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# RECENT ECONOMIC DEVELOPMENTS\*

## Main developments

Indicators of economic activity show that from April to September 2000 (the period reviewed) economic growth which had started in 1999:II continued, albeit more slowly. With the expansion in activity, there was a significant rise in the number of persons employed, and an improvement in the current account.<sup>5</sup> In the first half of 2000 GDP rose at an annual rate of 5.6 percent from its level in the equivalent period in 1999, and according to initial estimates the growth rate for the whole year is expected to reach 5.8 percent,<sup>1</sup> with even faster growth in the business sector. At the beginning of the period reviewed the rise in activity was based mainly on high-tech industries responding to the increase in demand abroad and on expansion in the trade and services industries. The Bank of Israel's quarterly Survey of Companies indicates that towards the end of the period (in 2000:III) activity continued expanding, with a slowdown in exports and an increase in domestic sales. The rise in prices in the period reviewed was not uniform, and came to an annual rate of 1.5 percent, the result of a rise in 2000:II and a fall in 2000:III.

The indices of activity show that growth was not reflected as a monotonic rate of expansion. The state-of-the-economy index, which fluctuated at the end of 1999, accelerated in the first half of 2000, but moderated in 2000:III. This was due to the slowdown in the growth of exports, which had hitherto made a significant contribution to the rise in output of the principal industries in general, and high-tech in particular, and which had been in the forefront of economic expansion, with an increase in the number of employed persons. The deceleration of exports was apparently due to the strengthening of the NIS and the contraction of the

number of incoming tourists. It is too early to say whether this is a reversal which will result in low growth rates, or just a correction to the steep increase in 1999. The security-related events of the last few weeks will probably cause a sharp drop in tourism, and reduce exports to the Palestinian Autonomy, which account for some 5 percent of exports, thus leading to a further deceleration in exports. An analysis of the use of resources shows that a) in addition to the slower rise in exports, private consumption rose mainly the purchase of consumer durables, which became more worthwhile due to the appreciation of the NIS and the cuts in purchase tax, b) gross domestic investment was 24.2 percent higher in 2000:II than in the previous quarter, largely due to a considerable rise in diamond inventories, and c) public consumption, which had risen by 3 percent in the first half of 2000 from its level in the first half of 1999, is expected to rise by 2.7 percent in the whole of 2000 (preliminary estimates).

Recovery from the recession was not reflected in the construction industry, which continued contracting in the first half of 2000, albeit more moderately than in 1999. Nevertheless, there were signs that the industry started to recover in the period reviewed, and according to the Bank of Israel's Survey of Companies for 2000:III, the number of construction companies reporting a rise in the extent of work carried out exceeded those in which it continued to contract. This industry, which led the recovery from the recession in 1988–89, has only now started showing signs of recovery, and the current rate of growth in activity is determined by the high-tech industries (see Box).

Regarding fiscal policy, there was a government surplus in the period reviewed—a deviation from the deficit path derived from seasonal budgetary developments in the last few years and the deficit target. This surplus reflects an unexpected increase in tax revenues arising mainly from a surge in income tax receipts while the (nominal) level of government expenses was as forecast.<sup>2</sup> Thus, despite the customary large share of government

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

<sup>5</sup> This review relates to the period prior to the latest outbreak of security incidents.

<sup>1</sup> The political and security developments at the end of the period reviewed have an immediate effect on demand, and are likely to slow down activity in various industries, but at this stage it is impossible to estimate how long they will continue, or their effect on future growth.

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<sup>2</sup> Nominal expenses in the budget include a price reserve (of 3 percent); as inflation was lower than expected, this means there was a real deviation from the predicted path of expenses.

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expenses in total expenses in December, it is reasonable to assume that the deficit for 2000 will be considerably below the maximum planned deficit. In August the government set the maximum deficit for 2001 at 1.75 percent of GDP, and it was agreed that the target would be reduced gradually until the European standard, as specified in the Maastricht Treaty, is achieved. The reduction of the deficit and the rapid growth of GDP lowered the debt/(gross) GDP ratio in the first half of the year to 99 percent, the lowest level for 15 years.

