

# **Recent Economic Developments**

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## Part 1: Review of Recent Economic Developments, January-June 2006

### Main developments

In the first half of 2006 (the period reviewed), prior to the deterioration in the security situation,<sup>1</sup> Israel's economy showed continued expansion of real activity, with an even faster rate of growth than the rate of the last three years. The forces that had caused the positive turnaround in the economy in the second half of 2003 and that affected the economy in 2005 continued to operate in the first half of 2006. National Accounts data for the first quarter of 2006 exceeded expectations and indicate sustained growth, with GDP rising at an annual rate of 6 percent.<sup>2</sup> The business sector maintained its position at the forefront of growth, with its product growing at an annual 7.7 percent in the first quarter. Among the principal industries, the services and manufacturing industries grew fastest, and the recovery in the construction industry was sustained, particularly in the private sector. Fixed investment increased, with a steep rise in investment in imported machinery, a sign of a process of sustainable growth. Private consumption rose considerably after exhibiting a certain steadiness in the second half of 2005. The positive trend in Israel's foreign trade persisted: exports of all export industries rose, leading to an increase in the current-account surplus to 3 percent of GDP. Tax revenues continued to rise in the period reviewed, as did labor input in the business sector. The Bank of Israel Companies Survey for the second quarter of 2006 also presents a positive picture of economic activity: a rise in activity that encompassed all industries, including a modest increase in the construction industry and in transport and communications; and the leading index in the survey indicates a further increase in business-sector activity in the next (i.e., third) quarter.<sup>3</sup> Output rose in manufacturing industries with all levels of technological intensity, and reflected increases in both exports and the domestic market. Trading companies reported a rise in sales.

The rapid growth also affected the rate of the rise in prices: the CPI rose at a rate of 1.6 percent in the first half of 2006, so that in the twelve months from July 2005 to June 2006 it rose by a total of 3.5 percentage points, above the upper limit of the target inflation range. The increase in domestic demand, which led to the convergence to full utilization of the economy's production capacity, the jump in energy prices and the depreciation of the NIS, all these boosted the pace of price rises in the first quarter of 2006, reflected in high indices that exceeded the forecasts. In the second quarter, positive indicators of real activity (including the positive balance in the current account), the rise in the nominal rate of interest,<sup>4</sup> the formation of a new government, and the approval of the budget for 2006 without deviations from the targets, all the above raised the public's confidence in the sheqel, which was reflected in its appreciation in Q2. This appreciation helped to moderate the rate of price rises in the second quarter and also inflation expectations for the next twelve months. The process of gradually raising the interest rate continued in the period reviewed, with hikes of 25 basis points in February, April and May, to reach 5.25 percent at the end of the period. At the same time the Fed and the European Central Bank (ECB) also continued raising their interest rates, so that the global economy moved into a higher interest environment. Israel's capital markets, which had recorded buoyant figures in the first quarter of 2006, were affected by falling prices in the emerging markets and the industrialized countries, and there were moderate falls in Israel too. Israel's investments abroad continued to increase, reflected by a net capital outflow.

Part 2 of this review features broader discussions on three topics: (1) a survey performed by the Bank of Israel into the aid granted by relief (nonprofit) organizations in 2005; (2) corporate governance in Israel—preferred methods of supervision; and (3) the family backgrounds of part-time employees.

<sup>1</sup> The economic implications of the events in northern Israel are discussed in Box 1 below.

<sup>2</sup> Since July 2006, Israel's GDP, following international practice, includes net import taxes. The new definition raises GDP over the last few years by 4 to 5 percent, but has hardly any effect on the growth rate.

<sup>3</sup> Companies responded to the questionnaire before the outbreak of hostilities in the North.

<sup>4</sup> Most of the effect of the interest rate is felt with a lag.

**Box 1: The effects of the security situation in the north on real economic activity**

The impact of the hostilities in the north of Israel that broke out on 13 July on real activity greatly depends on how long the situation will continue, and how it will end. It would thus be premature to assess the damage caused at this time. Nevertheless, it may be stated, with due caution, that situations of this sort, involving in this case heavy barrages of missiles into the northern part of Israel that cause fatalities and injuries, by their very nature embody potential harm to economic activity. The impact on town centers and the many surrounding settlements is greatly disrupting daily routine and economic activity in the north. Many residents are leaving their homes and moving south to other locations for as long as the hostilities continue; those remaining must stay in protected spaces or shelters, so that the rate of absenteeism from work is likely to be very considerable. A calculation performed in the bank of Israel gave the result that assuming a rapid end to the fighting, the damage to economic activity is likely to remain relatively low, up to one percent of GDP. The most immediate and severe effect that can be identified, partly due to the availability of data, is the effect on incoming tourism. Thus, for example, in the last quarter of 2000 following the outbreak of the second *intifada*, the export of tourist services plunged by 45 percent. Experience has shown that foreign tourists absent themselves very quickly at the first sign of a deterioration in the security situation, and they return only slowly when calm is restored. A reduction of 50 percent in incoming tourism in the third and fourth quarters of 2006 would cause a 0.4 percent decline in GDP. In addition to the effect on foreign tourists, internal tourism in the summer months, which constitutes the main pillar of the tourist industry in the north, is also likely to be seriously affected. Hotels in the northern region account for about 20 percent of the total number of hotel rooms in Israel, on top of which a whole industry of rural guesthouses is concentrated in the north. If tourism to the north is heavily reduced, the effect of tourism on the economy is likely to be, at a rough guesstimate, a relatively modest 0.1 percent of GDP, partly because some of the internal tourism will be diverted to other areas in Israel. Another way in which the effect of the situation may be felt immediately is via expectations. The reduction of expectations of economic activity, which is expressed in the share market, is likely to have an adverse effect on private consumption both directly and indirectly, via the effect on financial wealth—i.e., the value of public's assets portfolio.<sup>1</sup> It is too early at this stage to quantify this aspect, due to the high volatility of the share market. The expectations channel can suddenly become more firmly established. Tax revenues are likely to be affected by the events in the north, and government expenditure may be expected to rise, both defense expenditure and compensation payments, direct and indirect, but at present no deviation from next year's target deficit is anticipated. Despite the escalation of the crisis in the north, the fluctuations in the sheqel exchange rate have been relatively moderate: in the first few days of the fighting the exchange rate rose from NIS 4.40 to the dollar to NIS 4.52, but then the sheqel strengthened again.

To summarize: if the crisis is resolved soon, particularly if the new arrangement results in an improvement in the basic security situation, the impact on economic activity is likely to be a small one, due to the economy's strong condition.

<sup>1</sup> In 2005 about 25 percent of the public's assets were invested (directly and indirectly) in shares in Israel. An average annual drop of 10 percent in share values in 2006 is expected to cause a reduction of 0.3 of a percentage point in private consumption (see the Bank of Israel Annual Report, 2005, p. 42).

**Aggregate and by-industry real activity**

National Accounts data for the first quarter of 2006 present a positive picture of rapid and even accelerated expansion of GDP, with an annual rate of 6.0 percent in the first quarter following on increases of 5.9 percent and 4.7 percent in the fourth and third quarters of 2005 respectively, driven by business-sector product, which rose of 7.7 percent in the first quarter following on increases of 7.5 percent and 6.4 percent in the fourth and third quarters of 2005 respectively. These figures (Table 1) reflect:

1. An annual 7.3 percent in per capita expenditure on private consumption, its largest rise since the last quarter of 2004. This rise occurred after per capita consumption had remained steady in the last quarter of 2005 and had risen more slowly in the second and third quarters of 2005. The rise in the first quarter of 2006 incorporates a rise of 7.9 percent in per capita current consumption, after this had remained stable in the previous quarter. In contrast, per capita expenditure on consumer durables fell at an annual rate of 9.5 percent in the first quarter of 2006, in the wake of a 1.5 percent decline in the previous quarter.

This series is known to be highly volatile. The positive indicators relating to private consumption in the second quarter, including the index of trade revenue, the index or sales in retail chain stores and the index of consumer confidence, indicated continued expansion. The rise in private current consumption may be attributed to the improvement in individuals' disposable income, which resulted from wage rises in the business sector, from the decline in unemployment, and the high yields in the financial markets in the first quarter of 2006. The list may be extended to include the tax cuts, which gained credibility following the decline in the public debt, and the consolidation of growth, both of which increased consumers' permanent income.

2. Fixed investment rose even faster—at an annual rate of 13.3 percent, after rising by 10.9 percent in the previous quarter. This reflects mainly a steep rise (of 36.5 percent) in investment in overland vehicles, after this item had slumped by 29.3 percent in the last quarter of 2005,<sup>5</sup> and an increase of 14.9 percent in investment in machinery and equipment in the principal industries, following its increase of 16.4 percent in the previous quarter. Investment in inventory in the first quarter remained steady, in contrast to 2005 when it rose relatively steeply. Unlike in 2005, when most of the investment was directed towards domestic stocks, in the first quarter of 2006 the main investment was in imported machinery and equipment.

The increase in fixed investment after several years of decline indicates that growth is becoming more solid, with increased chances that it will become sustainable. The government's policy of cutting its share in economic activity, and its reduced borrowing requirements in the domestic market, enables long-term real interest to remain relatively low, and allowed sources to be diverted to boosting the business sector's share. The cut in corporation tax also played a part in this positive development.

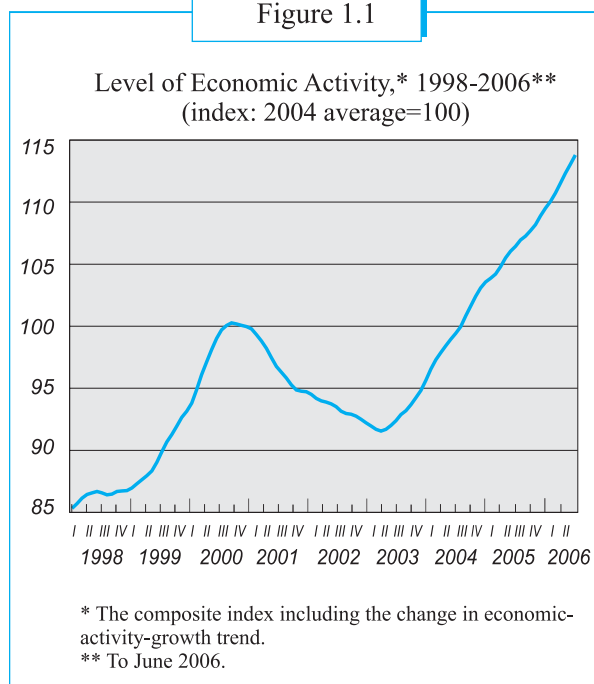
3. Goods and services exports increased by only 1.2 percent, annual rate, in the first quarter of 2006, after dipping by 1.4 percent in the previous quarter. The rise reflects an increase in services exports, including export of tourist services which rose annual rate of 38.4 percent. Manufacturing exports went up at an annual rate of 5.1 percent. Imports of goods and services rose faster than did their exports, by 5.1 percent, annual rate, following a steep 9.4 percent decline in the previous quarter. Israel's foreign trade data for the second quarter of 2006 (and also the index of services exports), including high-tech exports, show rapid acceleration of exports, and over the whole of the first half-year goods exports rose by more

than 10 percent. The increase in goods imports included a rise in imports of consumer goods and raw materials. This is in line with the information derived from the Companies Survey for the second quarter, which continues to indicate a steady increase in manufacturing and trading activity, and continued growth in the output of manufacturing companies.

4. Public consumption rose by 1.6 percent, or 1.1 percent excluding defense imports.

The accelerated growth in the first half of 2006 was reflected in the composite state-of-the-economy index, which went up by a cumulative 3.9 percent from the beginning of the year, and by 6.4 percent compared with the first half of 2005 (Figure 1.1). Almost all of the components of the index rose. Manufacturing production, which has risen steadily since the beginning of 2003 (Table 2 and Figure 1.2) declined in April,<sup>6</sup> dragging the rate of change in the index in the second quarter down a little. In the whole of the second quarter manufacturing production was 5.6 percent higher than in the second quarter of 2005. Most of the rise was due to growth in high-tech and knowledge industries, with a more moderate rise in other industries.

Figure 1.1

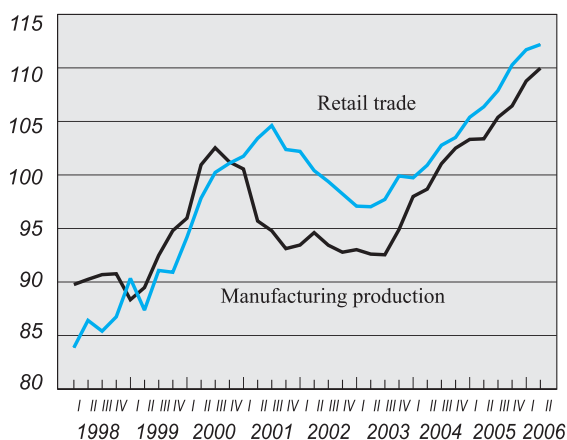


<sup>5</sup> This volatility reflects also the tax cuts.

<sup>6</sup> The 1.1 percent decline in manufacturing production from March to April may be due to the Passover holiday in April, and the effect of the Festivals are not taken into account in full.

Figure 1.2

Manufacturing production\* (index, average 2004=100) and large-scale retail trade\*\* (index, average 2002=100), 1998-2006



\* To May 2006. Seasonally adjusted.

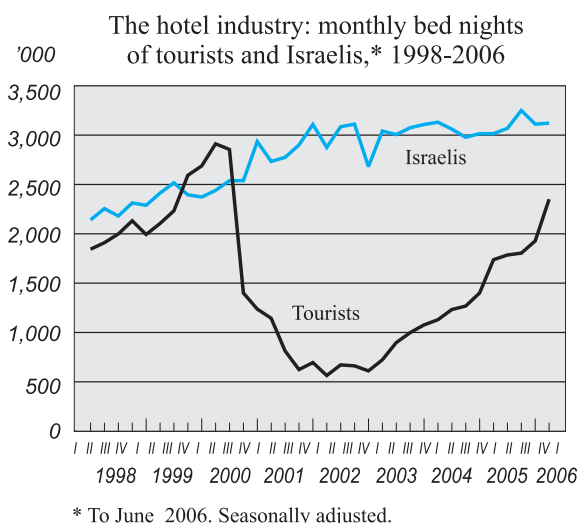
\*\* To June 2006. Seasonally adjusted.

