -5.3 | 0.1 | June |
| Public consumption excluding defense imports | 2.2 | 3.1 | 6.4 | 4.7 | 1.6 | -6.1 | -0.3 | June |
| Domestic use of resources | 4.3 | 0.6 | 3.0 | 11.7 | 14.0 | 4.2 | 6.5 | June |

^a Unadjusted data.

^b Compared with previous year.

^c New calculation - excluding subsidies.

^d Excluding defense imports, ships and aircraft.

^e New calculation - excluding taxes.

SOURCE: Based on Central Bureau of Statistics data.

Table 1.2. Indicators of Business Activity, 2010-2011
(percentage change, in annual terms, seasonally adjusted)

| | 2010 ^{a,b} | Change from previous quarter | | | | | May-August 2011 | | |
|--|---------------------|------------------------------|-------|-------|----------------|-------|-----------------------------|----------------------------------|--------------------------------------|
| | | 2010 | | 2011 | | | Change from previous period | Year-on-year change ^a | Last month for which data available* |
| | | II | III | IV | I | II | | | |
| Composite state-of-the-economy index | 5.9 | 7.0 | 6.6 | 6.7 | 5.5 | 3.3 | 3.3 | 5.1 | August |
| Unit labor cost | 1.8 | 0.4 | -1.4 | 1.7 | 3.1 | -1.7 | -1.7 | 0.4 | June |
| Large-scale retail trade | 3.4 | -1.3 | 15.7 | -9.2 | 0.8 | 7.4 | 5.1 | 2.8 | July |
| Industrial production (excl. diamonds) | 7.8 | 24.9 | -17.2 | 1.6 | 12.2 | -5.4 | -2.1 | -2.6 | July |
| Index of trade revenue | 7.4 | 2.3 | 2.7 | 4.4 | 6.0 | 1.9 | 6.2 | 5.4 | July |
| Index of trade and services revenue | 7.7 | 2.9 | 3.5 | 7.6 | 5.0 | 3.7 | 5.8 | 5.8 | July |
| Index of services exports | 11.0 | 21.1 | 2.6 | 16.5 | -11.7 | 14.1 | 22.6 | 9.1 | August |
| Tourist arrivals | 25.7 | 12.9 | -1.0 | 43.1 | -29.2 | -15.9 | 7.0 | -0.4 | August |
| Residential construction | | | | | | | | | |
| Starts | 14.3 | -15.0 | -17.5 | 41.3 | 33.1 | 18.2 | 3.3 | 11.6 | June |
| Completions | 1.3 | 172.5 | -21.1 | -17.7 | 5.5 | -7.5 | 36.6 | -8.1 | June |
| ILA land permits (units) ^{a,c} | 24,854 | 2,835 | 5,054 | 7,284 | 8,990 | 5,750 | | | June |
| Nonresidential construction | | | | | | | | | |
| Area of starts ^{a,d} | -1.0 | 12.1 | 30.8 | -25.1 | 16.4 | 4.7 | | 4.7 | June |
| Survey of companies (net balance, percent): ^e | | | | | | | | | |
| Weighted balance of the business sector | 23 | 18 | 20 | 27 | 20 | 16 | | | June |
| Output of manufacturing firms | 23 | 23 | 10 | 32 | 28 | 11 | | | June |
| Sales by trading firms | 23 | 17 | 23 | 21 | 6 [^] | 28 | | | June |

* When the last month is August, the period of comparison is four months; when the last month is July, the comparison period is three months; when the last month is June, the period compared is two months.

[^] Not significant at 10% level.

^a Unadjusted data.

^b Year-on-year.

^c Land transactions authorized by the Israel Lands Administration in the relevant period.

^d Period average, year-on-year change.

^e The net balance is defined as the difference between the number of firms reporting a rise and those reporting a decline, as a percentage of all reporting firms.

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

Table 1.3. Indicators of Labor Market Developments, 2010-2011

(percentage change, seasonally adjusted)

| | II/2011 ('000) | Percent change from previous quarter | | | | | May - August 2011 | | |
|--|-------------------|---|------|------|------|-------|--------------------------------------|---|--|
| | | 2010 | | 2011 | | | Change from previous period | Year- on-year change ^a | Last month for which data available * |
| | | II | III | IV | I | II | | | |
| Civilian labor force | 3,201.9 | 1.4 | 1.4 | 0.3 | 0.1 | 0.5 | 0.5 | 2.4 | June |
| Israeli employees | 3,026.9 | 1.7 | 1.3 | 0.5 | 0.6 | 1.0 | 1.0 | 3.1 | June |
| <i>of which</i> : in public services | 925.3 | 2.0 | -1.8 | 3.3 | 2.6 | 0.3 | 0.3 | 4.2 | June |
| in business sector | 2,104.5 | 2.2 | 1.5 | -0.1 | 0.0 | 1.1 | 1.1 | 2.6 | June |
| Foreign workers and Palestinians (unadjusted) | 286.7 | -2.9 | -2.2 | 0.8 | 3.0 | 2.3 | 2.3 | 3.8 | June |
| Average hours worked weekly per Israeli employee | 36.3 | -0.6 | 0.6 | 1.1 | 0.0 | -0.8 | -0.8 | -2.0 | June |
| Weekly labor input in business sector (incl. foreign workers and Palestinians) | 101,299.7 | 0.8 | 1.3 | 1.0 | 0.3 | 0.2 | 0.2 | 0.4 | June |
| <i>of which</i> : Israelis | 88,664.7 | 1.3 | 1.7 | 1.0 | -0.2 | 0.0 | 0.0 | 0.0 | June |
| Weekly labor input in public services (Israelis) | 21,287.1 | 0.4 | 1.5 | 5.2 | 3.3 | 2.3 | 2.3 | 6.4 | June |
| Unemployed | 174.9 | -3.3 | 2.8 | -2.4 | -7.8 | -7.8 | -7.8 | -9.0 | June |
| Job seekers | 183.4 | -1.0 | 0.1 | -1.8 | -2.2 | 0.5 | 0.3 | | June |
| Claims for unemployment benefit | 70.3 | -4.6 | -5.7 | 4.0 | -4.5 | -1.8 | 0.5 | -4.2 | August |
| Balance of employment ^b | | 1.2 | 0.6 | 1.8 | 2.1 | 1.4 | | | June |
| Job vacancies | 60.8 | 4.1 | 5.9 | 21.7 | 9.9 | -12.0 | | 16.2 | August |
| | (NIS) | | | | | | | | |
| Real wage per employee post ^c | | -0.2 | -0.1 | 1.0 | -1.0 | 0.4 | -0.5 | -0.1 | June |
| In public services | | -0.1 | 0.5 | 1.6 | -1.7 | 0.3 | -0.4 | 0.3 | June |
| In business sector | | -0.5 | 0.7 | 0.1 | -0.9 | 0.5 | -0.7 | -0.3 | June |
| Nominal wage per employee post ^c | 8,545.7 | 0.3 | 0.4 | 2.3 | 0.7 | 1.1 | -0.2 | 4.0 | June |
| In public services | 8,189.5 | 0.7 | 0.6 | 2.7 | 0.2 | 1.1 | 0.1 | 4.4 | June |
| In business sector | 8,718.0 | 0.0 | 1.1 | 1.3 | 1.0 | 1.0 | -0.5 | 3.8 | June |
| | | Percent, seasonally adjusted | | | | | | | |
| Participation rate | | 57.2 | 57.7 | 57.6 | 57.4 | 57.5 | | | June |
| Employment rate | | 53.4 | 53.9 | 53.9 | 54.0 | 54.3 | | | June |
| Unemployment rate | | 6.5 | 6.6 | 6.5 | 6.0 | 5.5 | | | June |
| Depth of unemployment ^d | | 36.0 | 32.1 | 33.3 | 29.8 | 28.9 | | | June |

* When the last month is August, the period of comparison is four months; when the last month is July, the comparison period is three months; when the last month is June, the period compared is two months.

^a Unadjusted data.

^b Posts filled minus terminations of employment, as a percentage of the total number of employees in businesses in the Employers Survey Sample. Beginning with the first quarter of 2011, the calculation is made by the Bank of Israel.

^c Including foreign workers and Palestinians. Seasonally adjusted data.

^d Percent of unemployed seeking work for more than six months (unadjusted).

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 (CBS) National Accounts estimates; job seekers, which are derived from the Israeli Employment Service; claims for unemployment benefit, which are derived from the National Insurance Institute, and job vacancies, which are derived from the CBS Survey of Job Vacancies.

Table 1.4. Government Budget Performance, 2010-2011

| | Change from previous quarter | | | | | | May - August 2011 | | |
|--|------------------------------|-------|-------|-------|------------------------------------|------|-----------------------------|---------------------|--------------------------------------|
| | 2010 ^a | 2010 | | | 2011 | | Change from previous period | Year-on-year change | Last month for which data available* |
| | | II | III | IV | I | II | | | |
| | | | | | | | | | |
| Domestic deficit, as percent of GDP | -2.5 | -2.3 | -0.4 | -6.5 | 1.7 | -2.0 | | June | |
| Total deficit excluding credit, as percent of GDP | -3.7 | -3.3 | -1.8 | -7.8 | 0.8 | -2.8 | | June | |
| Deviation from domestic budget path, excl. credit extended: ^b | | | | | | | | | |
| | | | | | (NIS billion) | | | | |
| Revenue | 10.5 | 1.6 | 2.2 | 4.9 | 0.9 | -1.1 | -4.2 | -5.5 | August |
| Expenditure | -1.3 | -2.1 | -2.8 | 3.7 | 0.0 | -1.9 | -2.6 | -1.2 | August |
| Deficit | 11.8 | 3.7 | 5.0 | 1.3 | 0.9 | 0.8 | -3.3 | -6.1 | August |
| Total deficit excluding credit | -30.2 | -6.7 | -3.7 | -16.2 | 1.6 | -6.0 | -7.9 | 2.2 | August |
| | | | | | Real change year-on-year (percent) | | | | |
| Government domestic revenues excluding credit | 5.5 | 3.3 | 1.5 | 5.3 | 11.1 | 5.4 | | 3.5 | August |
| Government tax revenue | 7.5 | 8.6 | 5.5 | 6.3 | 8.3 | 5.3 | | 3.8 | August |
| of which : income tax, net | 4.1 | 2.1 | 6.6 | 5.4 | 10.7 | 8.7 | | 8.0 | August |
| VAT, gross | 9.2 | 14.4 | 3.6 | 5.0 | 7.1 | 6.5 | | 6.5 | August |
| Government expenditure | 1.0 | -6.7 | -2.0 | 4.2 | 1.4 | 2.7 | | 1.4 | August |
| National Insurance allowances | 4.0 | 4.1 | 3.6 | 3.8 | 0.6 | 1.9 | | 1.3 | August |
| of which : Unemployment benefit | -18.5 | -26.4 | -24.6 | -21.7 | -12.9 | -2.2 | | -5.4 | August |
| Income support ^c | -1.0 | -2.2 | -0.9 | -2.8 | -6.0 | -5.7 | | -5.7 | August |
| Payments to the National Insurance Institute by the public | 7.5 | 10.5 | 8.8 | 5.7 | 4.6 | 3.9 | | 3.9 | August |

* When the last month is August, the period of comparison is four months; when the last month is July, the comparison period is three months; when the last month is June, the period compared is two months.