The CPI went up by 1.5 percent in the period reviewed (annual rate), having risen by 6.6 percent in 2000:II and

fallen by 3.3 percent in 2000:III. Twelve-month inflation expectations, which were at an average level of 2.6 percent in 2000:I, rose in 2000:II to the target level (3–4 percent), but declined again in 2000:III to below the lower limit of the target range, due to the strengthening of the NIS and the cuts in purchase tax. The rise in fuel and oil prices in the last few months are likely to raise the CPI in the future by increasing prices of electricity and transportation, but at this time it appears that according to actual inflation, inflation expectations, and inflation forecasts, inflation in 2000 will be below the lower limit of the target.

**Table 1. Indicators of Business Activity, 1998–2000**

(all data excluding construction are seasonally adjusted)

	1998	1999	1999		2000			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	1999	2000	
<b>Rates of change (annual averages, percent), compared with preceding quarter</b>										
State-of-the-economy index	3.0	2.9	15.6	-2.0	9.2	13.6	5.5	1.0	7.9	9
Large-scale retail trade	6.4	4.3	12.9	-1.6	13.8	22.3	9.3	3.4	11.0	9
Manufacturing production (excl. diamonds)	2.7	1.3	21.9	2.4	15.7	16.4	0.0	0.1	12.3	8
Business-sector consumption of electricity	2.5	2.8	16.8	16.5	7.5	-0.1		-5.9	10.0	6
Index of revenue in commerce	0.8	4.6	20.9	11.8	4.0	19.4	7.2	3.5	12.7	8
Index of total revenue	3.4	6.3	18.2	17.5	6.0	10.5	9.3	5.0	12.4	8
<b>Rates of change (percent), compared with preceding quarter</b>										
Tourist arrivals	-5.7	16.5	11.4	5.3	5.5	-2.3	-5.1	11.7	13.4	8
Immigrant arrivals	-15.4	35.5	47.8	9.7	-44.0	-3.7	15.2	39.8	-22.2	8
Residential starts	-21.2	-7.3	16.0	-10.5	18.8	-2.3		1.0	20.6	6
of which: Government-initiated	-44.4	3.0	38.0	-36.4	47.9	22.6		16.3	59.3	6
Residential completions	-21.6	-13.4	13.8	2.0	-1.0	-9.9		-30.0	3.5	6
of which: Government-initiated	-22.7	-4.7	7.6	-6.3	-37.8	7.4		-28.7	-32.7	6
<b>Survey of companies (net balance, percent)<sup>b</sup></b>										
Product of manufacturing firms (not adjusted)	-8	9	18	20	4 <sup>c</sup>	25	26			9
Product of manufacturing firms (adjusted)	-8	9	14	14	15	23	15			9
Sales by commercial firms (not adjusted)	-13 <sup>c</sup>	12 <sup>c</sup>	26	9 <sup>c</sup>	5 <sup>c</sup>	19	22			9
Sales by commercial firms (adjusted)	-14 <sup>c</sup>	12 <sup>c</sup>	7 <sup>c</sup>	25	6 <sup>c</sup>	25	-8 <sup>c</sup>			9

\* Last month for which data available.

<sup>a</sup> Compared with same period in preceding year.

<sup>b</sup> Difference between the number of firms reporting a rise and those reporting a fall, as a percentage of all reporting firms.

<sup>c</sup> Denotes non-significant result at 5 percent level.

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

	1998	1999	1999		2000			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	1999	2000	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	2.4	2.3	5.3	6.0	4.1	5.7		2.0	5.3	6
Business–sector product	2.6	2.0	7.1	7.8	6.0	8.3		1.4	7.3	6
Private consumption	3.5	3.4	12.1	-1.1	5.2	5.4		1.5	5.3	6
Gross domestic investment	-7.4	10.7	-4.0	1.8	1.1	24.2		24.9	5.2	6
of which: Investment in start-up companies (percent of GDP) <sup>b</sup>	0.5	2.5	0.4	1.5	0.8	0.8				6
Goods and services exports	6.3	10.1	23.9	23.1	28.5	9.4		1.4	21	6
Goods and services imports	1.8	14.6	18.5	13.0	17.3	-1.4		11.5	11.6	6
General government consumption	2.7	2.9	3.2	5.2	-4.9	-13.4		3.0	-2.8	6

\* Last month for which data available.

<sup>a</sup> Compared with same period in preceding year.

<sup>b</sup> Unadjusted data, percent of annual GDP. Data for 2000 are initial estimates.