Several factors contributed to the growth in the second quarter:

- (1) *Global growth*—Despite the fall in prices in most of the emerging markets, the disappointing real data of the US economy in the first quarter, and the expectations of further hikes in interest rates in Europe and the US, the IMF did not alter its forecast of economic growth in 2006, and it still stands at 4.9 percent. The rising demand for Israeli exports is not expected to ease in the near future.
- (2) *The relative calm in the security situation*—despite the deterioration at the end of the second quarter, Israel's security situation in the first half of 2006 was more stable than it had been in 2004. Supporting the above factors was the rapid formation of a government following the election, and the approval of the 2006 budget, both of which signal stability, which itself plays a focal role in economic growth. Fiscal policy as reflected in the budget that was approved in June continued to act to reduce taxes and the public debt, while meeting the deficit target. This policy supports growth and encourages domestic and foreign investment in Israel. Finally, the relatively expansionary monetary policy, which was gradually converging to neutrality, also signaled stability and encouraged investment. In contrast, the persistent rise in fuel prices adversely affected the terms of trade, the negative effect of which on the rate of growth slightly offset the positive effect of the other factors.

The continued calm security situation and global growth provided a good basis for the marked recovery in the **tourist** industry. In the first half of the year more than a million visitor entries into Israel were recorded, 22 percent more than in the first half of 2005. In the second quarter of 2006 the number of tourists arriving in Israel was 21.1 percent higher than the number in the second quarter of 2005 (Table 2 and Figure 1.3). The number of tourist bed nights (seasonally adjusted) also rose, and the number of Israelis' bed nights remained steady, at almost a million per month. Tourist hotels' revenue in the first three months of 2006 totaled \$ 1.3 billion, 24 percent higher than in the first three months of 2005, while tourist revenue surged by 42 percent to NIS 565 million. The real revenue from tourism has not yet reached the peak level it reached in the first quarter of 2000. Almost 23,000 people were employed in hotels in the second quarter of 2006, 13 percent more than in the second quarter of 2005, but their average salary, which is relatively low, remained close to its level in the second quarter of 2005. In the first half of 2006 the rate of hotel occupancy rose throughout Israel. The highest rate was in the Tel Aviv region, where it reached 67 percent, while in the Jerusalem region it showed the largest increase, 25 percent, from the level in the first half of 2005. The Companies Survey shows that orders were expected to rise, and the industry to continue expanding, in the next quarter too, despite the supply constraint, which became more severe.

Figure 1.3

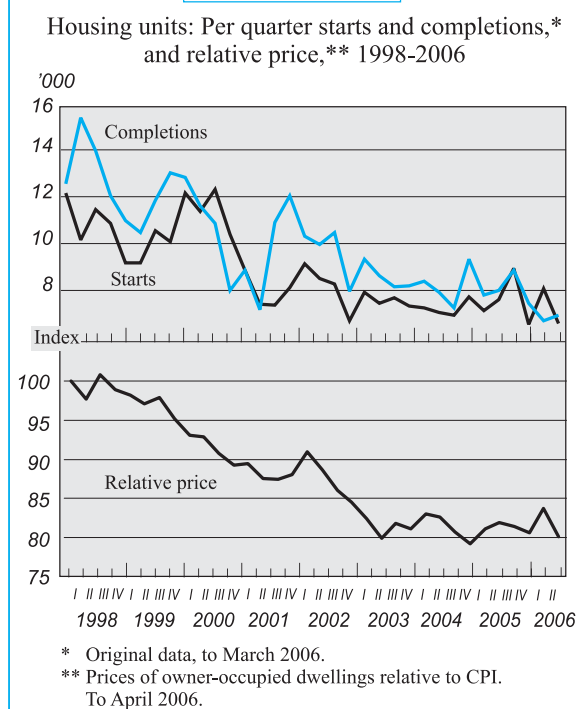


The **construction** industry continued to arouse particular interest due to its slow, late recovery during the current period of growth, in contrast to the other principal industries: only in the last quarter of 2005 and the first quarter of 2006 were



there signs of recovery from the recession. According to the Companies Survey, a small rise in the activity of construction companies was evident in the second quarter of 2006 too, due to an increase in the construction of infrastructures and buildings. The Survey shows that most construction companies, mainly the larger ones, expect a modest increase in their activity also in the third quarter of 2006, the fourth quarter in succession. After declining in the last quarter of 2005, the number of building starts was 13.4 percent higher in the first quarter of 2006 than in the first quarter of 2005 (Table 2 and Figure 1.4). The rise in building starts took place in the central region (where the number rose by 43 percent), Tel Aviv region (25 percent), Jerusalem region (24 percent), and the southern region (18 percent). In contrast, in the Haifa region and in Judea and Samaria building starts declined by 41 percent and 28 percent respectively. Eighty-five percent of building starts in the first quarter of 2006 were undertaken by private enterprise. Trend data indicate a rise in the sale of new apartments, and the rate of increase in the period reached 18 percent, in annual terms. In the Tel Aviv and central region the number of apartment sales rose, while in the northern, Jerusalem, southern and Haifa regions the numbers declined. The drop in the stock of apartments for sale in desirable areas, the rise in demand, the increase in input prices and the expectations of further increases in the effective interest rate boosted the relative price of apartments, mainly in the central region, in Ashdod and Jerusalem, and of high-priced and large apartments.

Figure 1.4

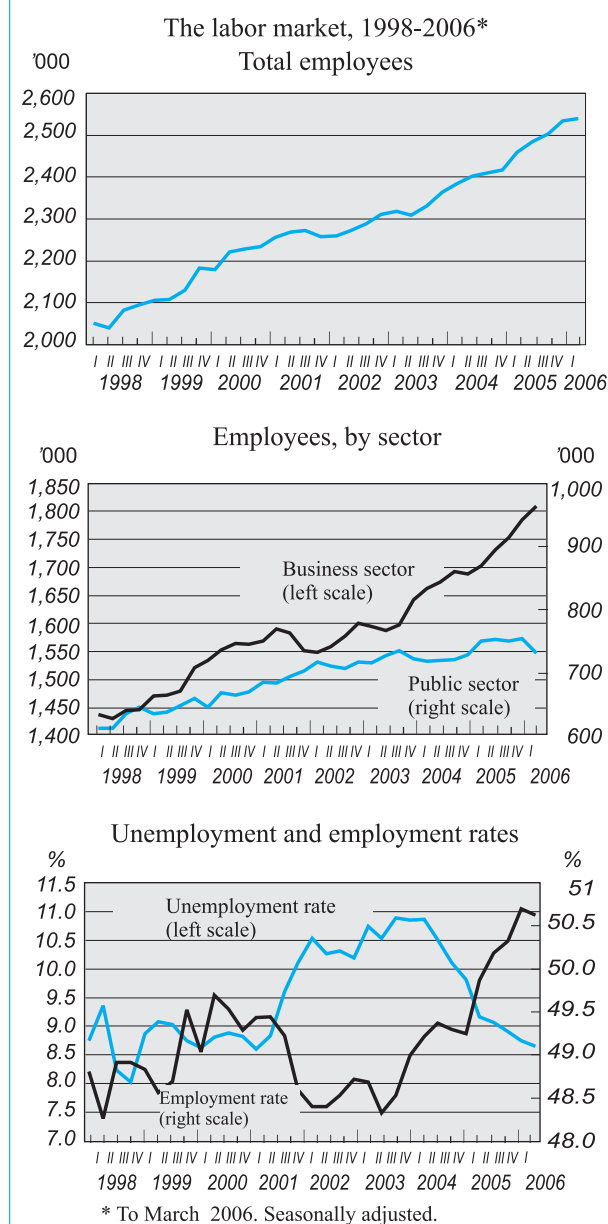


The general relative price of housing rose by 3 percent in the first quarter of 2006, after falling continuously in the second half of 2005. The dollar price of apartments rose by 0.9 percent in the first half of 2006, due to a one-percent rise in June.

## The labor market

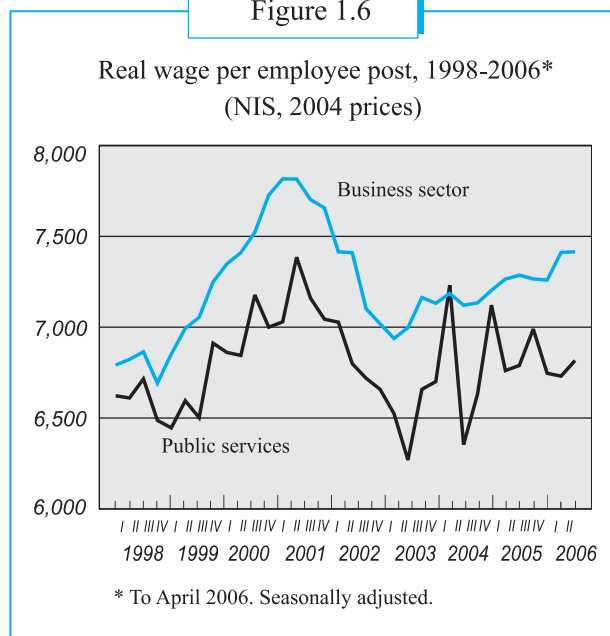
The consolidation of growth was reflected also in the labor market. Wages, productivity, and total labor input continued to rise steadily during the period reviewed (Figure 1.5).

Figure 1.5



The average real wage per employee post in the first half of 2006 was 1.2 percent higher than in the first quarter of 2005, reflecting a rise of 1.9 percent in the business-sector wage and a decline of 0.3 percent in the public sector (Table 3 and Figure 1.6). The real wage in the public services rose in the third quarter of 2005, but since then has declined continuously. This contrasts with the business-sector wage, which has shown a slight upward trend since the second half of 2004, with a relatively faster rise of 2.1 percent in the first quarter of 2006. Despite the rise in the business-sector wage, unit labor cost continued to fall in the first quarter of 2006, similar to its performance in 2005; this was due to the greater rise, 3.6 percent, in labor productivity in the last 12 months, which offset the effect of wage rise. The increase in labor productivity is consistent with the high level of fixed investment and increased capital utilization.

Figure 1.6



Unlike in the last quarter of 2005, when the number of employees in part-time employment increased and those in full-time employment fell, in the first quarter of 2006 the number of part-time employees declined by 1.3 percent,<sup>7,8</sup> while the number of full-time employees increased by 0.9 percent. The number of those in part-time employment not by their own choice fell by 2.5 percent, following the decline of 5.1 percent in the last quarter of 2005. The number of hours worked per employee per week rose from 35.9 to 36.3

<sup>7</sup> The number of males in part-time employment fell by 5.2 percent, while the number of females in part-time employment rose by 0.8 percent.

<sup>8</sup> In the last quarter of 2005 there was an exceptional jump of more than 10 percent in the number of part-time positions. The decline in the first quarter of 2006 may just be a statistical correction to this deviation.

after falling steadily over the previous two quarters, so that total labor input increased in the first quarter of 2006, after declining in the preceding quarter. The number of Israeli employees in the first quarter of 2006 was 3.5 percent higher than the number in the first quarter of 2005.

The two sectors showed conflicting trends in the first quarter of 2006: in the business sector the number of employees rose by 1.4 percent (25,000 employees), in the public sector their number fell by 3.1 percent (23,000).<sup>9</sup> The reduction in employment in public services was particularly notable in the health services and in public administration. The expansion of employment in the business sector was uneven: the number of employees rose in transport and communications (by 13,500), in hotels and catering (by 7,500), in trade and repairs (by 5,900), and in manufacturing (by 4,400); in contrast, the number of employees in security and cleaning companies fell by 19,100, the number in business services went down by 10,000, and in agriculture, by 3,500. The decline in the business services industry was in opposition to the trend of expansion in this industry in the previous period. The number of employees in the construction industry rose slightly, by 800, after a large increase of 6,000 in the last quarter of 2005.

The rise in the labor participation rate, the rise in the rate of employment and the fall in the unemployment rate, all of which were evident in the last two years, halted in the first quarter of 2006. Although the unemployment rate dipped slightly, from 8.8 percent to 8.7 percent, this was not entirely due to a reduction in the number of unemployed, but was due mainly to a drop in the participation rate from 55.6 percent to 55.4 percent;<sup>10</sup> without this decline the unemployment rate would have been 8.9 percent. The drop in the participation rate was also reflected by a fall of 0.1 of a percentage point in the rate of employment, following a steady rise since the beginning of 2005. The participation rate is still higher than it was in the second and third quarters of 2005, when it stood at 55.2 percent. Trend data for April and May, with unemployment at 8.9 percent, give a further indication of the stabilization of the unemployment rate. There was also an increase in the depth of unemployment in the first quarter of 2006, for the first time in a long while: the number of those seeking jobs for more than six months rose from 90,300 to 92,100, after declining by a cumulative 8 percentage points in the previous two quarters.

<sup>9</sup> The increase in employment in the last quarter of 2005 did not occur only in the business sector: the total rise of about 35,600 employees consisted of a rise of 27,100 in the business sector, and of 7,500 in the public sector (1.5 percent and 1 percent respectively).

<sup>10</sup> The reason for the decline was that the rise in the working-age population (0.43 percent) exceeded the rise in the labor force (0.13 percent). The participation among men declined by 0.1 of a percentage point, and among women by 0.3 of a percentage point.