^a Compared with previous year.

^b The path is determined in accordance with the deficit ceiling.

^c Not including income support in old-age and survivors' pensions.

SOURCE: Based on Ministry of Finance and National Insurance Institute data.

Table 1.5. Foreign Trade, Balance of Payments, and the Reserves, 2010-2011

(Seasonally adjusted)

| | 2010 ^{a,b} | Change from previous quarter | | | | | May - August 2011 | | |
|---|---------------------|--|------------|--------|--------|--------|-----------------------------|----------------------------------|--------------------------------------|
| | | 2010 | | 2011 | | | Change from previous period | Year-on-year change ^b | Last month for which data available* |
| | | II | III | IV | I | II | | | |
| | | (rate of change, percent) ^c | | | | | | | |
| Trade in goods ^d | | | | | | | | | |
| Goods imports | 19.0 | 1.5 | 1.3 | 8.3 | 11.6 | 6.5 | 7.0 | 28.5 | August |
| <i>of which</i> : Consumer goods | 14.3 | 0.6 | 2.2 | 11.6 | 4.4 | 6.4 | 6.5 | 20.9 | August |
| Capital goods | 12.8 | 2.5 | 3.2 | 13.0 | 20.7 | 8.3 | 8.8 | 49.2 | August |
| Intermediates | 23.4 | 1.5 | 0.4 | 5.1 | 11.2 | 5.6 | 6.2 | 23.5 | August |
| Goods exports | 16.2 | -2.5 | 0.3 | 0.2 | 11.2 | 0.5 | -2.4 | 10.6 | August |
| <i>of which</i> : Manufacturing | 16.3 | -2.4 | 0.8 | -0.1 | 11.1 | 0.8 | -2.1 | 10.6 | August |
| <i>of which</i> : High-tech | 12.3 | 3.1 | 2.8 | -0.7 | 9.7 | -2.5 | -6.7 | 1.5 | August |
| Balance of payments | | | | | | | | | |
| | | | \$ million | | | | | | |
| Goods and services exports | 80,400 | 20,047 | 19,948 | 20,790 | 22,037 | 22,641 | | | June |
| Goods and services imports | 76,060 | 18,539 | 18,578 | 20,264 | 22,593 | 23,788 | | | June |
| Balance of trade in goods and services account | 4,339 | 1,508 | 1,370 | 526 | -556 | -1,147 | | | June |
| Balance of trade in current account | 6,461 | 2,186 | 1,862 | 548 | 362 | -560 | | | June |
| Surplus/deficit in financial account (excl. foreign exchange reserves) ^b | 1,671 | -2,221 | 540 | 1,826 | 1,436 | 4,002 | | | June |
| <i>of which</i> : Nonresidents' direct investments ^b | 5,152 | -218 | 1,650 | 2,426 | 2,235 | 1,635 | | | June |
| Nonresidents' portfolio investment ^b | 9,028 | 633 | 323 | 4,328 | 1,800 | 727 | | | June |
| Residents' direct and portfolio investment abroad ^b | 17,621 | 3,485 | 6,292 | 2,500 | 3,126 | 1,194 | | | June |
| Bank of Israel foreign currency reserves, end-period ^b | 70,913 | 63,096 | 66,271 | 70,913 | 74,526 | 77,414 | 0.9 | 21.8 | August |
| Net external debt (percent of GDP) ^{b,e} | -24.0 | -24.1 | -23.4 | -23.7 | -23.9 | -23.9 | | | June |

* When the last month is August, the period of comparison is four months; when the last month is July, the comparison period is three months; when the last month is June, the period compared is two months.

^a Compared with previous year.

^b Unadjusted data.

^c The change relates to the dollar values of imports and exports.

^d Not including ships, aircraft, diamonds, and fuel.

^e GDP is calculated at the end-of-period NIS/\$ exchange rate.

SOURCE: Based on Central Bureau of Statistics data.

Table 1.6. Selected Price Indices, the Effective Exchange Rate, Nondirected Bank Credit, Interest Rates, Yields, and the Share Price Index, 2010-2011
(rates of change, percent)

| | 2010 ^a | (Change from previous year) | | | | | May - August 2011 | | | |
|---|-------------------|---|------|------|------|------|-----------------------------|---------------------|--------------------------------------|--|
| | | 2010 | | 2011 | | | Change from previous period | Year-on-year change | Last month for which data available* | |
| | | II | III | IV | I | II | | | | |
| | | Change during period ^b | | | | | | | | |
| CPI | 2.7 | 1.5 | 1.2 | 0.7 | 0.7 | 1.5 | 1.1 | 3.4 | August | |
| Consumer price index, seasonally adjusted | 2.6 | 0.7 | 0.9 | 1.2 | 1.5 | 0.5 | 0.2 | 3.4 | August | |
| Price index of owner-occupied homes ^c | 14.1 | 3.7 | 3.0 | 4.0 | 3.4 | 1.4 | 0.7 | 12.3 | June | |
| General share-price index | 12.6 | -13.8 | 10.8 | 6.8 | -2.6 | -8.6 | -16.0 | -5.3 | August | |
| | | Change in period average ^d | | | | | | | | |
| Real effective exchange rate ^e | -5.1 | -8.1 | -3.3 | -5.5 | -3.3 | -2.4 | -1.2 | -2.5 | August | |
| Nominal effective exchange rate | -4.8 | -7.8 | -3.5 | -5.5 | -2.3 | -1.8 | -0.7 | -2.1 | August | |
| Nondirected bank credit | 4.1 | 1.8 | 1.8 | 2.0 | 2.3 | 1.6 | 1.6 | 7.3 | August | |
| Effective interest rate in daily deposit auction ^f | 1.6 | 1.5 | 1.7 | 2.0 | 2.3 | 3.1 | 3.2 | 1.6 | August | |
| Yield to maturity on 5-year notes ^g | 0.9 | 1.1 | 0.7 | 0.5 | 0.8 | 1.6 | 1.5 | 0.8 | August | |
| Risk premium ^h | -38.7 | -3.1 | 3.4 | -4.7 | 25.0 | 2.2 | 5.2 | 26.8 | August | |
| | | Change during previous 12 months ⁱ | | | | | | | | |
| CPI | 2.7 | 2.8 | 2.0 | 2.5 | 4.0 | 4.1 | | 3.8 | August | |

* When the last month is August, the period of comparison is four months; when the last month is July, the comparison period is three months; when the last month is June, the period compared is two months.

^a Compared with previous year.

^b Last month in period compared with last month of previous period.

^c Not part of the CPI.

^d Quarterly average compared with quarterly average of previous year.

^e The real effective exchange rate is the weighted geometric mean of the exchange rate of the shekel against 28 currencies, representing 38 of Israel's main trading partners (weighted by the extent of Israel's trade with those countries), adjusted for the difference between the rate of inflation in Israel and the rates of inflation in those countries.

^f Period average interest rate.

^g Period average yield.

^h As measured by 5-year credit-default-swaps (CDS). Calculated as the difference between the monthly average in the quarter and the monthly average of the previous quarter.

ⁱ Year-on-year change in period average.

SOURCE: Based on Central Bureau of Statistics data.

Table 1.7. Indicators of Economic Development in Advanced and Developing Economies^a
(annual change, percent)^b

| | | 2009 | 2010 | 2011 Projection | 2012 Projection |
|---|-----------------------------------|-------|------|--------------------|--------------------|
| World GDP | | -0.7 | 5.1 | 4.0 | 4.0 |
| | Advanced economies | -3.7 | 3.1 | 1.6 | 1.9 |
| | Emerging and developing economies | 2.8 | 7.3 | 6.4 | 6.1 |
| World trade | | -10.7 | 12.8 | 7.5 | 5.8 |
| | Advanced economies | | | | |
| | Imports | -12.4 | 11.7 | 5.9 | 4.0 |
| | Exports | -11.9 | 12.3 | 6.2 | 5.2 |
| | Emerging and developing economies | | | | |
| | Imports | -8.0 | 14.9 | 11.1 | 8.1 |
| | Exports | -7.7 | 13.6 | 9.4 | 7.8 |
| Commodity prices (\$) | Oil ^c | -36.3 | 27.9 | 30.6 | -3.1 |
| | Nonfuel | -15.7 | 26.3 | 21.2 | -4.7 |
| Inflation (CPI) | Advanced economies | 0.1 | 1.6 | 2.6 | 1.4 |
| Short-term interest rate (%) ^d | Dollar deposits | 1.1 | 0.5 | 0.4 | 0.5 |
| | Euro deposits | 1.2 | 0.8 | 1.3 | 1.2 |
| Unemployment rate | Advanced economies | 8.0 | 8.3 | 7.9 | 7.9 |

^a According to the World Economic Outlook, Israel is classified as an advanced economy. The advanced economies include the industrialized countries and some emerging markets.

^b Except for unemployment and interest rates (percent).

^c The average price of a barrel of U.K. Brent, Dubai and West Texas Intermediate crude oil in 2010 was \$79.03, excluding freight costs. Estimated price for 2011 is \$103.20 and for 2012, \$100.00.

^d Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), September 2011.

Part 2: Broader Review of Selected Issues

The private rental market in Israel

- About a quarter of households in Israel live in privately owned rented accommodation, a similar proportion to the average in the OECD countries.
- The rental market serves as a mechanism for the supply of affordable housing: renting an apartment does not require capital investment, and it is relatively easy to match a household's needs with regard to a dwelling's size and location. The increase in rents since 2008, however, imposes an onerous burden on households, mainly because of the high share of housing expenses in total expenditure, and its rigidity.
- It is important to maintain a supply of a range of rental apartments at reasonable rents. It is therefore proposed herein to increase the supply of apartments gradually, including small apartments, both for rental and sale, in residential areas. We also recommend updating the rent subsidy.
- Direct intervention in the level of rents or in the length of contracts is not desirable. Nevertheless, in many countries companies are offered incentives, as they can provide longer term rental contracts. Such a subsidy can be in the form of designating some land in the urban construction programs for construction of homes for rent.

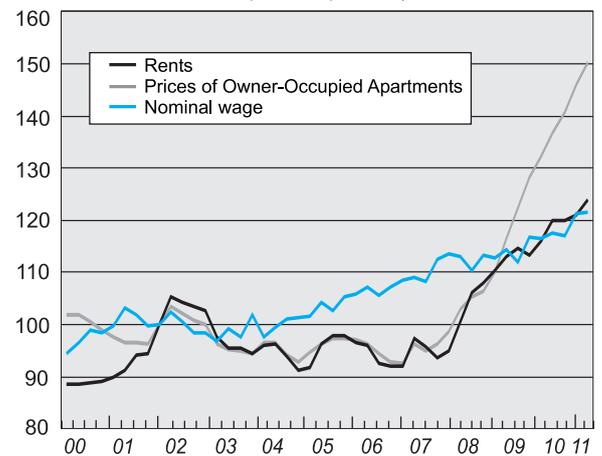
1. Introduction

The rate of increase of owner-occupied homes and home rents started to soar in the first half of 2008, following a period of moderate volatility and even a price decline. After a long period when the increase in the nominal wage outstripped the rise in house prices, in the second half of 2009 the pace of increase of house prices and rents caught up with the rate of increase in the nominal wage, and since then the rate of increase of house prices has greatly exceeded the rates of increase of the other two (rents and wages) (Figure 2.1)¹. In the last few months increases in rents have apparently resulted both from the increase in demand for rental homes,

due to expectations of a decline in the house prices that cause purchasers to delay the purchase, and possibly also from the drop in the supply of houses for rent resulting from some being offered for sale in reaction to the comprehensive temporary exemption from land betterment tax (see the second Selected Issue reviewed below in this publication). Rents increased in all part of the country in 2008–10, with the steepest increases in the central and Sharon areas and metropolitan Tel Aviv, and relatively moderate increases in Haifa and surrounding areas.²

Figure 2.1

The Index of Nominal Wage per Employee Post, the Rents Index, and the Index of Prices of Owner-Occupied Apartments^a (2002:Q1=100)



^a The rent index is a component of owner-occupied housing services in the CPI. The index of prices of owner-occupied apartments is taken from the Central Bureau of Statistics survey of apartment prices.