Labor market indicators point to continued expansion of demand for workers in both the business sector and general government. The number of employed persons continued rising rapidly, with an increase in the share of full-time employees. The rise in the number of persons employed was most notable in high-tech industries (a large part of whose output derives from demand from abroad), but was also significant in other industries such as hotel and tourist services. Nevertheless, the rate of unemployment did not fall, due to the rise in the civilian labor force. The real wage rose at an annual rate of 6.6 percent in the first half of the year, and especially rapidly in high-tech industries, where the demand for labor exceeded supply.

In the period reviewed monetary policy was directed towards anchoring inflation at its low level, while the nominal rate of interest was reduced by a total of 1 percentage point. The lowering of the rate of interest by the Bank of Israel, which has continued since the beginning of 1999, stopped in April for three months as inflation expectations rose, partly due to the accelerated depreciation of the NIS. The weakness of the NIS stemmed from a significant reduction in the extent of stock issues abroad by Israeli companies as a result of the fall in stock prices of technology and internet companies in the New York exchanges, and due to the publication of the recommendations of the tax reform committee, which made investment in the NIS less attractive and prompted many to purchase foreign currency.

The relatively low rate of price increases in 2000:III, due partly to appreciation of the NIS, reduced inflation expectations to below the target level. In that period the Bank of Israel continued to lower the rate of interest, while keeping a watchful eye on the differential in interest rates between Israel and abroad, which kept on narrowing also due to the rise in interest rates abroad. In 2000:III inflation expectations declined faster than did nominal interest, so that expected real interest rose. The boom which had characterized the domestic capital market in 1999 came to an end in the period reviewed as a result of shocks which affected the US capital markets, and the general share price index rose by 5.6 percent in that period, far less than in the previous half year.

### The principal industries

Indicators of economic activity suggest a slowdown in the rate of growth in 2000:III, after the rapid growth which began in the first half of the year. The state-of-the-economy index surged by 7.9 percent in the period reviewed, with a steep rise in 2000:II and a more moderate one in 2000:III. The main slowdown at the end of the period reviewed occurred in manufacturing industries, with the index of industrial production, which rose by an average of 16.2 percent in the first two quarters, remaining unchanged in the third quarter. A similar trend was evident in the index of revenue in trading industries. The total revenue index, which covers

also the service industries, continued its rapid rise throughout the period reviewed, and rose at a rate of 12.7 percent in the period. Revenue data show that in the trade and services industries the rapid rise in wholesale trade and in business services were particularly marked, while the real estate industry was notable due for its slow rate of growth.

It can be seen from the National Accounts data that the accelerated growth evident in the second half of 1999 continued in the first half of 2000. On the sources side, the business sector gross product was the main contributor to this growth: according to seasonally adjusted data, in the first six months of the year it rose at an annual rate of 7.9 percent, after rising by 7.2 percent in the previous half year. The rapid increase in business sector product reflects expansion in manufacturing industries and R&D activity in start-up companies, whose added value accounts for some 2 percent of GDP (Table 2). On the other hand, imports of goods and services rose steeply with the start of the accelerated growth, and contracted in the last few months—in 2000:II imports went down by 1.4 percent, after rising at an average rate of 15 percent in the previous two quarters. On the use of resources side, private consumption continued rising for the second successive quarter; according to trend data it rose by 5 percent, annual rate, in the first half of 2000, meaning a rise of 2.5 percent in per capita consumption. This rise reflects a sharp increase in purchases of consumer durables, as buying them became more worthwhile as a result of the rapid appreciation of the NIS. Gross domestic investment, which serves as an indicator of future activity, rose by 24.2 percent from 2000:I to 2000:II, an increase which derived mainly from a marked rise in stocks of diamonds. Exports of goods and services, which provide the main impetus for growth, increased by 21.3 percent in the first half of the year, mainly due to the large rise in manufacturing exports (mainly high-tech) and tourist entries. An analysis of exports by quarter shows the moderate rate of increase in 2000:II compared with the previous quarter, and it appears that this trend continued in 2000:III too.