The stagnation in the labor market persisted as in the previous period: unemployment among those with less than twelve years of schooling was still higher than the relatively low rates among those with higher education (13.2 percent unemployment, compared with 6.2 percent respectively, average over the previous two years).<sup>11</sup> In the light of the deeper unemployment among those with a low level of schooling and the relative stability of their unemployment rate in the last year, it seems that in order to improve their situation the non-employment of foreign and Palestinian workers, who offer employers a cheaper alternative, will have to be more rigorously enforced. Nonetheless, the various broader implications of such enforcement must be borne in mind. The data show that after the last quarter of 2005, when the number of foreign workers increased by 4,000, in the first quarter of 2006 their number increased by a further 1,600, about 90 percent of whom are not registered. Unlike in the previous quarter, when the number of Palestinian workers declined by about 10 percent (6,000 workers), in the first quarter of 2006 their number rose by 1,000, a rise of slightly more than 2 percent.<sup>12</sup>

The small drop in the unemployment rate was reflected by a similar decline in the number of job seekers. The number of those claiming unemployment benefit did not change significantly in the period under review, the outcome of a rise in the first quarter and a decline thereafter.

The minimum wage was increased in June by NIS 128, to NIS 3,585, following a rise in April of NIS 121, part of the planned gradual increase to NIS 4,600. In January 2006 the maximum income from which the reduced National Insurance and Health Insurance premiums are deducted was changed, and it is now 60 percent of the average wage according to the definition of the National Insurance Institute. Hitherto the ceiling was 50 percent of the average wage.

## The government

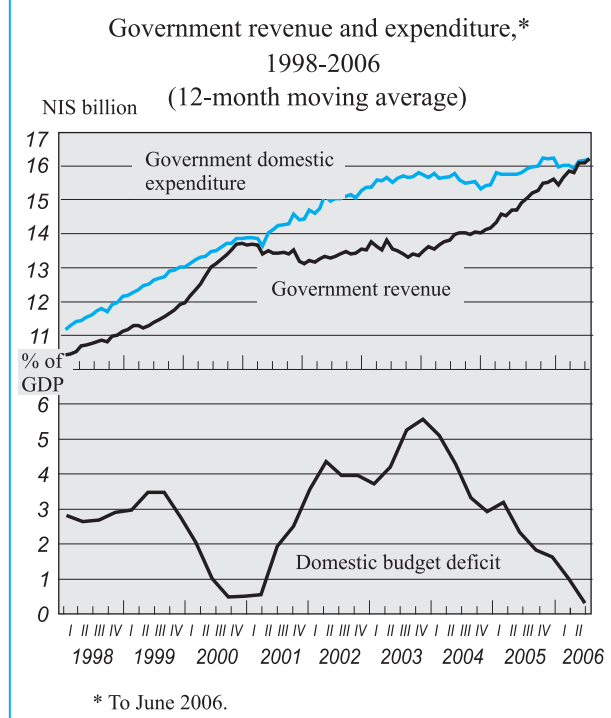
Adhering to the policy of the previous government, the new government undertook to cap the rate of its expenditure growth and to continue narrowing the debt/GDP ratio. The 2006 government budget, approved only in June, reflects this

policy and limits expenditure growth to 1 percent per year.<sup>13</sup> The government also decided to raise the maximum annual growth rate of expenditure from 1 percent to 1.7 percent starting in 2007. Until the 2006 budget was approved, the government operated within the framework of the 2005 budget.

The lack of an approved budget from the beginning of the year (and, consequently, the inability to reprioritize national needs) and the continuation of spending restraint were harmful to some public services and their quality. In contrast, the government's strict adherence to the expenditure target was reflected in public confidence manifested in the continued downtrend of yields on a 5–9 year government bonds, stability in the financial markets, and an increase in foreign investment. The deficit-cutting trend, now in its third year, also supports price stability and a relatively low interest environment.

Government activity had a **cumulative surplus** of NIS 6.2 billion in the review period as against an NIS 0.2 billion surplus in the year-earlier period (Table 6 and Figure 1.7) due to rather large underperformance of the budget in the first half of 2006 and continued increase in tax revenues.

Figure 1.7



<sup>11</sup> Unemployment among university graduates declined in the first quarter of 2006 from 6.5 percent to 5.0 percent, while among those with less than twelve years of schooling it rose slightly, to 12.3 percent (unadjusted data).

<sup>12</sup> In the whole of 2005 the number of foreign workers rose by 5,100, or 2.6 percent, when the number of Palestinian workers increased by 7,100, or 20 percent. This flies in the face of the government's declared policy of reducing their number.

<sup>13</sup> The NIS 1.3 billion cost of the coalition agreements was offset by spending cuts in other budget lines.

**Government expenditure** during the review period was far under the annual trajectory that would correspond to full performance of the budget. Nevertheless, expenditure increased by 3.2 percent (i.e., no real change) relative to the year-earlier period, in which the budget was quite severely underperformed. All ministries, especially those related to social services, underperformed their budgets in the first quarter of 2006.<sup>14</sup> There was no underperformance of expenditure in the second quarter, as against NIS 3.6 billion in the previous quarter. The underperformance in January–June came to 7.3 percent overall and more than 20 percent in social-services ministries. The security-related ministries overperformed their budgets by 6 percent. Transfer payments increased: National Insurance benefits advanced during the review period, mainly because outlays for old-age and survivors' benefits increased even as income-maintenance and unemployment-compensation payments declined. The reason for the upturn in benefits in early 2006 was that the freeze set forth in the 2002 and 2003 Economic Arrangements Laws ended in January 2006, resulting in a 2.7 percent upward adjustment.<sup>15</sup> The decrease in unemployment-compensation payments and the even stronger contraction of income-maintenance outlays (which together account for roughly 10 percent of total National Insurance transfer payments), despite the upward adjustment in the level of the benefits, is another indication of favorable developments in the labor market and also of the toughening of the qualifying criteria.

**Government revenues** continued to increase swiftly in the first half of 2006. Tax revenues (on account of indirect taxes and, in the main, direct taxes) were NIS 5.1 billion greater than the level consistent with the budget outlook,<sup>16</sup> giving evidence of the expansion of real activity. Government tax revenues began to increase in the middle of 2003 and have been growing at an accelerated pace since the middle of 2004. The trend continued during the review period, revenues expanding by 11.6 percent relative to the year-earlier period. The fact that the upturn persisted in the second quarter is a good indicator of the continued trend of growth.

In view of the surging tax revenues<sup>17</sup> and the expectations of continued rapid growth, the government lowered the

rate of Value Added Tax on July 1, 2006, earlier than had been expected. The cost of the VAT cut—from 16.5 percent to 15.5 percent—is projected at NIS 3.3 billion in annual terms<sup>18</sup> and is expected to lower the Consumer Price Index by 0.4 percent.<sup>19</sup>

In June, after two issue-free months, the government raised NIS 1.5 billion—70 percent unindexed. Even so, there was a net redemption of bonds in June, as in April and May (when no issues were made). The low level of capital raising, expressing the decline in the government's financing needs, many ease the effect of the larger upturn in bond yields abroad than in the domestic bond market. Privatization during the first half of the year contributed another NIS 2 billion toward the funding of the deficit, slightly more than the forecast for the entire year according to the budget. One should bear in mind that two large privatization transactions—of the refineries in Ashdod and Haifa—are in mid-process.<sup>20</sup>

The government's stringent restraint of its spending in the past two and a half years despite coalition demands that surfaced as the new government was being formed, the continued growth trajectory, and the increase in tax revenues all enhance the probability of an under-target government deficit and a continued decline in the national debt/GDP ratio this year, too—especially in view of the decision to use the tax-revenue surpluses to lower the government debt to 90 percent within two years.<sup>21</sup> The total government deficit in 2006 is projected at 0.5–1 percent of GDP, far below the 3 percent ceiling.<sup>22</sup> The contraction of the public debt, especially if based on cutbacks in government expenditure, is a crucial element in the cementing of sustainable growth. It frees up sources for investment by the business sector (by lowering interest payments), helps to bring down the long-term interest rate, reduces production costs, and improves the country rating, an indicator of concern to foreign investors.

<sup>14</sup> The ministries of Health, Education, Social Affairs, Housing, and Immigrant Absorption; municipal authorities; higher education; the National Authority for Religious Affairs at the Prime Minister's Office; and the National Insurance Institute.

<sup>15</sup> Old-age and survivors' benefits were adjusted by only 1.8 percent due to a 0.9 percent adjustment in January 2003.

<sup>16</sup> NIS 1.2 billion of the surplus reflects non-recurring revenues on account of notional sales on the capital market (NIS 900 million) and unusually vigorous collection from companies in January.

<sup>17</sup> Additionally, NIS 4.5 billion in revenue is expected in the second half of the year from the sale of Iscar, Ltd.

<sup>18</sup> The expected decrease in the price level may "save" the Bank of Israel a 0.25 percentage-point rate increase.

<sup>19</sup> However, since the VAT cut was made at a time of growth and rising demand, merchants may choose to increase their profits instead of lowering prices.

<sup>20</sup> Due to the events in northern Israel, the signing of the privatization agreement for the Ashdod refinery has been postponed.

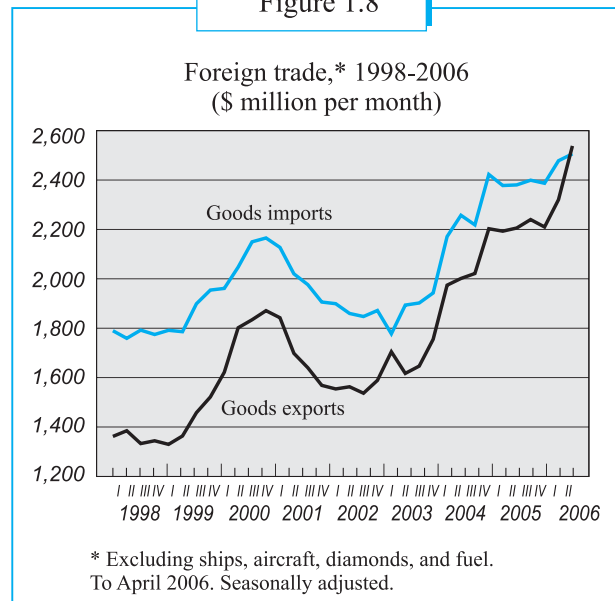
<sup>21</sup> Due to a change in the method of calculating GDP, the debt/GDP ratio for 2005 was reduced to 97.5 percent and the target of 90 percent will be attainable within a year.

<sup>22</sup> The effects of the recent events on public expenditure are not yet clear. However, the magnitude of the outlays, assuming that the confrontation will not be long-lasting and will not expand, are several tenths of a percentage point of GDP and will not affect the estimate of the substantially under-target deficit.

## The balance of payments

Foreign trade continued to trend upward in the first half of 2006 (Table 4 and Figure 1.8). The seasonally adjusted **current account** surplus increased in the first quarter and came to \$1.7 billion as against \$0.7 billion in the previous quarter.<sup>23</sup> The goods and services account ended the first quarter with a \$0.4 billion surplus as against a \$0.1 billion deficit in the previous quarter. The difference traces to (1) a narrowing of the deficit on goods account, occasioned by an increase in exports of goods and no change in imports, and (2) a larger surplus on services account: exports of services expanded from the previous quarter, most conspicuously in software, R&D, and tourism services, which continued to grow in the second quarter as well. Imports of services were largely changed from the previous quarter. In investment income in the balance of payments, Israel experienced its first-ever surplus of resident income from abroad (\$1.4 billion) over the economy's expenditure for foreign investment (\$1.2 billion). The total transfer inflow increased to \$1.6 billion.

Figure 1.8

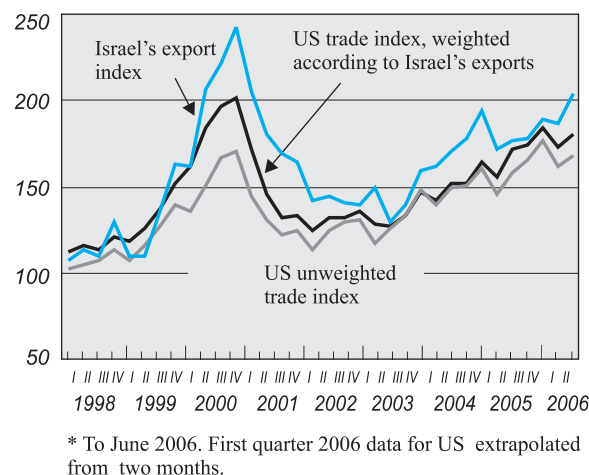


The index of Israel exports to the United States is another indicator of the increase in exports during the review period (Figure 1.9). According to the index of services exports, total exports of services increased by 6.5 percent during the first five months of the year.

<sup>23</sup> The relatively small current-account deficit in the last quarter of 2005 traced to a decrease in exports of goods and services.

Figure 1.9

Israel's exports of and US trade in electronic components, electronic communication equipment, and scientific and monitoring equipment,\* 1998–2006



Trade in **goods** (exports and imports) returned to the rapid pace of growth established in 2002–2004. Exports were driven by industrial exports,<sup>24</sup> especially those of high-tech, whereas the increase in imports was abetted mainly by imports of intermediates. The trade deficit in the first half of the year was \$3.6 billion.

**Nondiamond exports of goods** increased by 9.4 percent in the second quarter on the heels of a 5.0 percent increase in the first quarter. The growth occurred at all levels of technology intensity. High-tech exports, which account for nearly 50 percent of (nondiamond) industrial exports, expanded in the second quarter by 17.2 percent after a 5.2 percent increase in the first quarter. Growth rates at the other levels of technology intensity were gentler.

Seasonally adjusted **imports of goods** (excluding diamonds, ships and aircraft, and energy) expanded by 1.1 percent in the second quarter after a 3.8 percent increase in the previous quarter. Consumer goods imports climbed by 1.6 percent in the second quarter after advancing by 7.4 percent in the first quarter—a change that reflects an increase in imports of current-consumption goods and a smaller upturn in imports of consumer durables. Imports of capital goods (excluding ships and aircraft) increased in the second quarter, resulting in almost no change during the entire review period. Imports of intermediates grew at similar rates in both quarters, bringing the increase in the first half of the year to 4.7 percent compared with their level in the first half of 2005.

<sup>24</sup> Industrial exports increased by 14.2 percent over the past twelve months (in dollar terms).

The quantitative changes in the first quarter, net of seasonal effects and irregular factors, were 0.6 percent in industrial exports and 3.3 percent in imports of goods, after a slight decline in the latter parameter in the last quarter of 2005.