SOURCE: Based on Central Bureau of Statistics data.

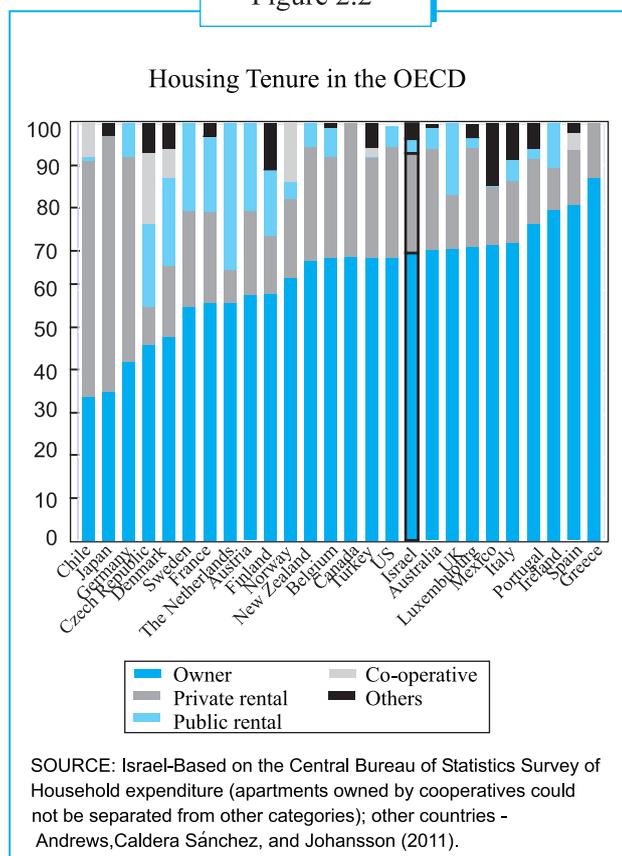
Expenditure on housing represents about a quarter of a household's outgoings, and is the largest single component. Compared with other items it is relatively rigid, because households are relatively inflexible regarding the location where they live, the size of their apartment, and the timing of a move. Many countries, Israel among them, intervene in the housing market with the intention of making dwellings

¹ For an analysis of the reasons for the increase in housing prices, see P. Dovman, S. Ribon and Y. Yakhin (2011), "The Housing Market in Israel: Are House Prices a Bubble?" Bank of Israel Research Department Discussion Paper Series, No. 2011.6; G. Segal and W. Nagar (2010), "The Housing Market in Israel: Structural factors in House Prices and Rents, 1999–2010," work in progress, paper presented at the Research Department Conference, December 2010. See also the reference by the Governor of the Bank of Israel to the increase in housing prices at a press conference held on August 1, 2011, on <http://bankisrael.org.il/press/eng/110804/110804f.htm>.

² Ministry of Construction and Housing, Information and Economic Analysis Division, "Developments in the Construction Industry and the Activities of the Ministry of Construction and Housing," September 2011.

more accessible, as they constitute an essential service for households, and in order to influence the geographical spread of the population. Intervention in the housing market is intended to affect the quantity, quality and price of homes and housing services, and the dispersion of the population. The distribution of housing tenure³ (Figure 2.2) is the product of historical and demographic developments, consumers' preferences, relative prices, and the government's housing policy.

Figure 2.2



The private rental market provides various possibilities of accommodation for diverse periods and budgets, and in different locations. Privately rented accommodation, in contrast to the purchase of an apartment, is economically accessible as it does not require a capital investment, and it is flexible from the aspect of matching it to the size of the household, its requirements, and its location. The flexibility regarding location is also expressed in the labor market, as the cost of matching the location of rented accommodation with the location of employment is relatively low. These

³ The distribution of households according to the category of housing: owner occupied, private rental, public rental, public housing or other.

advantages are more prominent in the private rental market than in public rentals, as the limited supply of the latter makes it very difficult to match them to households' changing needs. The supply in the private rental market is derived from the expected net return on the investment, the return on alternative investments, housing policy (e.g., regional planning, zoning, and building permits), and regulation in the rental area. The social protest that began in July this year initially focused on the increase in housing prices, both house prices and rents, that makes it difficult for more and more people in the population to live in housing appropriate to their needs. The social protest spread rapidly to other spheres, but the housing issue remained the main focus of attention. Due to the importance of the private rental market in the supply of affordable housing, we concentrate herein on the characteristics of that market in Israel compared with the situation in other countries, and discuss the effects of policy regarding the rental market on the affordability of housing.

2. The private rental market in Israel and in the OECD

Owner-occupied homes are the most common form of housing tenure in the OECD countries, including Israel (Figure 2.2). There are large differences between countries in the distribution of the various types of housing tenure. In Israel about a quarter of households rent homes privately, a similar proportion to the OECD average. In all the countries covered by this review, most privately rented homes are owned by households, with a small proportion owned by companies.⁴

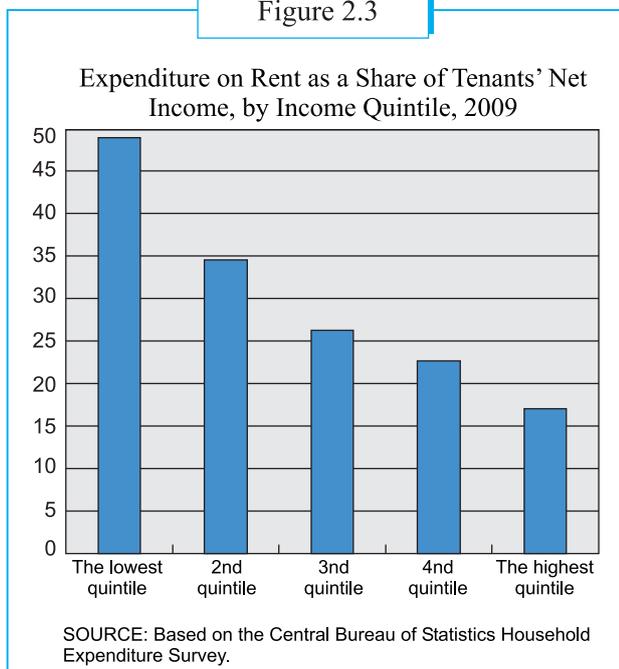
Compared with home owners, those renting apartments in Israel are younger, are concentrated mainly in the large towns, and constitute a relatively large share of those in the lower income quintiles; this is similar to the situation in the other OECD countries. In 2009 about 582,000 households lived in rented accommodation in Israel.⁵ Of these, 507,000 households were renting privately, and the rest (about 75,000) were living in homes not in private ownership, e.g., publicly owned housing. Most households renting homes do not own one: only about a tenth of households renting a home were at the same time renting out an apartment or room that

⁴ In Germany, Switzerland and the US, for example, the rental market of properties owned by companies is relatively large, with mainly real estate companies, pension funds, insurance companies and real estate funds involved. These hold properties for rent either directly, or indirectly via various financial instruments.

⁵ This figure is according to the 2009 Household Expenditure Survey of the Central Bureau of Statistics, the latest survey available to us. The results do not reflect the full picture that would emerge from an analysis of the years during which the constant increase in rents persisted, starting from the second half of 2008.

they owned.⁶ The demand for homes to rent in the private sector increased markedly over the years, and at the same time the number of those renting public sector homes fell, as about 30,000 public housing units (a third of the total) were sold in sales promotion campaigns in 1999–2009, without others being purchased or built to replace them. The ratio of expenditure on rent to income varies greatly between the different income quintiles: in the lowest quintile expenditure on rent is about half of a household's income, while in the top quintile rent is less than a fifth. The ratio of rent to income also varies greatly between households in different geographical areas (Figures 2.3 and 2.4).

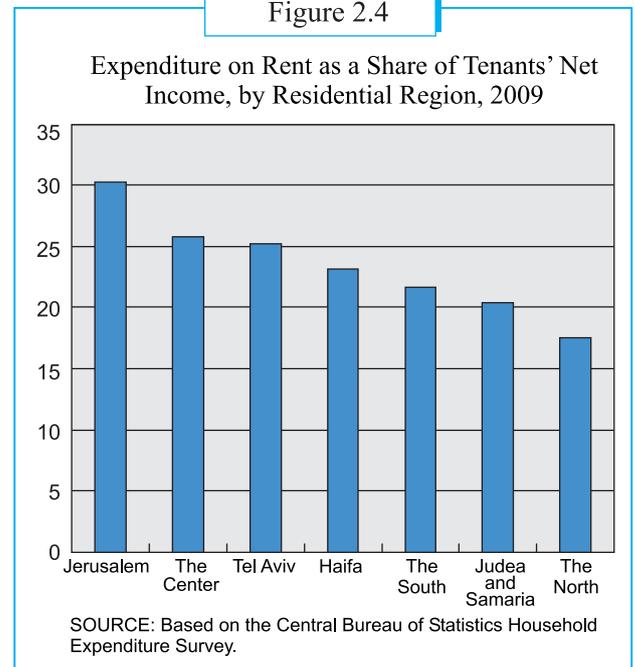
Figure 2.3



Housing assistance in Israel is granted in three ways: (1) a rent subsidy in the private rental market; (2) a mortgage subsidy to help finance the purchase, construction or extension of a housing unit in the private market; and (3) allocation of rental accommodation in public housing and sheltered accommodation for the elderly. The erosion of all types of housing assistance and intrinsic changes in it since the middle of the 1990s have been reflected in the decline in the number of families benefiting from such aid, and in a reduction of 77 percent in real terms in government budgets allocated to this end between 2000 and 2010. The decline in aid was to a considerable extent due to the fall in the share

⁶ Some of these households may be living in rented accommodation in Israel while renting out a property they own abroad. Households renting out homes and paying rent for their own accommodation may own more than one home.

Figure 2.4



of immigrants granted the subsidy (due to a decline in the rate of immigration and the acclimatization of immigrants and their absorption in Israel). In addition, changes in aid policy were introduced over the years: housing aid to some groups of those entitled to aid was cut; conditions for receiving aid were tightened; and mortgage aid became less worthwhile due to the stricter conditions for receiving it and the declining interest rate on the free market. Despite the reduction in the number of families receiving rent subsidies on the free market,⁷ it remains the main form of support for families in need of housing aid: about 27 percent of households renting accommodation in the private sector in 2009 (137,500 households, 7 percent of the total number of households) received aid towards their rent payments. The average amount of this aid was about NIS 780 a month per household, with a total government expenditure on this item of NIS 1.3 billion. The average real value of the rent subsidy per eligible family remained virtually unchanged during the years, but relative to the level of rents, which increased, particularly in the last three years, it has eroded very significantly.