The index of manufacturing production rose at an annual rate of 11 percent in the first eight months of the year, according to trend data, and in the last few months it rose more slowly than at the beginning of the year. Within the principal industries, the rapid growth of output of the high-tech industries continued in 2000:II, with a moderate increase in the other industries. The index of manufacturing production in the electronic equipment industry, which constitutes the largest share

(about a fifth) of the index, rose by 12.1 percent from the first quarter to the second, reflecting inter alia the increase in production of the Intel factory in Kiryat Gat to maximum capacity. The development in high-tech industries was accompanied by a 5.6 percent rise in production of the mining and non-metallic minerals industry, which is consistent with the positive trend evident in the rate of building starts, after a decline which continued for five successive quarters mainly due to the contraction of the construction industry. The output of the textile, clothing, and leather industry, and that of the food, beverages, and tobacco industry is still marking time, and in 2000 have been noted for their instability: sharp declines in 1999:IV, slight increases at the beginning of 2000, and reductions again in 2000:II.

The Survey of Companies shows that the upward trend in activity in most of the principal industries persisted in 2000:III. The rising trend in the output of manufacturing companies continued, with domestic demand increasing its share of total demand. Activity in transport and communications went on rising for the third successive quarter, and covered nearly all spheres, civil aviation, communications, and shipping. Trading companies, however, reported only a seasonal increase in sales, while the constraints on the expansion of sales, on both the demand and supply sides, worsened.

The Survey of Companies also shows that there was a turnaround in the construction industry in 2000:III, as companies reported a rise in the implementation of building projects. The long-drawn-out contraction in the construction industry slowed in the first half of 2000, as the rate of decline of construction investment amounted to 5.4 percent in that period, a smaller decline than in 1998 and 1999. The number of months of supply—(calculated as the total number of apartments for sale at the end of a month divided by the number sold in that month), which serves as an indicator of activity in the construction industry—stopped rising, and the figure for 2000:II was 12.8 months, the same as the average for 1999. The number of residential building starts, which affects future activity and expresses contractors' expectations regarding continued growth of activity, increased 11 percent higher in the first half of the year than in the previous half year, in both the public and the private sectors. At the same time the number of residential building completions rose by 5.3 percent. The demand side of the industry also showed some recovery, and in the first half of 2000 there was a real rise of 9 percent in mortgages taken up, despite the fact that average real interest on mortgages was 6.9 percent in that period, about half a percent higher than in the

previous year. The number of apartment sales provides another indicator of demand in the industry, and purchase-tax data show that in the first half of 2000 the number of apartments sold went up by 6 percent compared with the first half of 1999, and fell by 14 percent compared with the second half of 1999. (The number of apartments sold in December 1999 was exceptional, due to expectations of changes in purchase and sales taxes.)

The number of tourist bed-nights (seasonally adjusted) was highly volatile in 2000. In 2000:I it rose steeply, mainly due to the visit by the Pope in March; in 2000:II the trend was mixed, with indications of a rise at the end of the quarter; and in 2000:III there was a continuous decline in bed-nights of tourists and also Israelis. In October the security situation in Israel deteriorated, and this had an immediate effect on the hotel and tourist industry. If the current situation prevails, the number of tourist entries will drop significantly, as will internal tourism, so that a slowdown in the growth of the business sector's gross product is to be expected.

### The labor market

In 2000:II the number of employed persons rose by 1.6 percent from the level in the previous quarter. This reflects the continued recovery in the demand for labor—a trend which started in 1999:IV, but slowed in 2000:I. The recovery was also reflected in a rise in labor input of 2.2 percent, average, and an increase of 0.7 percentage points in the share of those in full-time employment. Nevertheless, the rate of unemployment in 2000:II rose slightly, by 0.1 percentage points, to 8.6 percent of the civilian labor force.<sup>3</sup> The reason for the fact that unemployment did not fall is that the rise in the civilian labor force exceeded the total rise in the number of employed persons. The rate of participation in the labor force rose by half a percentage point in 2000:II, to 54.5 percent (seasonally adjusted), the highest rate for a long time.

The number of employed persons in the business sector rose at the same rate as the total number, following the rapid rise in this sector in the previous two quarters. Within the sector, together with the increase in the advanced industries, the number of employed persons in industries which are not high-tech, such as hotel and

catering services, also rose, to some extent reflecting a rise in the standard of living and the boom in tourism. On the other hand, employment of Israelis in construction continues to contract, so that their share of total employed persons in the first half of 2000 fell by 6 percentage points to 5.1 percent. A similar trend is evident in agriculture, where there was a cumulative reduction of 7.2 percent in the number of employed persons since the beginning of the year. The number in general government rose by an exceptional 3.3 percent, after falling by 1.2 percent in the previous quarter. This increase is based on a marked rise of 16.9 percent in employment in public administration, in contrast with a contraction in health, welfare, and nursing services and in community services by 0.3 percent and 4.5 percent respectively.