The **terms of trade**<sup>25</sup> improved by 4.7 percent in the first quarter after two quarters of steady decline, even though goods import prices rose by 2.1 percent after falling by 2.6 percent in the previous quarter. The reason for this was a steeper upturn in export prices—6.9 percent, following a 3.7 percent decline in the previous quarter. The terms-of-trade index (excluding ships, aircraft, and energy) improved in the first quarter of 2006 by 1.4 percent. Energy import prices rose by 4.9 percent after falling by 5.3 percent in the last quarter of 2005.

In view of the narrowing of the NIS interest spread against foreign currencies and the equalization of tax rates on Israelis' financial assets abroad with those on domestic assets, resident investment abroad continued to increase in the first quarter of 2006 after an upturn in the previous quarter. The exceptional increase in the first quarter of 2006, the largest in history, traces almost entirely to the acquisition of a foreign company by an Israeli company: Teva's acquisition of Ivax. This added increment raised the total balance of resident investments abroad by more than 50 percent relative to the end of 2005. Foreign direct investment increased in the first quarter by \$2.3 billion despite political and economic uncertainty during that time<sup>26</sup> and in accordance with the global upward trend in investing in emerging-market economies. Notably, however, the increase in foreign investment was smaller in Israel than in the other emerging-markets. Accordingly, the outflow of money from Israel when global stock exchanges began to fall was much gentler. Since the increase in resident investments abroad surpassed the increase of foreign investment, the deficit on financial account increased by \$3.6 billion in the first quarter of 2006. Resident investment abroad declined in the second quarter. The capital inflow continued in April and May but slowed relative to the first quarter. The trend turned around in June; for the first time since the beginning of the year, nonresidents generated a net capital outflow (\$0.45 billion). In the second quarter overall, the deficit on financial account increased by \$0.24 billion. In the entire first half of the year, foreign investment was a record \$11.9 billion as against \$9.95 billion and \$7.2 billion in the entire years 2005 and 2004, respectively.

<sup>25</sup> The ratio of export prices to import prices.

<sup>26</sup> Due to the health of the prime minister, early elections, non-passage of the budget, and the accession of Hamas to power in the Palestinian Authority.

In late March 2006, the economy's total net external liabilities added up to \$26.2 billion. In contrast, the net external debt, comprising the economy's assets and liabilities vis-à-vis the rest of the world in debt instruments only, showed an asset surplus of \$21.0 billion—meaning that the Israeli economy lends more than it borrows.

## Global developments

Steep decreases in share prices around the world, especially in developing countries, did not affect the IMF's projection of 4.9 percent global economic growth in 2006, similar to the 4.8 percent rate achieved in 2005 (Table 5). The continuation of growth is expected to base itself on strong expansion of global trade, estimated at 8 percent, which will also support the continued growth of Israel's exports. U.S. economic growth remained rather vigorous. In 2006, according to the IMF outlook, the U.S. economy will grow by 3.4 percent and remain the locomotive of the global economic expansion. However, the ballooning U.S. balance-of-payments deficit, coupled with the fiscal deficit and the risk of an inflationary upturn, will compel the Fed to continue raising its key rate, which is likely to have a dampening effect. Japan is poised to grow by 2.8 percent, much as in 2005. The Chinese economic efflorescence is expected to continue, as annualized growth in the first half of the year exceeded 10 percent.<sup>27</sup> The emerging-market economies are expected to continue growing at the pace established in the past two years and will make a large contribution to global growth and the swift expansion of foreign trade. It should also be borne in mind that these countries, including China and India, export deflation to the West—absolving the Western countries (among other effects) from an inflationary upturn despite their own growth and the surge in energy prices. The eurozone growth trajectory remains modest, with a slight expansion trend (a little more than 2 percent growth annually) and a similar pace is expected in the near term. The global inflation environment is not expected to change in the next two years with the exception of Japan, where positive inflation is foreseen in 2006 and 2007 after deflation in 2005. In sum, the main indicators point to expectations of continued strong global growth in the short term, including an especially optimistic outlook for China and Japan. The main factors in the growth include exports, investments, and convenient global conditions. In contrast, oil prices continued to rise vigorously during the review period<sup>28</sup> due to growing demand (a consequence of continued economic growth) and uncertainties and concerns about oil supplies, which are dwindling due to geopolitical tensions such as the violence in Nigeria, the war in Iraq, and the diplomatic

<sup>27</sup> The growth in China has little effect on Israel, since Israel's exports to China remain negligible.

<sup>28</sup> Oil prices are 24 percent higher today than a year ago.



crisis with Iran. Most economists do not expect oil prices to decrease in the medium term, meaning that the price of petroleum will continue to pose an obstacle to international trade and trigger continued price increases in other energy products. As stated, the expected additional increase in energy prices has not yet found expression in a change in the inflation environment.

The steady increase in interest rates and, concomitantly, the slow transition to higher long-term rates and the expectation of continued increases, has been harmful to money liquidity in the developed countries and has slowed the outflow of money from these countries to emerging-market economies. As a result, developing countries' share indices have fallen steeply and their currencies have depreciated severely—including the Turkish pound, which was also affected by Turkey's current-account deficit. Shares in these countries, which ballooned by up to 1,000 percent during the past four years, fell by 10–25 percent in little over one month, from May 9 to the middle of June. Analysts tend to regard these tumbles not as the bursting of a bubble but as a typical correction that follows especially strong increases.

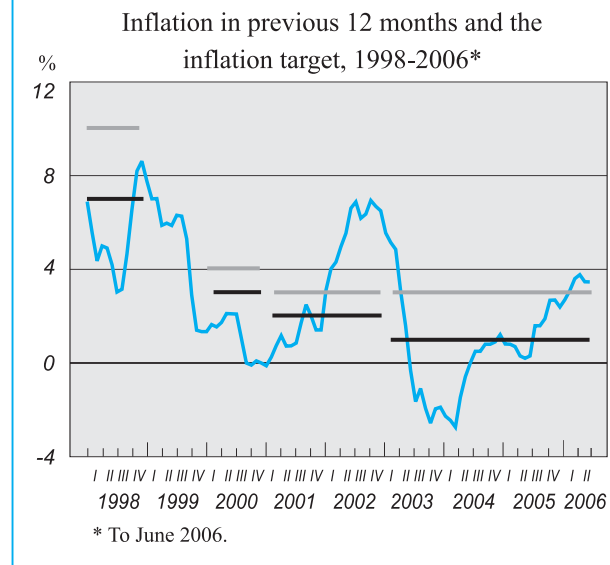
### Prices, monetary policy, and the money and capital markets

The expansion of real activity and the attendant increase in demand also affected the **inflation rate**. From this standpoint, the two quarters in the review period were markedly different. In the first quarter, the inflation rate accelerated; the CPIs in both February (0.6 percent) and March (0.3 percent) surpassed forecasts and were the highest for these months since 2002. In the second quarter, in contrast, the price increases were gentle and in line with the forecasts.<sup>29</sup> The CPI rose by a total of 1.6 percent in the first half of 2006, bringing inflation in the past twelve months (June 2005–June 2006) to 3.5 percent, surpassing the upper bound of the 1–3 percent inflation target (Table 7 and Figure 1.10). The CPI net of fluctuation-intensive components (fruit and vegetables, clothing and footwear) increased at a similar rate in the first half of the year—1.3 percent—bringing the increase in the past year to 3.4 percent, again exceeding the target range. Wholesale prices outpaced consumer prices, advancing by 5.5 percent in the first half of 2006 and 8.4 percent during the past twelve months.

The rapid and powerful transmission from the exchange rate to the inflation rate was the main factor in the inflationary

<sup>29</sup> In June, the CPI was again surprisingly high at 0.1 percent; most forecasts had predicted a negative or zero index. Housing prices were the main culprit: the outlook spoke of a 1.2 percent decline whereas the actual decrease was 0.5 percent. The recovery in the construction industry evidently offset more of the NIS appreciation had been expected.

Figure 1.10



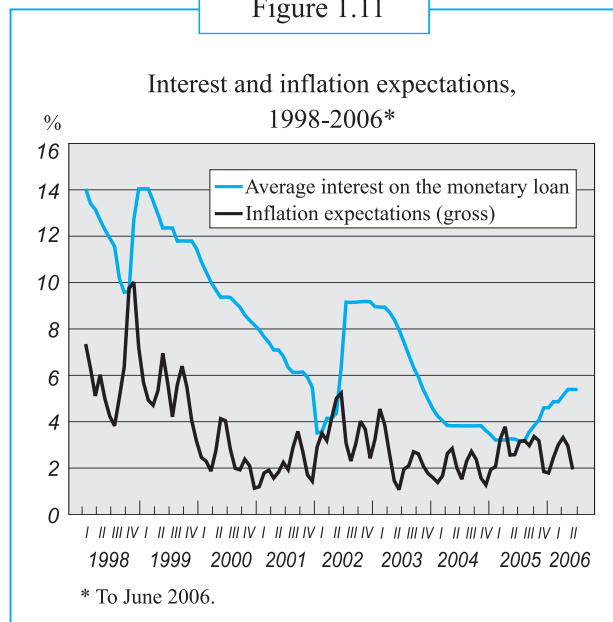
spike that occurred in February and March,<sup>30</sup> a time typified by 2.5 percent currency depreciation, and in the easing of inflation in April and May, when the currency appreciated by 5 percent. The correlation between the housing-price index and the exchange rate supports this claim. In contrast, the continued upturns (beyond the inflation target) in all deflated indices that do not reflect the moderating influence of the exchange rate suggests that: (1) the acceleration of price increases during the review period reflects the consolidation of domestic growth amid the elimination of surplus production capacity, and (2) the increase was strongly affected by the upturns in demand and import prices. The ongoing increase in GDP prices is consistent with this conclusion. Much of the price increase originated in a surge of more than 15 percent in fuel prices in the past twelve months. This, of course, indirectly affects the index by pushing up the prices of electricity, production, and overland, marine, and air transport. The Consumer Price Index net of the effect of fuel prices—an exogenous supply shock that harms manufacturers—is within the inflation target range.<sup>31</sup> In the case of a deviation from the inflation target due to a supply shock, a temporary upward overrun of the target is permissible within the framework of a flexible inflation target so as not to magnify the detriment to manufacturers by dampening demand.

<sup>30</sup> On top of this was a 3 percent increase in intermediates import prices in the first quarter, which contributed 0.25 percentage points to the increase in the index, according to econometric models.

<sup>31</sup> The difference between the index excluding fruit and vegetables and the index excluding fruit, vegetables and energy in the past twelve months is 1 percentage point. This underestimates the impact of energy prices because it fails to take their indirect effect into account.

Inflation expectations to twelve months ahead rose during the review period and peaked in the middle of April at 3.3 percent, surpassing the upper bound of the target (Table 9 and Figure A11). Since then, expectations have been declining toward the upper bound of the target.

Figure 1.11



In view of the emergence from the recession and the continued growth, the Bank of Israel had to shift from a growth-promotive expansionary monetary policy to a neutral monetary policy meant to thwart a price eruption, as is typical of an economy enjoying sustainable growth.<sup>32</sup> After leaving the rate unchanged for eight consecutive months in the belief that it was premature to conclude that the process of inflation upturn had begun, the Bank of Israel gradually raised its announced rate during the past ten months by 1.75 percentage point—from 3.5 percent in September 2005 to 5.25 percent in July 2006. In the first half of 2006, there were three rate hikes—in February, April, and May—a quarter percentage-point each time. The continued dollar depreciation, the upturn in yields on index and unindexed bonds, the relatively low real interest rate (1.9 percent), and the acceleration of economic growth in the third quarter all prompted the Bank of Israel to raise the rate for December by half a percentage point, to 4.5 percent. As the markets calmed and inflation expectations eased, coupled with slight currency appreciation, the Bank of Israel was able to leave the

rate for January unchanged. The process of gradual increase resumed in February with a quarter percentage-point hike as inflation approached the upper bound of the target, the production spread continued to narrow, and the Fed raised its rate. The unexpectedly high index in February, expectations of further high indices in March and April, continued rate hiking in Europe and the United States, and stronger action of the other aforementioned factors induced the Bank of Israel to continue to raise its rate in April and May by a quarter percentage-point each time. The decision to leave the rate unchanged in June and July came about for several reasons, including (1) the belief that the inflation rate for the past twelve months would move toward the target during the months to come; (2) NIS appreciation against both the dollar and the “currency basket”; (3) the new government’s commitment to the continuation of its predecessor’s fiscal policy; (4) inflation outlooks derived from the capital market and from scenarios that the Bank examined by means of econometric models, showing that inflation in the next twelve months would approximate the midpoint of the range; (5) expectations among capital markets and forecasters that the key rate would be raised by about half a percentage point by year’s end; (6) the VAT cut at the beginning of July, which was expected to have a price-dampening effect in the short term; and (7) the increase in labor productivity, which offset the inflationary pressures that originated in increases in business-sector wages. Despite continued rate hiking by the Fed during these months, the Bank of Israel held its rate steady at 5.25 percent until the NIS-dollar interest spread zeroed in July.<sup>33</sup> The rate increases during this time also affected government bonds, as yields on government bonds to all terms to maturity continued to rise in the first half of 2006. Despite the rate increases during the review period, Israel’s real interest environment remains relatively low when viewed from a decade-long perspective.

The decline in short- and medium-term inflation expectations at the end of the period was reflected in a gentle increase in the implicit real interest rate to all terms. Future yields on five- to nine-year bonds remained relatively low at less than 4 percent during the review period.

The *makam* curve responded to the rate increase by showing consistent horizontal upturns over the past year (Figure 1.12). Analysis of future *makam* yields in the past two months shows that expectations of rate increases have eased. Thus, the decline in the slope of the curve at the end

<sup>32</sup> Assuming that the real interest rate should be roughly equal to the rate of growth, and assuming 2 percent annual inflation and 4 percent annual growth, a nominal interest rate of 6 percent per annum is obtained.