Similar to the situation in the other OECD countries, the absolute majority of apartments for rent in the private sector are owned by households. Households' income from rent

⁷ The number dropped from about 180,000 in 2003 to 138,000 in 2009.

is taxed in one of two ways:⁸ ten percent tax on the total income, or the marginal tax rate on income above a certain threshold, which is currently NIS 4,680 a month. That said, in practice tax revenue from households' rent receipts is low.

There are two laws in the statute book that are intended to encourage companies to invest in housing for rent: (1) the Law to Encourage the Construction of Rental Housing, 5767–2007 (the “Sheetrit Law”), which grants incentives⁹ to entrepreneurs to build rental housing units. The incentives are considerable, but the requirements of the law, such as the size of the apartments and the period of the rental create difficulties for those willing to invest in this area to the extent that to date no building projects have been undertaken under the auspices of the law. (2) The Encouragement of Capital Investment Law, 5719–1959, which grants tax incentives to companies to build rental housing units. This is more attractive to entrepreneurs than the Sheetrit Law mainly because there are fewer restrictions regarding the size of the units, the rent, and the length of the rental period. In the years 2007–11, building permits for 1,100 housing units in 27 projects in all parts of Israel were issued under this law (no data are available on the extent of implementation of the permits, i.e., actual construction undertaken). In addition, the Ministry of Construction and Housing invited tenders in 2010 for two projects for the construction of rental housing, for 156 units in Jerusalem and 81 units in Ashdod, and the successful bidders are obliged to meet the legal criteria specified in the Encouragement of Capital Investment Law. All the above notwithstanding, the involvement of business entities in the supply of rental housing in Israel is very low, mainly because of the low level of return and the high cost of operating residential buildings.

Several municipalities in Israel have promoted initiatives in the last few years to construct “affordable housing”, including apartments for rent. The affordable housing policy is part of the process of urban renewal, intended to attract young adults and families—those with the potential to contribute to the local economy and its rejuvenation. These initiatives, currently in the planning stage, incorporate, for example, construction of new residential projects, including units for long-term rentals at controlled rents, for a population that will meet the income criteria to be determined by the municipality. In exchange for the rental of affordable apartments for a particular period of time,

the entrepreneur will be able to sell them, at the end of the period, at the market price. The initiatives are aimed at a middle- and lower-middle-class population, as distinct from public housing intended to help those who cannot meet the cost of housing.

Other OECD countries also intervene in the private rental market, because of the great importance they attach to the availability of housing and the geographical spread of the population.¹⁰ A review of policies regarding the rental market in several countries revealed the following: (1) most private rental homes are owned by households; (2) in countries with larger private rental sectors there are incentives to invest in homes, e.g., tax incentives, alongside factors that create high demand for rental accommodation (the difficulty of purchasing homes, use of the private rental sector as a framework for public housing, regulations regarding the level of maintenance of rented accommodation, etc.); (3) strict regulation regarding the level of rents and the length of contracts is likely to exert a moderating effect on investment in rental property, and may require compensation to maintain a reasonable return for investors.

Various countries try to broaden the range of participants in the rental market by offering incentives to companies to enter the market. These have the advantage of economies of scale, which may result in large-scale investment and are likely to raise the standard of maintenance of their apartments. Since companies' investment considerations are longer term than those of households, they are more likely to offer long-term rentals.¹¹ Another advantage is that government supervision of owner-tenant relations and the level of maintenance is likely to be simpler when apartments are owned by companies. Companies' investment in the rental housing market also has the advantage from the aspect of financial stability, as the risk of such investment is lower than that of investment in the financial markets.

3. Possible policy measures

The rental housing market serves as a source of affordable housing: it does not require a capital investment, and is easier to match to households' requirements. The rental market and its importance have increased in recent years, inter alia due

⁸ Tax on income from rent on residential property; there is another possibility in addition to the two described above, which recognizes the landlord's expenditure on the property, but this is less common than the other two methods.

⁹ The incentives include exemption from land betterment tax, accelerated depreciation, offsetting losses arising from rentals against other taxable income, etc.

¹⁰ Department for Communities and Local Government (2010). Promoting investment in the private rented housing supply – international policy comparisons http://www.dmu.ac.uk/faculties/business_and_law/business/housing/research/PRS.jsp; Andrews, D., A. Caldera Sánchez and Å. Johansson (2011). “Housing markets and structural policies in OECD countries,” Economics Department working paper No. 836.

¹¹ Alternatively, the companies can offer shorter-term rentals in regions where there is constant demand for such accommodation.

to the rise in house prices, the contraction of public housing, and greater geographical mobility in the labor market. The share of the population living in rented accommodation in Israel is similar to the OECD average. The continuous increase in rents since 2008, however, imposes an onerous burden on tenants in all parts of the country, due to the rigidity of expenditure on housing. Due to the importance of the rental market, housing policy should support the existence of good quality rental housing at reasonable cost, with optimal geographical spread that takes account of the structure of the labor market, the transport infrastructure and the composition of the population.

The analysis performed led to the following main recommendations:

(a) A gradual increase in the supply of apartments, including small ones (up to three rooms).¹² The limited supply of small apartments, especially new ones, makes it difficult for individuals and young couples to buy or rent homes that meet their requirements. It is recommended to increase the supply gradually, taking account of the current shortage, also by

- **increasing the supply of small apartments.** In urban construction programs a certain proportion of apartments, both in existing and new residential areas, and in all urban areas, should be 2–3 room apartments;
- **supporting the construction of apartments for rent in residential areas.** Against the background of low response from companies to the existing tax incentives, one way to encourage companies to build apartments for rent is by designating some land in urban construction programs (UCPs) in existing and new residential areas in all urban locations as rental construction.

(b) Updating the rent subsidy. Due to the importance of rental subsidies in support for the homeless, it is important to update the amounts of the subsidy, and to tighten the connection between wage income and the amount of the rent subsidy.

(c) Intervention in setting the rent and/or the length of the contract is not desirable. Such intervention is not recommended because such mechanisms are likely to have a negative impact on investors' willingness to invest in the rental market, increase bureaucracy, and create secondary markets in which the rights of supervised rents would be traded illegally.

¹² The return on a rental apartment (the ratio of rent to the sale price) of up to three rooms is higher than that on larger apartments, indicating relatively high demand for smaller apartments for rent.

Analysis of land betterment tax measures taken in 2011 to moderate the increase in home prices

- As part of a range of measures to restrain the increase in home prices, two main steps were taken, and legislated, in the area of betterment tax. The waiting period between sales of two homes in order to qualify for betterment tax exemption was lengthened from 4 years to 8 years; and an exemption was granted on the sale of an owner's second or third home in 2011 and 2012, regardless of waiting period.
- These steps will lead to a reduction of demand for houses as an investment and an increase in the supply of homes for sale by owners of three or more homes. They will be reflected, according to the analysis, in an additional 6,500 homes owned (estimate based on partial data) and to a moderation of about 1–3 percent in price increases.

1. Introduction

In principle, the sale of a home is subject to land betterment tax of 20 percent of the real profit. There is an exemption on a first (single) home¹³. An owner of more than one home was entitled, until 2010, to an exemption from the betterment tax on a second home as well, provided that it was sold at least four years after the sale of another home that he owned. In light of the increase in home prices, several steps were taken since the end of 2010 in the sphere of the land betterment tax exemption (as delineated in Table 2.1), with the aim of reducing the pressure for the continued increase.

At the end of 2010, a step was announced—which was anchored in law on February 21, 2011—which grants an exemption from the betterment tax for one who sells a second or third home in 2011 or 2012 (herein, the “time corridor”)¹⁴, regardless of the actual holding period of the property. This step was intended to provide an incentive for investors to sell apartments that they are holding. On May 31, 2011, the Minister of Finance announced the cancellation of the betterment tax exemption on investment homes (that is, a second or additional apartment used as a residence) as of

¹³ Provided that the home was sold at least 18 months after the date of purchase.

¹⁴ The limit for the exemption was set at a combined sales price of NIS 2.2 million for both homes.

Table 2.1 Betterment tax exemption—policy steps announced and legislated

| Step announced | Announcement date | Legislative date |
|--|-------------------|---------------------------|
| Original situation: Betterment tax exemption on the sale of a second home once in four years | From the 1990s | |
| 1. Betterment tax exemption on sale of second and third home as well, unrelated to holding period, if sold by the end of 2012. | December 16, 2010 | February 21, 2011 |
| 2. Cancellation of the betterment tax exemption on sale of a second home (effectively if it is sold beginning in 2013). | May 31, 2011 | Not legislated. See note. |
| 3. Extension, from 4 years to 8 years, of holding period to qualify for exemption on the sale of a second home. | See note. | August 1, 2011 |

Note: The legislation in August followed the proposal of May 31, 2011 to cancel the betterment tax exemption, and included changes to the original proposal.

the beginning of 2013. This step (and an additional one¹⁵), together with the time corridor for the exemption in the years 2011–12, was intended to reduce the incentive for buying homes as an investment, and to increase the incentive to sell those apartments, thus reducing the pressure for continued increasing prices. However, the legislation that passed the Knesset on August 1 was different. It did not cancel the exemption on an investment home, but brought back the original situation, though the minimum holding period to qualify for the exemption was doubled, from 4 years to 8 years.

Following is an analysis of the measure which was anchored in law in August, compared with the original situation, given the 2011–12 time corridor for the exemption.

2. Analytical framework

The home market can be divided between home dwellers living in homes they own (owner occupied dwellings) and home dwellers who rent their homes from investors who have more than one home.¹⁶ This division portrays two markets—one of homes for ownership, and one of rentals. In the market of homes for ownership, part of the demand is from investors—who create the supply in the rentals market. The return from buying a home for investment is equal to the amount of rent expected to be received over the course of

ownership of the property, as well as the expected difference in price when sold, net of betterment tax. (We ignore the issue of depreciation.) In order for an investor to want to buy an additional home, the return from ownership of the home needs to be at least equal to the net return that can be generated from an alternative investment with an equivalent risk level.

Betterment tax (when it is in force) equalizes the taxation on capital gains from housing to the taxation on real capital gains from alternative investments in capital markets. Nonetheless, there are taxation differences between the two investments at the time of purchase and during ownership: buying an apartment grants a tax advantage when renting it out (an exemption up to a limit), but involves high purchase taxes. Table 2.2 presents the differences in taxation between buying securities and buying an apartment, assuming that the apartment is liable for betterment taxes when sold. It is important to emphasize that a person who already owns an apartment already paid the purchase tax, so the tax is not relevant to his decision of whether or not to sell, but he still benefits, as noted, from the tax advantage in renting out the apartment.

Table 2.2 Taxation on investment in a home and in securities (percent)

| | Investment in home | Investment in securities |
|----------------------------|-------------------------------|--------------------------|
| Purchase tax | 5-7 | 0 |
| Rent/Dividend/ Interest | 0 (Up to NIS 4,680 per month) | 15-20 |
| Capital gains | 20 (Gain in real terms) | 15-20 |

¹⁵ The announcement included an additional measure: an exemption from betterment tax for sellers of homes which had not been used as residences—on condition that they are converted to residential use—for the years 2011–12. Legislation on August 1, 2011 established that the period begins on the legislative date and ends on June 30, 2013.

¹⁶ Of course, there are apartment dwellers who rent one home to others, while they themselves rent from someone else; or nonresidents who lease apartments to Israelis—we will not consider these situations.

Imposing betterment tax on a second (or additional) home is relevant to investors, not to single home owners. Extending the holding period required in order to receive the exemption, from 4 years to 8 years, is equivalent to effectively increasing the tax, since it reduces the future (net) price that investors—who hold the home for less than 8 years—are expected to receive when selling the property. Since the extension erodes the expected profitability for investors, given a fixed alternative return they will only be prepared to buy the property at a lower price, which will compensate them for the tax payment. This situation will lead to reduced investor demand, and thus—should lead to reduced prices, and in that way will aid those who are interested in buying a home for residential purposes.

In contrast, reduced demand for investment homes will reduce the supply in the rental market and so, under reasonable assumptions¹⁷, will lead to a rise in rents. This increase is another expression of the compensation that investors will demand for imposing the tax. In the end, the combination of lower home prices and higher rents will be expressed in a higher gross (with tax) return, or will bring the net return required on investment in housing to the level of before the tax change. The relative strength of the influences on home prices and on rent levels depends on the elasticity of supply and demand of the home and rentals markets.

Taking into account the economic considerations described above, for existing investors, the expected decline in return on a rental apartment will lead to increased supply of homes for ownership. Here too, the direction of the impact on the return is the same, since the sale of investment homes will also lead to reduced supply of homes for rent, and thus—to increased rents. Following, we will focus on the side of supply in the market of homes for ownership and we will examine the decisions of existing investors.

Since the measure of increasing the stringency of the terms for an exemption from betterment tax does not affect every investor, we will turn now to an analysis of the impact of the steps on investors at various stages, as part of an attempt to estimate the quantitative effect on home prices, given the financial alternative and taxation differences (Table 2.2).

¹⁷ Although, as a consequence of declining home prices and increased rent costs, the incentive will grow for tenants to switch to owning an apartment, and that switch will partially offset the increase in rents. Nonetheless, rents will be, generally, higher than they were in the beginning.

3. Extending—from 4 years to 8 years—the minimum holding period of an apartment for an exemption from betterment tax

A. “Traditional investors”

The following analysis is of investors who hold an apartment for lengthy periods, as well as on those who own three or more homes. The analysis assumes that there are no expectations of price changes going forward, but that the apartment value already reflects a capital gain (that is, the price has risen, as will be presented). This is because these investors, who can be termed “traditional investors”, tend to prefer investment in homes over financial investments, as part of their asset diversification strategy. They generally hold the apartment, or several apartments, for lengthy periods, by and large for 8 years or even longer¹⁸, and generate the primary and stable supply of homes for rent. This is a crucial market for the economy, not only in terms of housing services, but also in terms of mobility in the labor market. (See the first issue reviewed in Part 2 of this report.)

Investors who already own a second apartment for over 8 years: For investors who already own a second home for 8 years or more, there is no difference between the situation before the tax measures and the situation after the tax measures. In both cases, the sale of that apartment is exempt from betterment tax. In this regard, the time corridor, which is intended to increase the sale of apartments, is not effective in their case. With that, as far as they are concerned there is a negative effect of the change on their flexibility in replacing their primary residence. An investor who sells his investment home will have to wait 8 years, instead of the 4 years under the original situation, to qualify for the betterment tax exemption when selling his primary residence. In this regard, the change reduces the incentive to invest in homes, and works to reduce the market of homes for rent. With that, it is important to emphasize that the decision of whether to hurry and sell in this case is not connected to a betterment tax exemption in the time corridor, but rather to the investor’s priorities and plans regarding the suitability of his residence to his needs.

It therefore can apparently be concluded that even for “traditional investors”, who invest for the long term, the legislation serves to reduce the incentive to invest in an apartment, relative to the original situation. This works to constrain the rentals market, which is, as noted, critical to the economy.

¹⁸ There are no set figures, but this is the impression given by a perusal of Ministry of Finance data.

Investors who already own a third apartment: In the original situation, in order to qualify for the exemption from betterment tax, an investor who owns a third apartment needed to wait at least 8 years, provided the last two were sold at least 4 years apart. Now, under the new situation, the minimum waiting period has been doubled, so that the time corridor given—2011 and 2012— becomes even more worthwhile. The legislation from August thus increased the inherent incentive of the time corridor for an owner of a third home.

Owners of four or more apartments: The time corridor is not relevant, and in any case a sale will be liable for betterment tax. We note that now the minimum extent of time for the betterment tax exemption on a fourth home, provided that the last three apartments would have been sold four years apart, has now been doubled from 12 years to 24 years.

B. The change in status of investors who hold a second apartment less than 8 years

Now we will turn to analyze the situation of investors who hold an apartment less than 8 years. The analysis and effectiveness of the measure depend on the tax rates compared with alternative investments which will be described, and on the expectations of a change in prices of homes relative to alternative investments.

August 1st.¹⁹ Now, let us assume that on that date, the home is worth NIS 1.5 million, and the price will remain the same going forward. As such, the gain is NIS 500,000, and for the purposes of the example we will assume it is in real terms. (We ignore CPI inflation.) All this means that if the apartment is sold after the effective date and before January 2017, the tax on the aforementioned gain will be calculated based on the proportionate holding time. However, if the apartment is sold within the time corridor, the gain is tax exempt. The table presents two cases as examples: In Case A, the home is sold in January 2013, so that the apartment is actually held 4 years, the relative period liable for tax is the 1.5 years since the effective date, and the tax due is NIS 37,500. This means that even if home prices do not rise anymore, tax on the gains accrued in the past will be paid at the sale (unless the home is sold within the time corridor).

In Case B, the apartment is sold at the end of 2016, that is, shortly before the end of the 8 year holding period. The tax is calculated on the 5.5 years from the effective date, and the tax will be NIS 68,750. The tax due will increase the later the apartment is sold, as seen in Case B, up to the waiting period limit of 8 years. In this manner, the more that ownership of an apartment is “older”, the smaller the tax. Thus, if the same apartment would have been bought one year earlier, in January 2008, sold in January 2013, and the gain remained NIS 500,000, the tax liability would be smaller than for one bought in January 2009.

Table 2.3 Two examples of betterment tax (effective date: July 1, 2011)

| | Case A | | Case B | |
|---|--------|-------------|---------|-------------|
| | Date | Price (NIS) | Date | Price (NIS) |
| Purchase | 1/2009 | 1,000,000 | 1/2009 | 1,000,000 |
| Sale | 1/2013 | 1,500,000 | 12/2016 | 1,500,000 |
| Gain | | 500,000 | | 500,000 |
| Relative period of non-exemption | | 1.5/4 | | 5.5/8 |
| Total tax (NIS) | | 37,500 | | 68,750 |
| Compensation in terms of price increases (%) ^a | | | | |
| a. Total period | | 2.1 | | 1.9 |
| b. Annualized | | 1.38 | | 0.35 |

^a The rate of compensation takes into account the tax benefit of renting, the time period between the effective date and the sale date, and the betterment tax that will be collected due to the increase in price.

Table 2.3 presents two examples in order to understand the measure, for a person who already owns a second apartment. We assume that the apartment was bought in January 2009 for NIS 1 million. The following calculation assumes that the tax liability begins in July (herein, the “effective date”), which is not mentioned specifically in the legislation from

¹⁹ The change in legislation from August 1st only changed the number of years from 4 to 8. Thus it is not at all clear if the tax liability will be on the entire profit, or based on the relative holding period—the ratio of the period between the date of the legislation (the effective date) until the sale date, to the entire holding period (purchase date to sale date). In our calculation, we assume that the tax liability will be based on the relative holding period.

The effectiveness of the measure depends on future price expectations of various types of investors and on differences in taxation vis-à-vis alternative investments in securities. Here we will analyze the worthwhileness in various situations, based on the example and cases presented in Table 2.3.

(1) The demand side of the market for homes for ownership (new investors)

If a new investor does not anticipate price rises: The betterment tax is not relevant, since it applies to capital gains on the home (that is, on an increase in value, reflected by the sale price).

If a new investor anticipates price rises: Imposing the tax is equivalent to an erosion of the future price relative to expectations before the step. The attractiveness for new investors thus is reduced. And yet, the expected gain (including rent) after this erosion, from the point of view of the new investor, needs to be compared with the alternative financial rate of return (at the same risk level), and if it is still higher than the rate of return on the financial alternative, then new investors will continue to invest in housing, so that the measure is not effective. If the returns are equal, then the investor is indifferent, and the effectiveness of the measure is weak. Only if the expected rate of return on the financial alternative is higher than the expected return from an investment in a home after this erosion will the step be effective.

Table 2.4 compares the situation facing a new investor who anticipates rising prices for holding periods of 4 and 5 years (with betterment tax, including purchase tax and tax benefit

of rental income) with the previous situation (without betterment tax). The table presents, in terms of the expected sale price of the apartment, the erosion of the profit which is equal to imposing the tax, in two examples of the house price at the time of sale: NIS 1 million and NIS 1.5 million. The calculation shows that between the new situation and the old situation, the imposition of the tax is equivalent to a total reduction in sale price (in real terms) of 0.7–0.8 percent after holding the home for 4 years, and of 0.2 percent in annualized terms.²⁰ For an investor who holds a property for 5 years the required price compensation is even less. This is all under the assumption that there is no change in rent levels. Thus, with all else being equal, changes in those levels in the expected price are essentially the maximum required in these considerations vis-à-vis imposing the tax, when there is no change in rent levels. Since ostensibly rents will also rise, even a smaller increase in price will be equal to the tax. As such, it can be concluded that the measure is not effective in a case where the investor expects rising prices, even if moderate.

This analysis shows that extending the holding period to 8 years will lead to an overall reduction in ownership prices of 0.7–0.8 percent at most - a small effect.

(2) The supply side of the of the market for homes for ownership (existing investors)

For existing investors, purchase tax is not relevant, since it has already been paid. We will now check if, and to what extent, the time corridor is effective for existing investors. We will examine this using the example of Table 2.3, where there is already a gain of NIS 500,000.

Table 2.4 Change in house prices which compensates for the taxes on purchasing a home for a new investor - various situations

| | Home price (NIS million) | Holding period (years) | | | |
|---------------------------|-----------------------------|------------------------|--------------------------|---------------------|--------------------------|
| | | 4 | | 5 | |
| | | Total change (%) | Annualized change (%) | Total change (%) | Annualized change (%) |
| 1. With betterment tax | 1 | 3.48 | 0.86 | 2.78 | 0.55 |
| | 1.5 | 3.89 | 0.96 | 3.2 | 0.63 |
| 2. Without betterment tax | 1 | 2.78 | 0.69 | 2.23 | 0.44 |
| | 1.5 | 3.1 | 0.77 | 2.6 | 0.51 |
| 3. Difference | 1 | 0.7 | 0.17 | 0.55 | 0.11 |
| | 1.5 | 0.79 | 0.19 | 0.6 | 0.12 |

²⁰ All the calculations are simple, not discounted. Discounting, using any positive interest rate, would reduce even further the effectiveness of the measure for new investors.