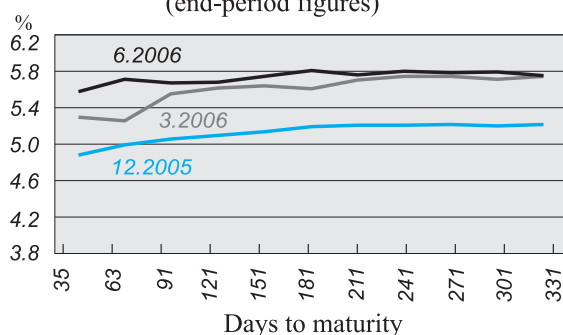
<sup>33</sup> “The Israel-U.S. interest spread, which fell recently to a historically low level, was affected mainly by low expectations of NIS depreciation due to Israel’s persistent maintenance of price stability”—Dr. Yossi Saadon of the Bank of Israel and Professor Nathan Zussman of the Hebrew University of Jerusalem, “Interest Spreads in a Small Open Economy—Long-Term Relationships, the Israeli Case,” June 2006.



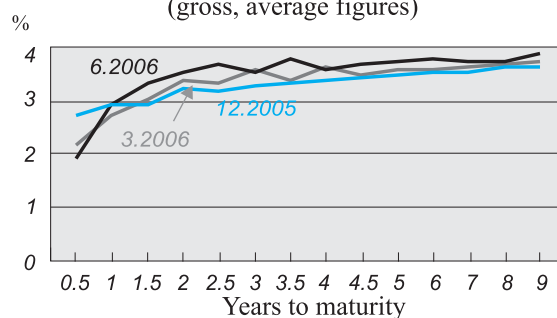
of the review period reflects the decrease in expectations of a short-term rate hike by the Bank of Israel. By implication, no meaningful interest change is foreseen until the last quarter, and even then at only 0.25–0.5 of a percentage point.

Figure 1.12

Treasury bills yield curve, December 2005  
to June 2006  
(end-period figures)



Yield curve of CPI-indexed Treasury bonds,<sup>a</sup>  
December 2005 to June 2006  
(gross, average figures)



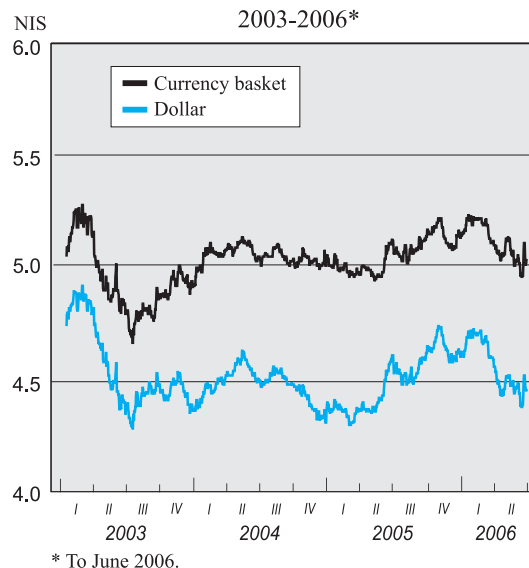
<sup>a</sup> Excluding the yield on CPI-indexed 10-year bonds.

One of the most interesting developments during the review period was the behavior of the **NIS-dollar exchange rate**. The steep appreciation<sup>34</sup> of the NIS against the dollar (and against the currency basket) in the second quarter of 2006 (5 percent and 3.4 percent, respectively<sup>35</sup>) cancelled out the depreciation in the second half of 2005 that brought the dollar to a peak of NIS 4.74 in November 2005 (Figure 1.13). Israel's exchange-rate trend during the review period was the opposite of the trends of most emerging-market currencies, mainly for domestic reasons: in the first quarter, political

uncertainty that was also reflected in operations without an approved budget; in the second quarter, the rapid formation of the new government and the passage of a balanced budget coupled with continued fiscal restraint, which made the Israeli economy more attractive to foreign investors. The NIS depreciation was also abetted by the narrow interest spread and the equalization of tax rates on external investments, as against several pro-appreciation factors: the current-account surplus, the real indicators for the first quarter, the disclosure of the Iscar transaction, and the attractiveness of investment in Israeli high-tech industries. Despite these clashing factors, the foreign-currency market avoided severe volatility during the review period. It absorbed the excess supply and demand amid gentler exchange-rate adjustments that those recorded in other currencies, including the depreciation of the Turkish and Brazilian currencies. In the short term, the various forces will continue to affect the exchange rate in clashing directions. Therefore, there is no clear estimate of where the exchange rate will be heading during this time. Foreign financial institutions expect the NIS to continue appreciating, private forecasters and econometric models predict relative stability, and the Companies Survey shows that most domestic firms expect the NIS to depreciate to NIS 4.57 per dollar by the end of the third quarter of 2006 and NIS 4.70 by the end of June 2007. In view of the strong transmission that exists from the exchange rate to the price index, the inflation rates for 2006 and for the coming twelve months are hard to predict. Even if the NIS loses ground, however, the inflation target may be met by means of an appropriate monetary policy.

Figure 1.13

The NIS exchange rate against the  
currency basket and the dollar,  
2003–2006\*

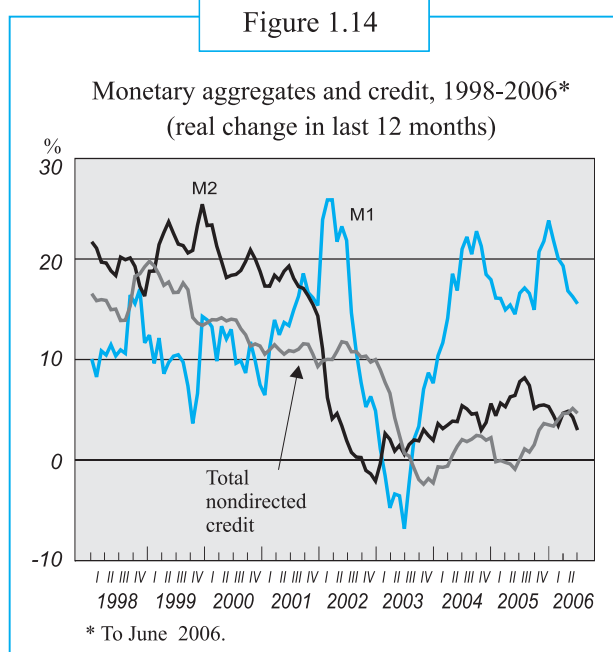


<sup>34</sup> By Israeli standards.

<sup>35</sup> The period of Euro appreciation began on May 30 and ended on June 20. Since depreciation occurred both in early May and in late June, the euro exchange rate at the end of the quarter was hardly affected; as for the dollar, the period of relevance is the entire second quarter.

The **M1 money aggregate** expanded by 6.8 percent in the first half of 2006, slower than the 2005 rate but still more the inflation rate plus the growth rate and the changes in the monetary lending rate (Table 8 and Figure 1.14). With inflation low and interest relatively cheap, the public does not seem to be afraid of holding large-scale unindexed assets. The proportional increase in M1 in the M2 aggregate (from 13 percent at the end of 2003 to more than 18 percent during the review period) reflects the ongoing liquidation of the assets portfolio. Since the end of 2005, however, the share of short-term deposits in M2 has been falling and that of long-term deposits has been rising, the latter climbing from 8.7 percent in December 2005 to 9.4 percent in May 2006. The relatively low level of total bank credit (C3) and its moderate rate of increase over the past year (3.7 percent) reflect, mainly, the redirection of capital raising to nonbank sources, including the stock exchange—both in domestic investment portfolios and in foreign portfolios and foreign exchange. In credit, the unindexed NIS components are expanding at the expense of the indexed and forex components. The stability of credit is characterized by an upturn in raising of capital by means of corporate-bond issues on the TASE at the expense of nongovernmental-bond issues via other channels, which have been declining significantly. Overall, more capital was raised in the review period than in the year-earlier period. The worth of the public's assets portfolio continued to rise during the review period, mainly due to the component of foreign shares.

Figure 1.14



**The capital market.** Until May, the TASE was a surging bear market that peaked with the agreement for the \$4 billion acquisition of Iscar, which prompted several investment houses to improve their rating outlook on Israel. The trend changed in the middle of May as the stock market responded to the falling share prices in international markets generally and those in emerging-market economies particularly. Notably, Israel's rates of decline (5–10 percent) and of increases during the past two years resemble those in Europe and United States and fall far short of the rates of change in emerging-market economies. The steep tumbles in the emerging-market class originate in the transition to an environment of high global interest rates (especially long-term) and the resulting blow to global liquidity: the expectation that the Fed rate would level off at around 4.5–5 percent was set aside as the eurozone rate continued to climb and the Bank of Japan terminated a five-year policy of massive capital injection to the banking system in March 2006. Average daily trading volumes increased in May and June 2006 by more than 40 percent over the average in the previous three months.

In late June, at the end of the review period, prices fell faster on the TASE in response to the security deterioration.<sup>36</sup> During the review period as a whole, the leading indicators were negative<sup>37</sup> with the exception of the real-estate index, which leaped by more than 50 percent between the beginning of 2006 to the middle of May. Afterwards, however, the real-estate index retreated by nearly 18 percent, bringing its estimated cumulative return since the beginning of the year to 24 percent. The question is whether this should be blamed on the rising global interest rates and the weakness of the emerging-market economies or, simply, on the end of a three-year cycle. Israel's positive and stable macro data suggest that the capital market will resume its upward march—depending as usual, however, on the security situation.

<sup>36</sup> The price decreases occasioned by the deterioration of security in southern Israel were relatively mild under the political circumstances. In the past, the stock market reacted more powerfully and recovered more slowly.

<sup>37</sup> The three main shares that make up the TA-25 index that lost considerable ground is being a 2006 are indicative of what happened in January-June: Teva lost 20 percent, Hapoalim ten percent, and Leumi 8 percent.

Table 1. National Accounts,<sup>a</sup> 2005-2006

	2005	2005			2006		2006	Last month for which data available
		II	III	IV	I	II	I <sup>b</sup>	
GDP	5.2	6.4	4.7	5.9	6.0		5.7	Mar
Business-sector product	6.7	7.8	6.4	7.5	7.7		7.3	Mar
Private consumption	3.4	7.4	3.1	2.0	9.2		5.4	Mar
Gross domestic investment	11.5	17.2	24.3	4.5	0.9		11.3	Mar
Fixed investment	2.9	15.8	4.9	10.9	13.3		11.2	Mar
Goods and services exports	5.1	6.0	2.4	-1.4	1.2		2.0	Mar
Goods and services exports								
excl. diamonds	7.5	7.7	8.1	4.4	2.6		5.7	Mar
Goods and services imports	3.5	10.9	-2.6	-9.4	5.1		0.7	Mar
Goods and services imports								
excl. diamonds	5.2	8.9	2.7	-1.1	8.6		4.7	Mar
Public sector consumption	2.7	6.9	-2.3	-0.9	1.6		1.3	Mar
Public sector consumption								
excl. defense imports	1.8	3.3	2.3	1.8	1.1		2.1	Mar

<sup>a</sup> Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.

<sup>b</sup> Compared with 2005:I

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,<sup>a</sup> 2005-2006

	2005	2005			2006		Jan 06- Jun 06 <sup>b</sup>	Last month for which data available
		II	III	IV	I	II		
Composite state-of-the-economy index	3.4	6.7	5.0	5.9	7.2	8.5	6.4	Jun
Large-scale retail trade	5.6	3.8	5.8	9.2	5.3	1.8	5.7	Jun
Manufacturing production								
(excl. diamonds)	4.6	0.2	8.0	4.1	9.0	4.5	5.6	May
Index of revenue in commerce	7.1	4.1	6.3	11.1	5.8	11.8	7.7	May
Index of commerce and services revenue	8.1	4.8	11.6	14.0	7.2	10.1	10.1	May
Index of consumer confidence <sup>c</sup>	1.1	-2.0	0.5	4.6	4.4	10.4	7.4	Jun
Tourist arrivals	26.7	64.7	1.3	15.2	28.1	27.5	21.1	Jun
Residential construction <sup>d</sup>								
Starts	4.3	7.8	29.1	-15.4	13.4		13.4	Mar
Completions	-2.5	0.6	22.3	-20.2	-14.0		-14.0	Mar
Nonresidential construction								
Area of starts		5.9	39.4	-13.4	71.1		71.1	Mar
Survey of companies (net balance, percent) <sup>e</sup>								
Weighted balance of the business sector		23	24	28	39	31		Jun
Output of manufacturing firms	25	23	29	30	38	36		Jun
Sales by trading firms	27	32	26	25	39	31		Jun

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

<sup>b</sup> Compared with January 2005 -June 2005.

<sup>c</sup> The index is the average of two consumer confidence surveys carried out every month: TNS-Teleseker and Globes-Smith.

<sup>d</sup> Change from equivalent period one year earlier.

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

SOURCE: Central Bureau of Statistics.

Table 3. Indicators of Labor Market Developments,<sup>a</sup> 2005-2006

	2006		2005			2006			Last month for which data available
	I	II	II	III	IV	I	II	Jan 06- Jun 06 <sup>b</sup>	
	('000s)		percent change from previous quarter						
Civilian labor force	2,781		1.0	0.6	1.4	-0.2		3.0	Mar
Israeli employees	2,541		1.1	0.7	1.2	0.3		3.5	Mar
<i>Of which:</i> in general government	731		0.3	-0.4	0.5	-3.1		-2.7	Mar
in business sector	1,808		1.7	1.2	1.8	1.4		6.3	Mar
Foreign workers and Palestinians (unadjusted)	389		3.3	-0.3	0.3	1.1		4.4	Mar
Average hours worked weekly per employee	36.3		0.8	-2.4	-1.1	1.1		-1.6	Mar
Labor input in business sector (incl. foreign workers and Palestinians),weekly	85,572		1.3	0.4	-0.9	2.8		3.6	Mar
<i>Of which:</i> Israelis	74,700		0.8	0.5	-0.8	3.1		3.9	Mar
Labor input in general government (Israelis)	17,997		0.7	-2.5	-0.4	-2.3		-5.3	Mar
Unemployed	241		-0.2	-1.2	-0.3	-1.4		-2.2	Mar
Work seekers	221	221	0.7	-1.6	-1.1	-2.0	0.1	-3.9	May
Claims for unemployment benefit	71	70	2.2	0.7	-4.1	1.4	-0.7	-1.3	Jun
	Nominal NIS (unadjusted)								
Real wage per employee post <sup>c</sup>	7,258	7,133	1.3	0.6	-1.9	1.2	0.2	1.2	Apr
In general government	6,714	6,491	0.4	3.0	-3.5	-0.2	1.3	-0.3	Apr
In business sector	7,520	7,440	0.3	-0.3	-0.1	2.1	0.0	1.9	Apr
Nominal wage per employee post <sup>c</sup>	7,468	7,432	1.8	1.8	-0.9	1.7	0.9	4.6	Apr
In general government	6,908	6,763	0.9	4.2	-2.7	0.4	2.4	3.0	Apr
In business sector	7,738	7,752	0.3	1.3	0.9	2.7	0.8	5.2	Apr
Participation rate			55.2	55.2	55.8	55.4		0.9	Mar
Employment rate			50.2	50.3	50.7	50.6		1.5	Mar
Unemployment rate			9.1	8.9	8.8	8.7		-5.6	Mar
Depth of unemployment <sup>d</sup>			43.9	36.6	36.1	36.1		-12.0	Mar

<sup>a</sup> Seasonally adjusted.<sup>b</sup> Compared with January 2005 -June 2005 (unadjusted)<sup>c</sup> Including foreign workers and Palestinians.<sup>d</sup> 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' National Accounts estimates.

Table 4. Foreign Trade, Balance of Payments, and the Reserves,<sup>a</sup> 2005-2006

	2005	2005			2006		Jan 06- Jun 06 <sup>b</sup>	Last month for which data available
		II	III	IV	I	II		
	percent change from previous period <sup>c</sup>							
Trade in goods <sup>d</sup>								
Goods imports	5.2	0.1	0.8	-0.5	3.8	1.1	4.8	Jun
<i>Of which:</i> Consumer goods	7.2	7.0	-2.5	-0.2	7.4	1.6	8.8	Jun
Capital goods	4.3	-0.2	4.6	-5.1	4.7	-4.6	1.4	Jun
Intermediates	5.0	-1.9	0.5	1.1	2.4	3.1	4.7	Jun
Goods exports	7.9	0.6	1.5	-1.3	5.0	9.4	10.5	Jun
<i>Of which:</i> Manufacturing	7.7	1.1	1.8	-1.6	5.1	10.1	11.1	Jun
<i>Of which:</i> High-tech	6.4	5.7	0.4	-0.5	5.2	17.2	17.2	Jun
	\$ million							
Balance of payments								
Goods and services exports	57,874	14,598	15,016	14,384	14,892			Mar
Goods and services imports	57,525	14,583	14,683	14,440	14,458			Mar
Balance of trade in goods and services	349	15	333	-56	433			Mar
Current account	3,756	961	1,702	655	1,738			Mar
Financial account (excl. foreign exchange reserves) <sup>e</sup>	-1,291	-2,169	-533	-1,834	-3,656			Mar
<i>Of which:</i> Nonresidents' direct investment <sup>e</sup>	1,396	1,129	394	2,183	2,333			Mar
Nonresidents' portfolio investment <sup>e</sup>	1,154	711	-168	1,400	8,705			Mar
Residents' direct and portfolio investment abroad <sup>e</sup>	2,239	1,706	2,751	2,257	14,492			Mar
Net foreign debt (precent of GDP) <sup>e</sup>	-18.5	-15.0	-15.7	-18.1	-16.1			Mar
Bank of Israel reserves, end-period <sup>e</sup>	27,858	26,210	27,319	27,858	27,896	27,345		Jun

<sup>a</sup> Seasonally adjusted.<sup>b</sup> Compared with January 2005 -June 2005 (unadjusted).<sup>c</sup> The change relates to the dollar values of imports and exports, not to their volumes.<sup>d</sup> Data on trade in goods do not include ships, aircraft, diamonds, and fuel.<sup>e</sup> Unadjusted data.

SOURCE: Central Bureau of Statistics.



Table 5. Indicators of Economic Development in Advanced and Developing Countries<sup>a</sup>  
(annual rate of change, percent)<sup>b</sup>

	2002	2003	2004	2005	2006	2007 Projection
World GDP	3.1	4.1	5.3	4.8	4.9	4.7
Advanced countries	1.6	2.0	3.3	2.7	3.0	2.8
Developing countries	5.1	6.7	7.6	7.2	6.9	6.6
World trade	3.4	5.4	10.4	7.3	8.0	7.5
Advanced countries						
Imports	2.5	4.1	8.9	5.8	6.2	5.6
Exports	2.2	3.3	8.5	5.3	6.6	6.1
Developing countries						
Imports	6.3	10.3	15.8	12.4	12.9	11.9
Exports	7.0	10.6	14.6	11.5	10.9	10.3
Commodity prices (US\$)						
Oil <sup>c</sup>	2.5	15.8	30.7	41.3	14.8	2.9
Nonfuel	1.7	6.9	18.5	10.3	10.2	-5.5
Inflation (CPI) in advanced countries	1.5	1.8	2.0	2.3	2.3	2.1
Short-term interest <sup>d</sup> (%)						
Dollar deposits	1.6	1.0	1.4	3.2	4.9	5.1
Euro deposits	3.3	2.3	2.1	2.2	3.0	3.4
Unemployment rate in advanced countries	6.3	6.6	6.3	6.0	5.8	5.8

<sup>a</sup> According to World Economic Outlook, Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

<sup>b</sup> Except for unemployment and interest rates.

<sup>c</sup> Average price per barrel in 2005 was \$53.35.

<sup>d</sup> Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), April 2006.

Table 6. Government Budget Performance vis-à-vis Deficit Target, 2005-2006

	2005	2005			2006		Jan 06- Jun 06	Last month for which data available
		II	III	IV	I	II		
Domestic deficit as percent of GDP	-0.6	-1.4	-0.5	-3.8	6.0		6.0	Mar
Deviation from domestic budget path, excl. credit extended <sup>a</sup> (NIS billion)								
Government revenue	-0.8	-1.0	-0.2	0.4	2.9	2.2	4.4 <sup>b</sup>	Jun
Government expenditure	-6.2	-3.4	-0.8	-2.0	-3.6	0.0	2.3 <sup>b</sup>	Jun
Domestic deficit	-5.4	-2.4	-0.6	-2.4	-6.5	-2.2	-2.1 <sup>b</sup>	Jun
Total government surplus (deficit )	-8.4	-4.4	-1.6	-7.1	8.6	-2.3	6.0 <sup>b</sup>	Jun
Percent change from respective period, previous year								
Government tax revenue	5.9	8.3	10.6	1.5	12.6	13.7	11.6	May
Of which: income tax, net	6.6	8.0	10.8	2.9	21.5	25.5	21.3	May
VAT, gross	5.9	8.1	10.6	3.7	11.9	8.9	10.4	Jun
Government expenditure	1.1	4.2	9.0	-6.0	-1.1	7.3	3.2	Jun
National insurance allowances	1.1	1.7	4.6	1.6	4.4	2.9	3.8	May
Of which: Unemployment benefit	-5.9	-3.2	1.6	-0.6	-0.4	-3.3	-2.1	May
Income support	-5.7	-3.5	-3.0	-5.7	-3.9	-5.4	-4.8	May
National insurance contributions received from the public	4.9	4.5	8.1	4.8	2.1	4.2	2.9	May

<sup>a</sup> The path was determined on the basis of a deficit of 3.4 percent of GDP in 2005, and 3 percent of GDP in 2006.

<sup>b</sup> Compared with January 2005 - June 2005.

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

Table 7. Changes in Selected Price Indices,<sup>a</sup> 2005-2006

	2005	2005			2006		Jan 06- Jun 06 <sup>b</sup>	Last month for which data available
		II	III	IV	I	II		
CPI	2.4	1.1	1.4	0.5	0.6	1.0	1.6	Jun
CPI excl. housing, fruit and vegetables	1.8	1.3	0.8	0.2	0.5	2.0	2.5	Jun
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	1.7	0.6	1.6	-0.7	1.5	1.7	3.3	Jun
Index of housing prices	5.9	1.6	3.3	2.1	0.3	-3.2	-2.9	Jun
Wholesale price index	5.2	1.5	1.6	0.9	3.3	2.3	5.6	Jun
NIS/\$ exchange rate	6.2	3.6	1.2	1.6	1.7	-4.6	-3.0	Jun
NIS/currency-basket rate	1.6	1.1	1.2	0.2	2.1	-3.0	-1.0	Jun

<sup>a</sup> Rates of change during period, percent.

<sup>b</sup> Change in last six months.

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2005-2006  
(annual terms, percent)

	2005				2006		Cumulative in previous 12 months	Jan 06- Jun 06	Last month for which data available
	2005	II	III	IV	I	II			
	Changes from preceeding quarter						During period		
M1 <sup>a</sup>	17.5	23.4	24.3	23.6	10.8	7.1	15.6	6.8	Jun
M2 <sup>b</sup>	6.1	6.3	7.9	-0.2	2.8	5.7	3.0	2.7	Jun
M3 <sup>c</sup>	7.9	8.8	14.0	2.6	9.1	6.1	6.2	5.4	Jun
Nondirected bank credit	1.0	0.8	5.7	9.5	0.3	3.9	4.7	2.8	Jun
Unindexed local-currency credit	10.8	6.3	11.9	13.8	7.2	13.9	1.9	8.6	Jun
CPI-indexed credit	-2.6	1.5	6.8	7.8	-2.1	2.3	4.5	2.9	Jun
Credit in and indexed to foreign currency	-7.8	-8.7	-5.6	4.7	-7.7	-10.5	-5.5	-7.4	Jun

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

<sup>b</sup> M1 plus short-term local-currency unindexed deposits.

<sup>c</sup> M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2005-2006  
(quarterly average, percent)

	2005	2005			2006		Jan 06- Jun 06 <sup>a</sup>	Last month for which data available
	2005	II	III	IV	I	II		
Nominal interest on:								
SRO deposits	2.8	2.7	2.7	3.2	3.7	4.1	3.8	May
Nondirected local-currency credit	6.4	6.2	6.2	7.0	8.3	8.4	8.3	May
Effective local-currency credit	3.8	3.7	3.6	4.2	4.8	5.3	5.0	Jun
LIBID 3-month dollar interest	3.4	3.2	3.6	4.2	4.6	5.1	4.9	Jun
Yield to maturity on:								
<i>Makam</i>	4.3	4.0	4.2	4.9	5.5	5.8	5.6	Jun
Yield on 10-year bonds	3.6	3.7	3.5	3.5				Nov
Yield on 5-year bonds	3.0	3.0	2.7	3.1	3.5	3.8	3.7	Jun
Risk premium <sup>b</sup>		0.3	0.3	0.3	0.3	0.3	0.3	Jun
Inflation expectations <sup>c</sup> (gross)	2.8	3.0	3.1	2.8	2.4	2.7	2.6	Jun
General Share-Price Index (change)	33.2	-1.2	13.2	11.7	1.7	-8.4	-6.9	Jun

<sup>a</sup> Compared with January 2005-June 2005.

<sup>b</sup> As measured by the 5-year credit-default-swap (CDS) market

<sup>c</sup> Derived from the yield gap between indexed and unindexed bonds held by tax-exempt institutional investors, minus the x-day effect on the price of the bond.

SOURCE: Bank of Israel.

## Part 2: Broader Review of Selected Issues

### Survey of Charities that Granted Monetary and Material Aid in 2005<sup>1</sup>

One of the fields of activity of nonprofit organizations in the third sector is that of welfare, which includes welfare services and charities that give assistance, whether monetary or in kind, for example, distributing food, medical equipment, household appliances etc. As a result of the downturn in the economic cycle at the beginning of the decade, the increase in poverty and the attention drawn to the issue of food insecurity (see for example the Bank of Israel Annual Report 2005)—while at the same time the erosion of public resources devoted to welfare policies—the matter became uppermost for those charities. Despite this, the information on the activities of these organizations has been meager.

The Research Department of the Bank of Israel conducted a nationwide survey at the end of 2005 of charities that grant monetary or material assistance. The aim of the survey was to examine various quantitative aspects of their activities and the changes over time. A total of 343 non-profit organizations responded to the survey, representing some 30 percent of the total potential population. Efforts were made to reach all the largest charities in Israel and so we can assume that the volume of charitable activities covered by the survey is relatively high, but in the absence of reliable data on the total population of charities and their activities, we cannot estimate the proportion of coverage in the survey.

About three quarters of the organizations surveyed reported that their main activity in 2005 was food distribution, whether through food baskets/coupons or by delivering meals to homes or soup kitchens. The activities of all types of charities (excluding loan provisions) totaled some NIS 360 million, 80 percent of which was for transfers in kind. Compared to 2004 this was an increase of about a fifth.

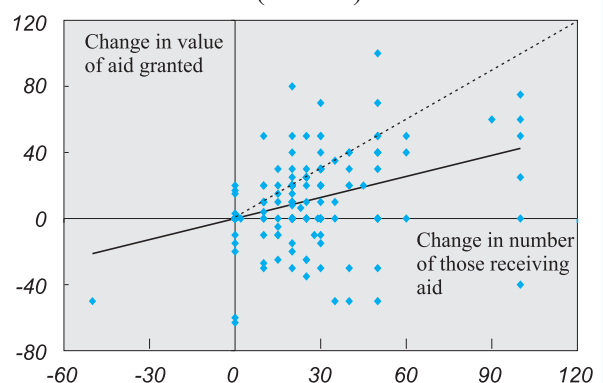
The main criterion for receiving assistance from the organizations surveyed—practiced by two fifths of the organizations—was a referral from a public body (such as the municipal welfare office), while one quarter helped all those in need. The organizations came to the aid of

123,000 people and 48,000 families on average each month, an increase of one fifth on the previous year. The average monthly assistance to a needy individual (excluding interest-free loans) stood at NIS 127.