In the examples of Table 2.3, imposing the tax is equivalent to a reduction in price of 2.1 percent in Case A, and of 1.9 percent in Case B, from the effective date through the sale date. These are about 0.4–1.4 percent on an annualized basis, respectively, in real terms²¹; since rents will rise as well, the price change in equilibrium will be even lower. By utilizing the time corridor an investor can avoid this erosion, and if the reduction in house price at sale will be lower than those rates, then the impact on the investor—as a result of the imposing of the tax—will be smaller as well. This situation, too, is reflected in the lower overall price of about 2 percent at most, even though the examples assume a very large gain of 50 percent. With any gain less than that, the change in equilibrium price will be even smaller. As such, the size of the impact in these cases is similar to that of the results in the case of a new investor who anticipates rising prices (Table 2.4).

Following, we will analyze the situation from an additional perspective, when the situation is not in equilibrium.

If the current investor expects further price increases: If the expected increase is more than these levels (2.1 percent in Case A and 1.9 percent in Case B), then the measure is not effective (again, given the rates of return and risks in alternative investments in the capital markets).

If the current investor expects prices to decrease: It is certainly worthwhile to sell within the time corridor and to take advantage of the betterment tax exemption. We also note that even without the measure, the value of the tax exemption on rental income per year is equivalent to a price decline of 0.6 percent in the example of Table 2.3 above, and every expected decline larger than that justifies the sale of the apartment.

The conclusion that arises from this analysis is that for those who hold an apartment for less than 8 years, the extension of the holding period of the apartment in order to qualify for a tax exemption from 4 years to 8 years is equivalent to a decline in price of 2 percent at the most.

The extension, together with the exemption during the time corridor, has no significant impact on the entry of new investors and on existing investors, who expect a moderate rise in home prices of about 1 percent per year or even less, in real terms, relative to their expectations before the measures. These steps are effective only from the perspective of existing investors who anticipate stable (and certainly those who expect falling) prices.

Table 2.5 summarizes in general the effectiveness of the steps in the various situations which were analyzed above.

Table 2.5 General summary of effectiveness^a of measures in comparison to the situation before the measures

| Investor status | General | Expect increasing prices | Expect stable/declining prices |
|------------------------------|--------------------------------------|--------------------------|--------------------------------|
| 1. More than 8 years | Not effective/ relevant ^b | | |
| 2. Third home | Effective | | |
| 3. Fourth or additional home | Not relevant | | |
| 4. Less than 8 years | | | |
| A. New investors | | Not effective | Not Relevant |
| B. Existing investors | | Not effective | Effective |

^a Effective means it is worthwhile to sell due to the measures.

^b It is relevant in that there is likely to be an effect, due to a negative impact on the flexibility of switching the investor's primary residence.

²¹ Here, too, the calculation takes into account the tax benefit of rental income, assuming a rent yield of 3.7 percent; the time period from the effective date through the sale of the home; and the additional betterment tax stemming from increased prices. The calculation was done in simple terms, without discounting the flows, though this does not trouble us since realizing the gains on the sale, and paying the betterment tax, will both be at the end of the period. Additionally, the rent receipts are over the course of the period, so that the discounted cash flows will be even higher, (for a given discount rate) relative to the cash flows used.

The measures are effective primarily for owners of a third apartment; it is worthwhile for them to utilize the time corridor. What stands out is that the combination of steps is not effective with regard to new investors and existing investors with a relatively short time horizon—those at whom the measures were primarily aimed—if they expect rising prices (since even a moderate increase in price will compensate for the payment of betterment tax). In contrast, if expectations are for stable or falling prices, the steps are

liable to accelerate the pace of declines. For investors who hold an apartment more than 8 years (traditional investors) the measures are not relevant, but their flexibility in terms of the suitability of their primary residence is negatively impacted by the extension of the waiting period to qualify for a tax exemption from 4 years to 8 years.

Another central conclusion that arises here is that taxation measures such as these are very limited in their ability to influence the homes market at a time of expectations of rapid price increases, which has been the situation in Israel since 2009.

4. Estimation of the size of the relevant market

This section presents an additional direction for the analysis of the effect of these measures on home prices, through segmentation of investors and measuring the effectiveness of the steps on them, as summarized in Table 2.5. The table shows that the measures impact primarily on owners of a third apartment. If the expectations before the measures were for price stability, then the steps will also prevent the entrance of new investors. Following, we will estimate the possible quantitative impact of these two groups, and then the impact on prices.

The percentage of people in Israel living in homes which they own is estimated at around 69 percent.²² About another 25 percent are renters of apartments which are generally owned by individuals, and the remainder are in homes rented out by companies and government leasing companies (see the first issue reviewed in Part 2.) Nonetheless, even in low periods (or normal periods) the *stock* of homes for investment is around 25 percent, as seen from these figures and from the 2008 Population Census. Apparently, a large part of the inventory of homes for investment is not connected to price cycles for homes, and reflects the priorities of investors in diversifying their asset portfolios.²³ It can thus be estimated that “speculative” investors who buy for relatively short periods of time hold only a small percentage of the existing inventory.

In contrast, it seems that in terms of *flow* data of apartment transactions, their weighting increased in the recent wave of price rises. The change in investor purchases in apartment transaction figures can be used to reach a quantitative estimate. In the past three years the number of transactions

has been around 100,000 per year. Partial data show that investment transactions (buyers) represented about 31 percent in one of the peak months of 2010; and in March 2011 they represented about 25 percent—apparently as an effect of the measures taken in the end of 2010. We will assume that this portion—25 percent—is a stable share, which is not affected by price cycles in the home market. (This figure is also in line with the percentage of households who are living in a rented apartment, as noted above.) In this approach, the speculative share in the transactions is about 5 percent.

The above analysis showed that the measure will prevent the entrance of new investors who, before the measure, expected price stability. If we assume that all potential new investors expect that, so that demand will be reduced by 5 percent of transactions (a decline to 25 percent from 30 percent of total transactions), it means about 5,000 units per year.

Regarding the group holding a third home, based on an estimate derived from partial figures from the Ministry of Finance, assuming that 10 percent of apartment owners will sell their third home, the figure is around 1,500 units.

The rough estimate of those two groups shows an increase in the quantity of homes for sale, or drop in demand, of 6,500 units. In order to illustrate the effect on prices, we can draw up an estimate from the model of Nagar and Segal (2011),²⁴ which includes a variable of apartment inventory. (We emphasize that the model is linear): Our exercise is increasing the inventory of apartments in the economy by 6,500 homes, without a parallel change in population. **Such an increase will act to reduce prices by an average of about 3 percent.**²⁵ However, it is possible that a secondary effect of the switch from renting to owning, as a result of increased rents and lower home prices—as seen in the analytical framework—will moderate part of that reduction. We emphasize that this is a rough estimate, as the model does not have supply and demand functions; in the case reviewed there is a shift of the demand curve to the left and downward from the “speculative” side, and a shift to the right and downward in the supply curve of owners of three or more homes.

²² Central Bureau of Statistics data for 2006–09, based on municipal tax files. In those years, no trend of declining ownership was seen, nor a rising trend in rented apartment figures.

²³ In addition, some of the apartments for rent are for inheritances, which do not react to incentives, since they are limited because of various legal processes or arrangements between several inheritors.

²⁴ Nagar, Weitzman and Segal, Guy (2011) “What explains the development of home prices and rents in Israel, 1999–2010”, to be published soon.

²⁵ Obviously, there is variance surrounding this estimation: Assuming linearity, calculating one standard deviation yields 0.6 percentage points around the mean; and for 2 standard deviations, 1.2 points around the mean. That is, a range of drops in prices of 2–4.4 percent.

We point out that in the case of expectations for declining prices, the measures enacted may even accelerate the decline of home prices.

In conclusion, it is important to note that the analysis of changes in prices does not take into account inertia in prices over the shorter run.

Trends in Profitability of Exporting and Non-Exporting Companies

- The average gross profit margin of exporting companies has been 20 percent (net profit was 0.7 percent) of revenue over the past six years. The average gross profit margin of non-exporting companies was higher—25 percent (net profit figure was 3 percent) of revenue.
- The average gross profit margin of large exporting companies—three firms with a total weight of about 40 percent of total revenue of exporting companies—has been 27 percent (net profit was 12 percent) of revenue over the past six years, and is on a rising trend.
- A detailed examination shows that the real exchange rate impacts profits of small exporting companies, which are all the exporters except for the three largest.
- As the explanatory power of the exchange rate on exports is limited, it can be concluded that the profit level is impacted primarily by other factors (including, apparently, the firm's productivity and economies of scale).

We present here an index to measure the profitability of exporting companies. The export sector is considered one of the main growth engines of the Israeli economy, and so constant monitoring of its profitability is crucial for drafting policy. The index allows monitoring the level of profits of publicly traded companies, both those that export and those that do not, on a quarterly basis immediately after publication of their quarterly financial reports. Currently, there are several other measures of profitability of the exporting sector, based on classifying various industries into exporting and non-exporting industries.²⁶ In contrast, the classification presented here is based on exports on an individual company basis, and so it is, apparently, more precise.²⁷

In order to construct the index, we used data from publicly traded companies. We divided the companies into two

²⁶ See, for example: Estimating the profitability of manufactured exports, Recent Economic Developments #122 May–August 2008 (Bank of Israel).

²⁷ In addition, while existing indices define profitability as the return on capital, the current index defines profitability as the gross profit margin—the ratio of gross profit to company revenue.

groups—companies that export and companies which only operate in the domestic market. The index of profitability of companies is calculated as the average of the share of gross profit²⁸ out of revenue (gross profit margin) for each group. The advantage of using this data is the availability of the figures on a company level and with quarterly frequency. The disadvantage is that apparently it is not a random sample of Israeli companies, but a group of companies with unique characteristics. We do not have data on the nature of this deviation and its effect on profit. For example, since publicly traded companies are generally bigger than private companies, it may be that changes in the exchange rate will impact them less than smaller companies, since they are able to hedge against losses through financial market operations. We measure the profitability of 500 publicly traded companies in the manufacturing and service industries²⁹, classified as exporting and non-exporting companies. The classification was based on information gathered from several sources: reports of companies to the stock exchange through 2006; data received from the Bank of Israel Information and Statistics Department—to which companies whose annual revenue is over \$50 million and whose financial assets are over \$20 million report—as well as firms' responses to the Bank of Israel Companies Survey. We identify about 200 companies which reported that they exported, and about 200 companies that reported that they do not export.

We divided stock exchange companies into three groups—exporters, non-exporters, and firms for which this information is unavailable. In order to construct the index we examined the ratio of gross profit to revenue for each group. Figure 2.5 shows the profitability index for exporters, the profitability index for non-exporters, and the real effective exchange rate. The average share of gross profit for exporting firms over the past six years is about 20 percent of revenue (net profit was 0.7 percent of revenue), and is lower than in the past. The average share of gross profit for non-exporting firms is higher, about 25 percent of revenue (net profit was 3 percent of revenue).³⁰ Figure 2.6 shows the index for exporting companies, but here it is divided into large

²⁸ Gross profit is defined as the total revenue from the company's core activities minus total expenses of those activities.

²⁹ We excluded the financial sector—holding companies, insurance companies, and banks—from the study.