Figure 1 shows the rates of change in the numbers of those receiving aid and the value of the aid in 2005 compared to 2004. It appears that the growth in numbers receiving aid was greater than the growth in the value of the aid, such that the average value of aid given to the needy fell.

Figure 2.1

Change in Numbers of Those Receiving Aid from, and the Value of Aid Given by Charities in 2005, compared to 2004<sup>1</sup>  
(Percent)



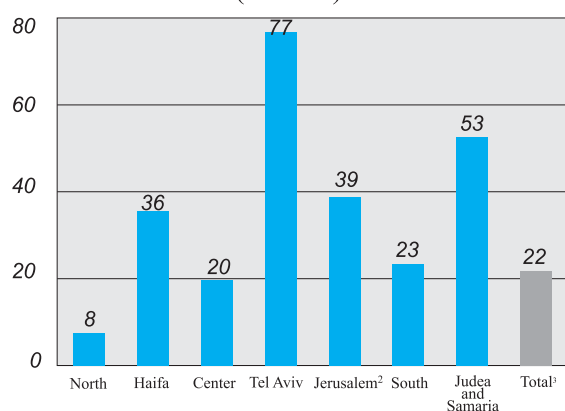
<sup>1</sup> The dotted line (at 45 °) represents where the change in aid given equals the change in numbers of those receiving aid.  
SOURCE: Survey of Charities by Bank of Israel in 2005.

The numbers of those receiving assistance from the organizations surveyed stood at over 5 percent of the total population. Those receiving aid totaled about one fifth of the poor (Figure 2): in Tel Aviv this rate approached 80 percent due to the profusion of organizations there coupled with relatively low numbers of poor. This compared to the northern district, where those receiving aid out of the total poor population was very low, apparently due to the large Arab population in the district, which is characterized, on the one hand, by low levels of activity by charities and on the other by high rates of poverty.

<sup>1</sup> For the full results of the survey (in Hebrew) see the Bank of Israel website [www.boi.gov.il](http://www.boi.gov.il)

Figure 2.2

Those Receiving Aid as Proportion  
of District Poor Population<sup>1</sup>  
(Percent)



<sup>1</sup> Poor is defined as where disposable family income per standardized person is less than half the median income per standardized person. Division by districts is according to that of the CBS.

<sup>2</sup> This does not include East Jerusalem Arabs.

<sup>3</sup> Includes countrywide organizations.

SOURCE: Survey of Charities by Bank of Israel in 2005 and Central Bureau of Statistics.

About one fifth of all those that applied for aid to the charities surveyed were not granted assistance, and two thirds of the organizations noted that this was due to lack of resources. Large families were highly represented among those that were granted assistance. The vast majority of those using the services of these charities turned to them at least once a month, and were helped for long periods (some 80 percent of them for more than six months), which means that for the population in need of assistance, this is an ongoing matter.

Those organizations surveyed were assisted by some 35,000 volunteers each month. Almost one third of the charities had at most five volunteers, while seven of the organizations had the use of more than 500 volunteers. The volunteers contributed on average 15 hours a month, equal to 2,800 full-time jobs a month. About 30 percent of the organizations surveyed employed salaried staff, and the numbers employed reached 1,700.

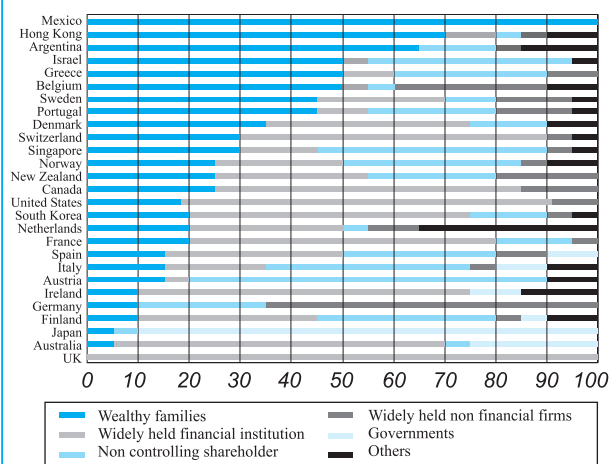
## Conference on Corporate Governance in Israel: What's Best for Supervision

In a conference held on June 12, 2006<sup>2</sup> several issues concerning corporate governance<sup>3</sup> were discussed. The conference covered corporate governance from an international perspective and the best ways to arrange and supervise it, both in terms of companies and regulatory authorities. Corporate governance has many implications for companies and other economic units (the microeconomic effect) as well as significant aggregate implications (the macroeconomic effect). Efficient corporate governance which protects investors from company mismanagement encourages saving and investment in the economy, boosts financial strength and has a positive effect on income distribution among the various sectors of the population.

An international comparison of ownership of large companies (Figure 1) shows a particularly high level of concentrated ownership in Israel: about half the ownership of the large companies is concentrated in the hands of wealthy families, with 40 percent being held by the government and small shareholders holding only a very small percentage of the ownership.

Figure 2.3

Who controls the world's great corporations?



SOURCE: Randall K. Morck and Lloyd Steier.

<sup>2</sup> The conference was organized jointly by the Bank of Israel, the Israel Securities Authority and the Hebrew University, Jerusalem.

<sup>3</sup> Corporate governance is a collection of principles and rules defining the correct behavior for companies in matters of control and supervision.

The concentration of company ownership in Israel is among the highest in the world, with only Mexico, Hong Kong and Argentina having higher concentration than Israel. At the other extreme of distribution is the model of widespread ownership, where the shares are held by non-controlling shareholders, as in UK and the US.

The central question is whether this concentrated model in Israel is desirable. This question can be tackled in several ways: by looking at competition in the market and measuring the ability to bring down the price of financial intermediation and to maximize returns for all shareholders; or by examining the ownership model's contribution to stability of the financial system particularly in whether it ensures financial strength and minimizes risks of crisis; and finally, addressing a recent hot topic, by testing whether Israel's concentrated ownership structure increases inequality of income distribution by creating monopoly rents for the controlling shareholders. One practical question in this context is how much should corporate executives be paid. In addition, it is important to examine the question of regulation and supervision of corporate governance given the concentrated ownership structure of the economy.

A central topic concerning the corporate organization and the desirable corporate governance is the issue of business groups. These groups are legal independent units which sometimes work in various industries and often belong to a family and are managed by members of the family. According to a study by Dr. Yishay Yafeh of the Hebrew University, Jerusalem, presented to the conference, most business groups operate in undeveloped countries although occasionally too in developed countries. Generally business groups operate in countries characterized by weak legal protection for investors. According to the research, the business groups have a positive side: in many cases they stand in for economic institutions that do not otherwise exist; developing financial instruments between business groups could be an alternative source of funds to the local capital market which is often underdeveloped. The business groups also have a dark side, connected to their tendency to channel profits to members of the family as owners of the company, through executive pay and other arrangements, mostly at the expense of the minority shareholders. As a result, a control premium is created: controlling shares are sold at a high price while minority shares are sold at far lower prices. This brings with it high costs of raising capital, low rates of investment and, as a result, a lack of development in the capital market. This exacts a high price in terms of business sector growth.

Another issue concerning corporate governance touches the way in which executive pay is determined and regulated. One solution to the question of executive compensation is to strengthen the power of corporate boards. The US has implemented strict rules in this field as a result of

recommendations following the Enron affair. Research by Dr. Yaniv Grinstein of Cornell University, and presented at the conference, checked the effect of toughening standards on the role of the directors, both through imposing greater accountability on directors and tightening the criteria for appointing members of the board. He found that in firms that followed this path, executive pay fell significantly compared to other companies. The research also found that a more significant arrangement that brought executive pay down was that of filling a board with a majority of independent directors. It was also found that the component of executive remuneration that fell fastest following the toughened new rules was the executive share options.

There are many tools for dealing with desired corporate governance. According to research conducted using a sample of companies in the US<sup>4</sup>, it was found that of twenty-four governance provisions, six were proposed as an entrenchment index for proper governance. Four of these provisions appeared in the companies' constitutions and were intended to prevent a majority of shareholders from having their way (with disregard for the minority shareholders), while two were provisions designed to prevent takeovers of the firm. According to the research, companies demonstrating higher levels of corporate governance, characterized by these six provisions, achieved higher returns for the investors than firms with lower standards of corporate governance.

Concerning corporate governance in Israel, one of the problems is the lack of efficient tools for dealing with conflicts in corporate governance. The committee for setting a code of corporate governance in Israel, appointed by the chairman of the Israel Securities Authority, and headed by Dr. Zohar Goshen, referred to the problems associated with the inability of the legal system to deal with disputes in the financial and corporate worlds. This was due both to a shortage of personnel, shown in the extensions in time taken to resolve the disputes, and a lack of suitable professional experts to deal with technical issues in financial dealings; and this requires highly trained professionals given the many innovations in the financial field in recent years. One of the committee's main recommendations is to establish a court for financial and corporate matters, whose purpose would be to mediate and decide on disputes brought by minority shareholders whose rights are often infringed by controlling shareholders. Another recommendation, presented to the conference by Prof. Eugene Kandel of the Hebrew University, Jerusalem, is to encourage institutional shareholders to hold corporate behavior up to scrutiny, and for this a forum of institutional investors in Israel has been established with the aim to supply material for analysis and detailed information—that would include

<sup>4</sup> The research was conducted by Profs. Alma Cohen, Lucian Bebchuk and Allen Ferrell.



details of the company's corporate governance—in order to support institutional shareholders in taking reasoned, sound decisions when voting on corporate matters. In this way small shareholders can protect their rights ex-ante (before corporate decisions) and this, together with protecting their rights ex-post (after the fact) through customized courts, should reduce the possibility of infringement of their rights by the controlling shareholders.

Regarding the supervision of corporate governance in Israel<sup>5</sup>, apparently the existence of a core of controlling shareholders makes the work of a supervisor easier in several areas of the economy. For example, in light of the heavy concentration in the banking industry, a pivotal industry, there is a clear address one need turn to if one wishes to compel the banks to meet standards of supervision, and this improves the authorities' ability to implement regulations that enforce the stability of the system. However it is not clear occasionally if this advantage is seen in a significant improvement in the work of the regulators in comparison to other tools. This is a focal point in future research plans.<sup>6</sup>

### Family Backgrounds of Part-Time Employees

Like many other economies, Israel witnessed an expansion in part-time employment in recent decades<sup>7</sup>. According to the latest data from the Manpower Survey in the first quarter of 2006, the number of employees in part-time posts increased by 13.6 percent in one year alone (compared to the parallel quarter). This rise in part-time employment is explained mainly by the expansion of employment in services, which relies heavily on part-time positions, and a rise in women's participation rates in the workforce, as women account for the majority of part-time employees<sup>8,9</sup>.

<sup>5</sup> The points raised in this section are based on the conference panel discussion on "Core of Controlling Shareholders", chaired by Prof. Eugene Kandel of the Hebrew University, Jerusalem and with the participation of ISA chairman, Moshe Terry, Supervisor of Insurance, Yadin Antebi, Deputy Supervisor of Banks, Avi Visnovitz and chairman of the Public Companies Association, Danny Goldstein.

<sup>6</sup> Two sessions of the conference were opened by the Governor of the Bank of Israel, Prof. Stanley Fischer and the Director of the Research Department, Dr. Karnit Flug. Other speakers at the conference included Prof. Lucian Bebchuk of Harvard Law School, Davida Lehman-Masser (Deputy Attorney General), Dr. Ira Sorkin (former Northeast SEC administrator) and hedge-fund operator Michael Steinhardt.

<sup>7</sup> For details of part-time employment and proportion of employees in part-time posts in recent years see Box 5.2 of Bank of Israel Annual Report 2005, p.211.

<sup>8</sup> See for example Euwals R. and Hogerbrugge M. (2004), *Explaining the Growth of Part-Time Employment: Factors of Supply and Demand*, IZA DP No. 1124.

<sup>9</sup> In Israel of all part-time employees, 74 percent are women. This compares to 80 percent among part-time employees in the OECD countries (*Woman and Structural Change: New Perspectives*, OECD (1994) Paris).

number of part-time posts is one of the explanations for the growth of poverty. The following analysis was based on Income Survey data from 2004<sup>10</sup> and its aim was to learn the characteristics of part-time employment. The emphasis was mostly on the group of part-time employees with low household incomes, and this was in order to check if part-time employment is concentrated among the poorer population. From the analysis we see that there are few poor families with children among those low-income households with part-time employees. Furthermore, and similar to the findings in the developed countries, part-time employment is a positive factor, contributing to a more flexible labor market, allowing certain sectors of the population, that do not wish or cannot be obligated to full-time employment to enter the labor market.

As the income from part-time employment is relatively low due to the reduced number of hours<sup>11</sup>, the starting point of public debate in Israel was, as mentioned, to determine if the increase in part-time employment was a negative thing. This claim was based on, inter alia, of an entire group of people who are "unwilling part-timers" i.e. those who sought extra work but did not find it. According to the Labor Force Survey data, this group in 2004 constituted 28.5 percent of all part-time employees (26.9 percent of the men and 29.1 percent of the women). For 18.8 percent of part-time employees (most of them in education and health services) part-time work was considered a full-time job<sup>12</sup> whereas the rest—52.7 percent of all part-time workers in the economy—work fewer hours a week through choice due to physical limitations (of sickness or handicap) or through being occupied for much of their time elsewhere, in studies or looking after children or/and the home. This shows that part-time employment is not necessarily a market failure—that is the inability of employers to create full-time jobs—as most of the part-time workers actually do not seek to extend their working week, either temporarily or in the long-term. Part-time work is the preferred option for young people, students, mothers of young children and more mature workers either before or after retirement. Moreover it is reasonable to assume that some of the women employed part-time are not obligated to develop a career or do not seek high-paying jobs with responsibility that demand investment in human capital and

<sup>10</sup> In the Income Surveys of the Central Bureau of Statistics, posts are not categorized so for our analysis, we defined part-time posts as work of 1-34 hours a week in all industries except that of education, where part-time was defined as anyone working less than 20 hours a week. According to this definition, in 2004 around 20 percent of employees in Israel were employed part-time.