³⁰ Gallo (2011) found, using a representative sample of companies in Israel, that the productivity of exporting firms is higher than the productivity of non-exporters. The relatively low profit level for exporters may stem from the higher employee salaries at exporters, or from exporters' intensive use of inputs. See Gallo, L. (2011) "Export and Productivity - Evidence from Israel", Bank of Israel Research Department, Discussion Paper Series no. 2011.08.

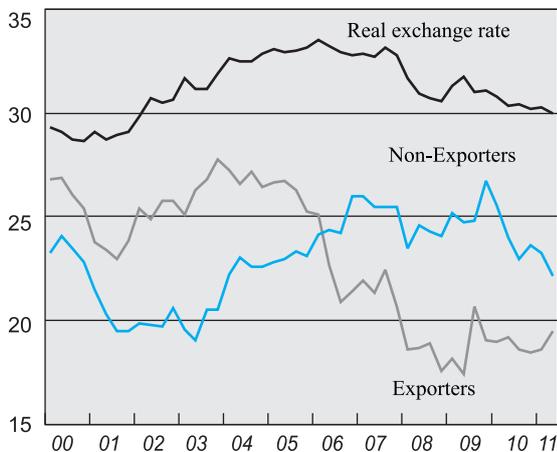
companies and small companies. An examination showed that concentration of revenue is very high: the weighting by revenue of the three largest companies is 40 percent, so this graph is appropriate for measuring developments of total revenue among exporters (a macroeconomic aspect), while Figure 2.5 is more suited to examining developments on the average company (a microeconomic aspect).

The gross profit margin of the large companies was 27 percent (the share of net profit was 12 percent) over the past six years, and is on a rising trend. In contrast, the gross profit level of the other companies over the past six years was 20 percent (net profit was 0.6 percent), after declining from the average at the beginning of the previous decade.

In Figure 2.7, the profit indices for large and small non-exporting companies are shown. The gross profit margin for large non-exporters over the past six years was 29 percent of revenue (net profit was 4.9 percent of revenue); the profit level for small non-exporters was lower, at 20 percent of revenue (net profit was 2.8 percent of revenue). The different development of the indices stands out in the graph—while for large non-exporters the index rose in recent years, for small non-exporters it has been falling.

Figure 2.5

Average profitability level of public companies and the real exchange rate 2000–June 2011



In recent years there has been marked currency appreciation seen in the real exchange rate. The real appreciation is liable to negatively impact profits for Israeli exporting companies, since the remuneration for their output is received in foreign

Figure 2.6

Average profitability level of exporting companies by company size, and the real exchange rate 2000–June 2011

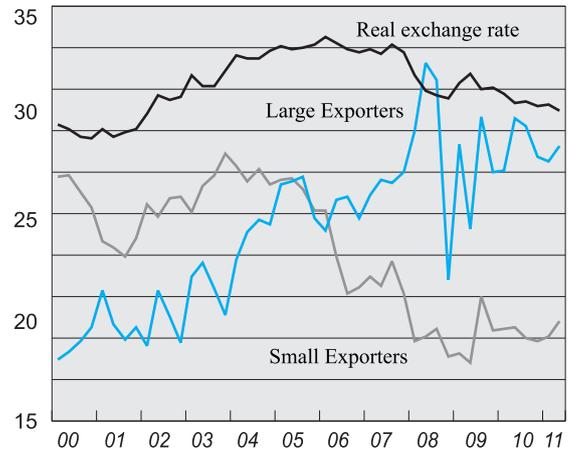
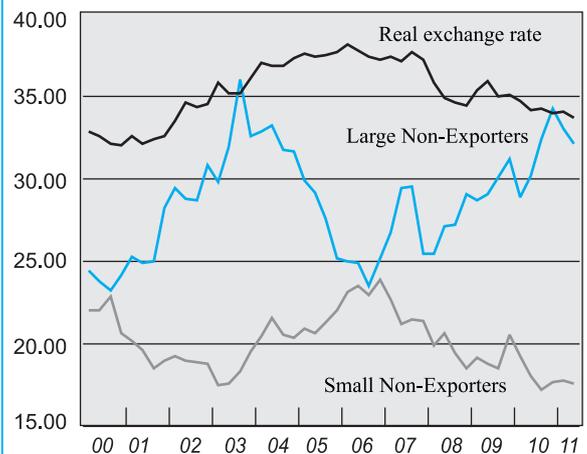


Figure 2.7

Average profitability level of non-exporting companies by company size, and the real exchange rate 2000–June 2011



currency, while they generally pay for local production inputs with local currency. The real appreciation thus leads to a decline in the remuneration that those companies receive in local currency terms, while their expenses do not change, and so it can lead to a decline in their profitability. Changes in world trade also have an effect on profits of Israeli companies that are involved in international trade, through changes in price and quantity. The appreciation in the real exchange rate was expected to negatively impact exporters' profits relative to profits of non-exporters, and

eventually even to shift production from export oriented production to domestic market oriented. Figure 2.5 does in fact show deterioration in the relative profit of exporters in recent years while Figure 2.6 shows that the deterioration occurred at smaller companies, while the profit level of large companies continued to increase, despite the appreciation. The figures show that the effect of the real exchange rate on corporate profits declines with the increasing size of the company, and with a firm’s increasing market power.

In order to examine the influence of the exchange rate and world trade on the profitability level of publicly traded companies which export, we estimated a regression equation where the dependent variable is the change in the level of gross profit out of company revenue. The independent variables are the rate of change in the real effective exchange rate (with a lag) and the rate of change in world trade (with a lag). In estimating the equation, we also took into account the profitability of exporters with a lag, in order to neutralize the possibility of a stochastic process. The results of the estimation are presented in Table 2.6.

The real exchange rate has a statistically significant impact on the profit level of small exporting companies, which make up most of the companies in the sample, but it does not have a statistically significant impact on profitability of the large exporters. An appreciation of 1 percent in the real exchange rate leads to a drop of about 0.1 percent in the share of profit from revenue of small exporting companies.³¹

Changes in world trade have a greater effect on exporting companies than on non-exporters, and the effect is stronger for large exporters.

Changes in the exchange rate explain a relatively small part of the overall changes in profit level. Thus, profit level is impacted primarily by other factors (including, apparently, the company’s productivity, economies of scale, and market structure).

Table 2.6 Regression equation estimation of the change in profit level of publicly traded companies^a

| Independent variable | Coefficient | Standard deviation | P -VALUE |
|---|-------------|--------------------|----------|
| Effect of change in real exchange rate (with lag) | | | |
| Small non-exporting companies | 0.02 | 0.04 | 0.60 |
| Large non-exporting companies | -0.11 | 0.15 | 0.49 |
| Small exporting companies | 0.10 | 0.05 | 0.04 |
| Large exporting companies | -0.07 | 0.26 | 0.78 |
| Effect of change in world trade (with lag) | | | |
| Small non-exporting companies | 0.08 | 0.04 | 0.02 |
| Large non-exporting companies | 0.03 | 0.08 | 0.69 |
| Small exporting companies | 0.11 | 0.03 | 0.00 |
| Large exporting companies | 0.26 | 0.14 | 0.06 |
| Effect of change in raw materials prices | -0.02 | 0.01 | 0.02 |
| Explanatory power of the regression | 17.5% | | |
| Number of observations | 9,560 | | |

^a In estimating the regression equation, we took quarterly seasonal factors and the profit level into account with a lag.

³¹ For example, the estimation shows that depreciation of 10 percent will increase the gross profit margin from 20 to 21 percent.

Diary of Events: May to August 2011

| Month | Date | Event | Details |
|-------|------|---|---|
| May | 1 | US soldiers kill Osama Bin Laden. | US soldiers killed the Al-Qaida leader in his Afghanistan hideout. |
| | 4 | The EU and IMF will grant aid to Portugal. | The Prime Minister of Portugal said that his country reached an agreement with the EU and IMF on a \$116 billion (€78 billion) loan to his country, in return for commitments to reform. Portugal thus joined Greece and Ireland, both of whom needed aid from the EU and IMF. |
| | 11 | Nonresidents' tax benefits for short term foreign currency trading cancelled. | The Knesset's finance committee abolished nonresidents' capital gains tax exemption for investments in short term bonds and <i>makam</i> . The move is aimed at reducing speculative foreign currency trading by nonresidents. |
| | 15 | The Consumer Price Index increased 0.6 percent in April. | |
| | 15 | GDP grew at an annualized rate of 4.7 percent in the first quarter. | GDP grew at an annualized rate of 4.7 percent in the first quarter, after growth of 7.6 percent in the previous quarter. |
| | 16 | The US Department of the Treasury warns of default. | Treasury reported to Congress that the government was near the debt limit, and that by August 2 it will exhaust its borrowing authority. Treasury called on Congress to work together to raise the debt ceiling. |
| | 18 | IMF managing director resigns. | Dominique Strauss-Kahn announced his resignation as IMF head, after his arrest in the US on sexual assault charges. |
| | 23 | Bank of Israel interest rate raised 0.25 percentage points to 3.25 percent. | The Bank of Israel raised the interest rate for June, after leaving it a 3 percent the month before. The decision was based on above target inflation expectations, positive growth data, the high pace of home price rises, and continued interest rate hikes worldwide. |
| | 27 | G-8 countries will grant Egypt and Tunisia \$40 billion in aid. | At the G-8 summit, countries agreed to grant \$40 billion in aid to Egypt and Tunisia, both of whom recently changed regimes, with a goal of supporting democratic reforms. |
| | 29 | Agreement signed for reforms in high school. | The "Oz L'tmurah" reform in high schools will be adopted gradually between this school year and 2013–14. It significantly raises teacher salaries, increases their work week to 40 hours, allows merit-based promotion and remuneration, and more. The annual cost when fully implemented will be over NIS 3 billion. |

| | | | |
|------|----|---|--|
| May | 31 | Announcement of cancellation of betterment tax exemption on homes for investment beginning in 2013. | The finance minister announced the cancellation of a betterment tax exemption on “homes for investment” (owners’ second homes or more) beginning in January 2013, as well as the granting of a betterment tax exemption in 2011–12 for sales of homes not used as residences but which will be converted to such. The Property Tax Law (Amendment) (Temporary Order) 5771-2010 was legislated on August 1, with these changes: betterment tax exemption on investment home will be granted once every 8 years (instead of once every 4 years), beginning in January 2013. The exemption on homes not used as residences but will be converted to such will be in place from the law’s date until June 30, 2013 (instead of the end of 2012). |
| June | 1 | US Congress rejects President Obama’s proposal to raise the debt ceiling. | |
| | 5 | Government approves benefits plan for buyers of homes in periphery. | The government decided (Decision 3282) to grant benefits to young couples who don’t own a home and buy a home in outlying areas – a NIS 60,000 grant upon purchase and a NIS 40,000 subsidy of land development costs. The localities included in the plan (Decision 3382 dated June 26, 2011) are: Ofaqim, Al Sayyid, Bet She’an, Bu’eine-Nujeidat, Dimona, Hura, Hatzor Hagelilit, Tiberias, Yafi, Yeroham, Kafar Manda, Carmi’el, Migdal Haemeq, Ma’alot-Tarshiha, Mizpe Ramon, Nahariyya, Nahef, Nazereth, Nazereth Illit, Netivot, Sakhnin, Acre, Zefat, Qiryat Shemona, Rahat, Sederot, and Shelomi. |
| | 7 | Shekel-dollar exchange rate hits multi-year low. | The representative shekel-dollar exchange rate reaches NIS 3.363/\$, its lowest level in over three years. |
| | 15 | Standard & Poor’s lowers Greece’s credit rating to CCC. | The credit rating agency gave Greece the lowest rating in the world granted to a country, and said it was based on increased probability that Greece will default. |
| | 15 | The CPI increased 0.5 percent in May. | |
| | 15 | Increase in Israel’s international investment position. | Bank of Israel data show that in the first quarter of 2011 the value of the portfolio of assets held abroad rose by \$12 billion, while the value of liabilities to abroad rose by \$5 billion. With that, the economy moved from a \$1 billion surplus of liabilities at the end of 2010, to a \$6 billion surplus of assets. The net external debt fell to \$58.7 billion. |
| | 22 | The US Federal Reserve lowered its growth outlook for 2011. | The Federal Reserve Bank’s forecast for US growth was lowered for the second time this year, to 2.7–2.9 percent, from 3.1–3.3 percent in the April forecast. |
| | 28 | A new IMF managing director is appointed. | France’s finance minister, Christiane Lagarde, was named IMF managing director to replace Dominique Strauss-Kahn who had resigned. |

BANK OF ISRAEL RESEARCH DEPARTMENT

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| June | 29 | Bank of America will compensate victims of the sub-prime crisis. | The bank signed a precedent-setting settlement with 22 investors who were negatively impacted by the crisis, under which the bank will pay \$8.5 billion. It is estimated that the deal will serve as a precedent for other banks as well. |
| | 29 | Greece authorizes an austerity plan. | The Greek parliament authorized a plan which includes tax increases, privatization, and salary cuts, in order to meet criteria for additional aid. |
| | 29 | Consumer boycott of cottage cheese leads to price cuts. | Tnuva and Strauss announced that they will cut the price of a container of cottage cheese to NIS 5.90 from around NIS 8, after two weeks of consumer boycott. |
| July | 1 | Minimum wage raised to NIS 4,100 per month. | As part of the March 2011 deal between the Treasury and the Histadrut, the monthly minimum wage was raised from NIS 3,890.25 (NIS 20.92 per hour) to NIS 4,100 (NIS 22.04 per hour). This was the first of two planned steps, and the minimum wage is set to rise to NIS 4,300 per month in October 2012. |
| | 7 | The ECB raises the interest rate to 1.5 percent. | This was an additional 0.25 percentage point hike, after a similar rise in March. |
| | 7 | New instructions regarding limiting Israeli economic activity with Iran. | The Israel Securities Authority, the Finance Ministry's Capital Markets Commissioner, and the Supervisor of Banks jointly published a directive calling on entities under their supervision to check if they are maintaining prohibited connections with Iran, and the level of exposure to the risk entailed in maintaining such contacts. The background to the directive was publication by the media in May of alleged contacts by an Ofer brothers firm with Iran. |
| | 13 | Moody's warns of a cut to the US credit rating. | Moody's said it is examining lowering the credit rating of the US if the national debt limit is not raised soon. |
| | 14 | Widening social protest against cost of housing. | A protest tent city rose in Tel Aviv and in other cities. Leaders called on the government to provide solutions for affordable housing. |
| | 15 | The CPI increased 0.4 percent in June. | |
| | 18 | The powers of the anti-trust authority head are expanded. | The Knesset approved in 2 nd and 3 rd readings the expansion of the powers of the anti-trust authority general director. The general director can declare firms to be a concentration group in an industry with low competition, even if no monopoly has been declared in that industry. |
| | 22 | Additional aid program for Greece. | A summit of eurozone leaders agreed on another aid plan for Greece, under which Greece will reach "selective default" and will gain €109 billion in aid. This was in continuation of an IMF announcement of €3.2 billion in aid to Greece several days earlier. Similar debt conditions will apply to Ireland and Portugal. |
| | 25 | Bank of Israel leaves the interest rate at 3.25 percent. | |

RECENT ECONOMIC DEVELOPMENTS NO. 131, MAY–AUGUST 2011

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| July | 25 | Moody's lowers Greece's credit rating. | The credit rating was lowered to Ca following the rescue plan that was agreed to several days prior. The agency sees default as nearly certain. |
| | 26 | Another program to lower housing prices. | Against the background of the public battle against housing prices, the Prime Minister presented another program for the real estate market: a reduction of 50 percent in the cost of land to build homes in "cost to dweller" auctions, where contractors bid with the price they will offer to home buyers—with preference to young couples, discharged soldiers, and national service participants; land granted for free to contractors who build units for long term rental – a tax break will be granted to the contractor who offers the lowest price to the renter; granting free land for building 10,000 new rental units in student dormitories; and a 50 percent reduction for student travel on buses and trains. |
| | 27 | Moody's lowers Cyprus's credit rating. | The credit rating was lowered to Baal in light of significant exposure to Greece and economic and political uncertainty in the country after a power plant explosion on July 11. |
| | 28 | Dairy market to open gradually to imports. | The Prime Minister accepted the conclusions of a committee led by Ministry of Industry, Trade & Labor general director Sharon Kedmi, including gradual approval of dairy product imports, lowering the price that farmers receive for milk (the target price) by NIS 0.06, increasing transparency in dairy and supermarket operations, cancelling the monopoly exemption on agricultural products and opening to competition production allocations which will not be utilized. The government has not yet approved the recommendations. |
| | 31 | Reduction of excise on gasoline. | The excise on gasoline was cut for one month by NIS 0.31 per liter (including VAT), in order to avoid the rise in fuel price following its price rise around the world. |
| August | 1 | Agreement reached on raising the debt limit in the US. | Congress passed the "Budget Control Act of 2011" and immediately raised the debt ceiling by \$400 billion, to \$14.3 trillion. This was in addition to giving the President the option of raising it another \$500 billion, and to \$1.5 trillion with the decision of a special committee which will be set up by the end of the year. It also set that the budget will be cut by another \$916 billion over a decade. |
| | 2 | The Bank of Israel updates its growth forecast for 2011 to 4.8 percent. | The growth forecast for 2012 was revised to 3.9 percent. |
| | 3 | Knesset approves the "National Housing Committees" Law. | Knesset approves the Planning and Building Procedures Law (Temporary Order) 5771-2011, known as the "National Housing Committees" Law. The law sets out that for a year and a half, in each district, planning committees will be set up that will deal with national housing plans of 200 or more units on state lands. The objective is to accelerate the planning and building processes. |

BANK OF ISRAEL RESEARCH DEPARTMENT

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| August | 3 | The Banking Supervision Department launches a financial education program for youth. | The information campaign “Taking responsibility for our money” will use Facebook as a platform to raise the financial awareness of youth and give them the tools for proper money management. |
| | 4 | Japan intervenes in the appreciation of the Yen. | Bank of Japan figures show that the government sold \$56-69 billion worth of yen. This was the first intervention in the exchange rate since the earthquake in March. |
| | 5 | S&P lowers the US credit rating for the first time. | The ratings agency lowered the US’s long term credit rating by one level, from AAA to AA+, with a negative outlook. This came in light of S&P’s assessment that the fiscal consolidation plan that was agreed on by the government is not enough to stabilize the debt dynamic in the medium term. |
| | 6 | Hundreds of thousands participate in social protests. | It’s the second week in a row of mass protests in Tel Aviv, Jerusalem, and other cities. |
| | 7 | Excise and purchase taxes cut on diesel fuel for electricity. | Due to complications in supply of natural gas from Egypt, and in order to prevent some of the expected rise in electricity rates, the Finance Minister signed a temporary order to cut the excise and purchase taxes on diesel for electricity. The order is in force from February 2011 through year-end. |
| | 8 | The Prime Minister appoints a team for socio-economic change, led by Prof. Manuel Trajtenberg. | The professional team was set up under the pressure of the social protests, and is to deliver its recommendations to the socio-economic cabinet and the government in mid-September. By order of the Prime Minister, the issues dealt with included ideas for changing the priorities in terms of reducing the economic burden, a change in the composition of taxes, expansion of availability of social services, increased competition and steps toward implementing plans presented on housing. |
| | 8 | Deal to raise salaries for starting police officers and prison guards. | Under terms of the agreement, beginning in September, the salary of about 6,000 starting police officers and prison guards will rise by about NIS 2,000 per month. |
| | 9 | US Federal Reserve says that it will leave the interest rate at its current low level through at least mid-2013. | |
| | 13 | Italy’s government authorizes a €45 billion austerity plan. | The plan will be spread out over 2 years and comprise tax hikes and budget cuts of about 1 percent of GDP each year. |
| | 15 | The Bank of Israel grants Barclays Bank a license to conduct banking business in Israel. | Barclays Bank was granted a foreign bank license and a permit to open a branch in Israel, and becomes the fifth foreign bank allowed to open a branch in Israel. |
| | 15 | The CPI declined 0.3 percent in July. | |
| | 18 | Seven die in coordinated attacks on border with Egypt. | Some of the attackers reached the Sinai from Gaza. After the attack, Israel responded in Gaza, and rocket fire from Gaza into southern Israel killed an Israeli. The violence wound down on August 26 th . |

RECENT ECONOMIC DEVELOPMENTS NO. 131, MAY–AUGUST 2011

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| August | 21 | Libyan rebel forces take control of much of Tripoli. | The takeover symbolized the end of the rule of Muammar Ghadafi. |
| | 23 | Credit rating agency Moody's lowered Japan's credit rating. | The credit rating was lowered one notch to Aaa3, due to the debt load accumulated by the government. |
| | 24 | Japan's government sets up a \$100 billion aid fund. | The fund is to provide support for local companies to invest overseas, as part of the government's struggle with the yen's appreciation. |
| | 25 | A deal is signed to end the doctors' strike. | After an extended strike, an eight year salary deal was signed with doctors. The annual increase in the deal, when fully implemented, will be over NIS 2.5 billion. The deal will considerably raise doctors' salaries, will limit the number of shifts by residents, and lets specialists be asked to work shifts (at a higher rate), a considerable one time grant will be paid to doctors who switch to work in the periphery, and doctors will need to punch time clocks. Most of the added salary will be paid differentially to support doctors working in the periphery and in specialties where there is a severe shortage of specialists. About 1,000 additional doctor positions will be added to public hospitals, mainly in order to reduce the number of shifts by residents, and the length of an examination by a primary care physician will be extended. |
| | 26 | US Federal Reserve Chairman's speech has an optimistic tone. | In the speech, Fed chairman Ben Bernanke did not speak of concrete steps, and only said that the Fed has additional tools to encourage US economic activity. |
| | 28 | Hurricane Irene hits the East Coast of the US. | Hurricane Irene caused a lot of worry, and 2 million people moved out of their houses ahead of the storm, but in the end the hurricane caused less damage than expected. |
| | 28 | Cooperation agreement between Israel's Supervisor of Banks and US banking regulators. | The deal establishes supervisory procedures for banks which are incorporated in both countries. |
| | 29 | Bank of Israel leaves the interest rate at 3.25 percent. | |
| | 31 | Unemployment rate fell in second quarter to 5.5 percent. | |
| | 31 | The marketing spread for regulated gasoline was reduced. | The marketing spread charged by fuel companies was reduced by NIS 0.19 (including VAT), in parallel with the expiration of the order to reduce the excise during August. |