<sup>11</sup> In 2004 around 80 percent of all part-time employees and three quarters of all part-time employees in the main working age (25-54) earned salaries of less than NIS 4,000 a month. This compares to 23 percent of full-time employees in the same year that earned less than NIS 4,000 a month.

<sup>12</sup> In other words, in these posts a shorter working day was the norm.

prefer employment that allows them greater freedom of movement in and out of the labor force<sup>13</sup>. This claim leads on to a further claim that among women employed part-time, those from high-income households are disproportionately represented. This requires therefore an examination into the family background of those employed part-time.

In 2004, 38.4 percent of part-time employees declared themselves as the economic head of the household, 35 percent were the spouse of the household head and the remainder (26.6 percent) were other members of the household. Among the households of part-time employees, in 30 percent of them the part-time workers was the sole wage earner, in 47 percent of cases there were two wage earners in the household and in the remaining 27 percent of households, there were three or more wage earners. Table 1 below shows the income distribution<sup>14</sup> of households that include a part-time worker.

**Table 1: Total Income of Households That Include a Part-Time Worker, by Status of Worker in Household (percent)**

Total household income (NIS)	Group as percentage of total households with part-time worker	Part-time worker is head of household	Part-time worker is spouse of head of household	Part-time worker is other member of household
Up to 2,000	2.1	4.9	0.2	0.5
2,000-3,999	10.7	25.6	1.4	1.4
4,000-5,999	13.5	26.2	5.5	5.7
6,000-7,999	11.8	13.6	11.9	9.0
8,000-9,999	10.7	9.2	12.8	10.1
More than 10,000	51.2	20.6	68.1	73.5
Total	100.0	100.0	100.0	100.0

The data in the table shows that more than half of all households that include someone with a part-time job are comfortable or wealthy, and only 13 percent of households with a part-time worker live on total income of less than

NIS 4,000 a month. The picture that emerges from the data shows that the problem with part-time employment is with those households that rely on the part-time worker for their sustenance. Some 30.5 percent of all households where the part-time employee is the head of the household have a total household income of less than NIS 4,000 a month and a further 26 percent have total household income of between NIS 4,000 and NIS 6,000 a month. In contrast, the number of low-income households where the part-time worker is not the economic head of the household is negligible; most of the households where the part-time worker is not the head of the household are wealthy households with total monthly income of more than NIS 10,000.

Now we will try to characterize those households with part-time employees whose household income is less than NIS 4,000 a month, and it is important not only to ask what is the total household income in these cases but what is the income per capita. In 2004, a considerable proportion of these households were of young individuals with no children; 44 percent were single-individual households. Some 65 percent of part-time workers whose total household income was less than NIS 4,000 a month were unmarried. Forty percent were aged 18-24 and 26 percent were aged 25-34. In only 15 percent of low-income households with part-time workers were there children under the age of 17. Possibly a large proportion of these households were of students living away from the family home, which is supported by the fact that 44 percent of all part-time workers living in households with a total monthly income of less than NIS 4,000 had 13-15 years of education, and furthermore, some 57 percent were employed as clerks, agents or sales and service staff. Labor Force Surveys also support this claim, as they show that 18.3 percent of part-time workers cited studies as their reason for choosing part-time employment (30.1 percent of the men, and 13.9 percent of the women). For students a low income does not point to poverty, and is a passing stage that may last only a few years. In contrast, the problem group is that of poor households with children. One quarter of households with a part-time worker with monthly household income below NIS 4,000 counted two individuals, a further 31 percent counted three or more persons in the household<sup>15</sup>, while only 4.3 percent were single-mother households.

We add and note that among households with low-income part-time employees there are almost no Arab households; 96.4 percent of these households are Jewish or Other. Some 28 percent of them are households of immigrants from the 1990s or later.

<sup>13</sup> See Hakim c. (1997, p.43) "A Sociological Perspective on Part-Time Work" in Blossfeld and Hakim (eds.), *In Between Equalization and Marginalization: Women Working Part-Time in Europe and the United States of America*. Oxford: Oxford University Press, 22-70.

<sup>14</sup> This includes capital income, pensions, institutional support, advanced training funds, income from private individuals, from overseas and National Insurance welfare payments.

<sup>15</sup> Nevertheless, these households accounted, by weight, for only 7 percent of total households with a part-time worker.

### Diary of Events from January–June 2006

Month	Date	Event	Details
January	10	The minimum threshold increase for IPOs on the Tel Aviv Stock exchange is raised.	The minimum threshold value of the public's holdings ("floating shares") in corporate IPOs is raised from NIS 8 million to NIS 16 million. This means that henceforth any new company will have to raise at least NIS 16 million from the public. The increase was made due to the recommendations of the Hauser Committee, which discussed the need to make the Tel Aviv Stock exchange more tradable. In February, the value of floating shares in corporate IPOs will be raised to NIS 20 million.
	18	An NIS 40 million assistance fund for small businesses in the Arab sector is activated.	The need to establish a fund for the Arab sector was taken up due to complaints about barriers that prevented small businesses in the Arab sector from receiving aid. Within the framework of the fund, the state creates bank deposits that serve as collateral for bank loans to small businesses.
	23	The Knesset Finance Committee approves by majority vote a Ministry of Finance proposal concerning banks' distribution charges.	The approval was given four and a half months after the Minister of Finance first presented the regulations. The approval of the regulations, worded as the government proposed and as the Finance Committee discussed on many occasions, completes the legislative process relating to the Bachar capital-market reform.
			The Mutual Cooperative Investment (Distribution Charge) Regulations and the Supervision of Financial Services (Provident Funds) Regulations determine the method of charging and the maximum sum that banks will be allowed to charge the managers of mutual, provident, and pension funds for the distribution of their products.
	24	The Director General and Deputy Director General of the National Insurance Institute unveil an antipoverty program.	The budget of the proposed program is NIS 3 billion per year. The purpose of the program is to reduce the share of poor households in Israel by 10 percent, mainly by means of a negative income tax.
	27	Hamas wins the Palestinian authority elections.	
Feb.	9	The Bank of Israel will expand the monetary activity that takes place by means of "repo" transactions.	The level of such transactions will be raised from NIS 200 million (par value) to NIS 500 million. The term of the transaction will be shortened from two weeks to one. The frequency of transactions will increase: once per week instead of once every two weeks.
	16	Securities regulations requiring public corporations to keep their investors abreast of changes are approved.	The new rules include reporting about material events that occur after the publication of periodic statements; the expansion of compulsory reporting that applies to banks, insurance companies, and dual companies to holding companies; and the inclusion of disclosure of transactions by companies and principals.
	21	The banks reduce their business hours due to prolongation of the business day.	

Month	Date	Event	Details
	23	The Acting Prime Minister and the Minister of Finance approve the plan that proposes to narrow social disparities.	The plan envisages a negative income tax as a way to narrow social disparities.
March	2	The Supervisor of Banks presents the Knesset Finance Committee with his first-ever report on acts of embezzlement that were reported to him in 2005.	According to the report, the Supervisor of Banks in 2005 was informed about twenty-one acts of embezzlement, adding up to NIS 7.5 million.
		The Finance Committee approves to privatization of both of Israel's refineries—in Haifa and in Ashdod.	
	10	Japan ended the monetary policy it had followed during the last five years, which was intended to overcome deflation.	As a result of the change, credit to banks was slashed by 80 percent.
	17	World Bank: the Palestinian Authority is on the verge of an economic depression.	The main reason, according to the World Bank, is that Israel has stopped injecting funds to the PA as a consequence of Hamas' accession to power.
	27	The interest rate for April is raised to 5 percent, an increase of 0.25 percentage point.	The rate is raised in order to preserve price stability within the government's inflation target range, 1–3 percent. The rate hike is the second in the past three months. The rate for February was also raised by a quarter percentage-point; that for March was left unchanged.
	28	General Knesset elections take place.	The results (expressed in number of mandates): Kadima 29, Labor 19, Shas 12, Likud 12, Yisrael Beiteinu 11, National Union-NRP 9, Gil (Pensioners) 7, United Torah Judaism 6, Meretz 5, Ra'am-Ta'al 4, Balad 3, Hadash 3.
		The Fed raises its key rate for the fifteenth straight time.	Although Chairman Alan Greenspan retired and was succeeded by Ben Bernanke, the policy of regular rate-hiking remains in effect. The new interest rate is 4.75 percent.
	29	French trade unions carry out a one-day general strike in order to generate pressure for the repeal the "Employment Law."	The new statute pertains to workers under age 26 who are hired for a two-year trial period. It allows employers to fire such workers with neither explanation nor notice. The purpose is to bring down the high unemployment rates in the 18–25 age group
April	2	The Bank of Israel presents its 2005 Annual Report to the President of Israel.	The main goal of economic policy in the years to come is to create the conditions that are needed for sustainable growth, in order to enhance the welfare of the public at large and allow the country to tackle its social problems.

Month	Date	Event	Details
	3	The Research Committee, chaired by the Chief Scientist of the Ministry of Industry, Trade, and Employment, Dr. Eli Ofer, approves thirty-three R&D plans in electronics, optics, and software, adding up to NIS 144 million.	The committee reviewed fifty-seven R&D plans for which NIS 339.8 million in investment funds were requested. The committee approved thirty-three new R&D plans at an investment of NIS 144.7 million, of which NIS 59.5 million will be forwarded to companies in the form of R&D grants from the budget of the Chief Scientist.
	10	The Supervisor of Banks, Yoav Lehman, sends the banks a draft directive ordering them to amend clauses in their standard contracts.	The main deletions that the Supervisor of Banks ordered the banks to make in their contracts include any provision that absolves the bank of liability for unauthorized actions taken in the customer's account and any provision absolving the bank or any third party of liability for the transfer of any information from the bank to a third party in the course of service, or the use thereof. The directive also limits the banks' exemption from liability after mishaps and disruptions that affect service.
	11	The Acting Prime Minister and the Minister of Industry, Trade, and Employment sign a new free-import order that replaces the one enacted some thirty years ago and amended many times since in a patchwork manner. The new order provides relief to importers.	The changes in the new order: a list of officials to contact at the various ministries in, the deletion of dozens of products from the licensing requirement, the repeal of compulsory licensing for imports from several states that do not have diplomatic relations with Israel, the repeal of compulsory "Class A" marking on suppliers' invoices, and compulsory licensing of goods identified as being factors in terrorism or that may endanger the public.
May	4	The 31st Government, headed by Ehud Olmert, is presented to the Knesset and receives the Knesset's vote of confidence.	The Government is based on a coalition among Kadima, Labor, Shas, and the Pensioners.
	6	Berkshire, Warren Buffett's investment fund, acquires an 80 percent stake in Iscar for \$4 billion.	The company's plants are situated in the Tefen industrial area, in the Western Galilee. The tax to be collected on the transaction is estimated at \$1 billion.
	15	The committee that investigated barriers to small and medium businesses in government procurements presents its report to the outgoing Director General of the Ministry of Industry, Trade, and Employment, Ra'anun Dinur, and to the Accountant General, Dr. Yaron Zelikha.	The committee's report includes a mapping of barriers to the participation of small and medium businesses in government procurements, a survey of the global state of affairs in this field, solutions that selected countries have applied, and recommendations from committee members that can be applied in Israel.



Month	Date	Event	Details
	22	The Ministry of Finance adjusts its 2006 growth outlook to 5.3 percent.	After the Central Bureau of Statistics released its initial estimate of rapid growth in the first quarter of 2006, and in view of current economic indicators that point to continuation of the growth process, the Ministry of Finance adjusts its 2006 growth outlook to 5.3 percent as against the 4.1 percent outlook that it released in February.
	28	The Vice Premier and Minister of Industry, Trade, and Employment, Eli Yishai, instructs his ministry's legal bureau to distribute a legislative memorandum for an amendment to the Minimum Wage Law, enshrining in legislation the raising of the minimum wage as agreed in the government's basic guidelines.	According to the basic guidelines, a target should be established by which the minimum wage shall be raised during the tenure of the current government to NIS 4,600 (\$1,000) per month. In the first stage, the minimum wage (as it existed on April 1, 2006) is to be raised by NIS 500, in three phases: (1) half of the increment during the current fiscal year and no later than June 1, 2006; (2) one-fourth of the increment on April 1, 2007; and (3) on June 1, 2007
	30	The Central Bureau of Statistics releases the International Monetary Fund's recommendations, part of a report produced by the IMF delegation when it visited Israel in November 2005 to examine the quality of Israel's economic and financial data.	The main recommendations: <ul style="list-style-type: none"> <li>• The central Bureau of Statistics, the Bank of Israel, and the Ministry of Finance should improve their coordination.</li> <li>• Israel should generate its monetary statistics on the basis of a recommended method and international standards</li> <li>• Though should be given to releasing the Consumer Price Index earlier and separating it from the Wholesale Price Index, in order to better serve users' needs.</li> </ul>
	31	The Accountant General reports that the government will issue its first thirty-year bonds in June. The bonds will be indexed to the CPI and will pay fixed interest.	This prolongation of the yield curve is expected to have several favorable outcomes, such as responding to the needs of pension funds and insurance companies, which incur long-term liabilities, and applying instruments that are conventional in other markets in developed Western countries.
June	7	The Knesset approves the state budget.	The 2006 state budget is NIS 271.4 billion.
	18	The banks release their first quarter 2006 earnings.	The earnings of the five largest banks were about 39 percent larger than in the year-earlier quarter.
		The government bond market reform gets underway.	In the reform, bonds will be sold directly to a list of twenty "market makers," who undertake to buy a certain amount of bonds each year and to quote buy and sell prices for some government bonds. This will make the government-bond market more liquid.
	26	The key rate for July 2006 will remain at 5.25 percent.	The rate for June was also left unchanged, after the quarter percentage-point increase in May. The decision not to touch the interest rate is consistent with the attainment of price stability within the 1–3 percent target range.
	29	The Fed raised its key rate by a quarter percentage-point, to 5.25 percent.	This is the Fed's seventeenth consecutive increase. In its aftermath, the NIS–dollar interest spread has fallen to zero.