Labor input of Israelis rose by 3.1 percent in the first half of 2000—2.4 percent in the business sector and 3.3 percent in general government. The rise derives from the increase in the number of employed Israelis combined with a small decline in the number of weekly hours worked per employee. This is characteristic of an economy emerging from a recession: initially the working week gets longer, due to uncertainty regarding the new conditions of demand and the length of time taken to recruit new workers, and thereafter, as the rise in activity is consolidated, new employees are recruited and the number of hours per employee are reduced. The rate of participation among immigrants (since 1990) reached 57.2 percent in 2000:II, its highest since the start of the influx of immigrants, yet the rate of unemployment among them was 1.7 percentage points lower than in 1999, at 9.7 percent. This is still higher than the general rate in the economy, and is evident among men and women.

In the field of labor relations, the physicians' strike ended after 120 days with the signing of an agreement in which the physicians undertook not to strike for ten years, and all disagreements between them and the Ministry of Finance would go to arbitrators who would take many criteria into account, including wage policy and fiscal constraints. This long-term arbitration agreement is an innovation in labor relations in general government, and it is difficult at this stage to assess how it will affect labor relations in the future. It was agreed that a public committee would be set up to examine private medicine within the public health services, and its findings will have implications for physicians' pay in general, and that of senior physicians in particular. The overall cost of the agreement was 13.6 percent (excluding the allocation for the transition from unfunded to funded pension plans and improvement of pensions for senior physicians), and

<sup>3</sup> According to trend data the rates of unemployment for July and August were 8.6 percent and 8.7 percent respectively.

Table 3. Indicators of Labor Market Developments, 1997–99  
(seasonally adjusted)

	1998	1999	1999		2000		Apr–Sept <sup>a</sup>		*	
			III	IV	I	II	III	1999		2000
	('000s)									
Civilian labor force	2,266	2,344	2,352	2,391	2,396	2,436		3.0	5.0	6
Israelis employed	2,073	2,136	2,139	2,179	2,192	2,228		3.4	5.4	6
Business sector	1,444	1,491	1,490	1,521	1,536	1,560		3.0	5.5	6
General government	628	646	647	658	650	672		4.3	5.0	6
Average hours worked per employee	37	37	38	38	38	38		-1.6	3.3	6
Business sector	40	40	40	40	41	40		-0.3	1.0	6
General government	31	31	32	32	31	30		-0.3	-1.6	6
Labor input of Israelis employed	77,128	79,545	80,524	81,852	82,525	84,386		1.4	8.6	6
Business sector	19,362	20,156	20,773	20,431	20,237	20,937		2.0	8.0	6
General government	57,766	59,389	59,751	61,421	62,287	63,449		1.1	8.9	6
Claims for unemployment benefit	108	108	108	108	110	102	103	-2.5	-5.2	8
Work seekers	156	158	153	163	161	165	166	-2.9	6.8	8
Real wage <sup>b</sup> per employee post (NIS)	4,206	4,304	4,271	4,458	4,536	4,515	4,512	1.4	5.6	7
of which: Business sector	4,262	4,409	4,404	4,551	4,676	4,666	4,669	2.4	6.4	7
Unemployment rate (%)	8.6	8.9	9.1	8.9	8.5	8.6				6

\* Last month for which data available.

<sup>b</sup> At 1994 prices.

<sup>a</sup> Percent change compared with same period in preceding year.

it does not deviate significantly from the government's declared wages policy.

The real wage per employee post rose by 6.6 percent in the first half of 2000 compared with the equivalent period in 1999. This reflects a sharp rise of 7.5 percent in the business-sector real wage which encompassed most industries, but which was particularly notable in high-tech industries in which demand for labor outstripped supply, for instance in the computing services industry, in which the real wage was 15.3 percent higher than in the first half of 1999. The rise in the real wage in the business sector derived partly from a 1.4 percent increase in labor productivity, and from a slower than expected rate of price increases. The real wage in the general government sector rose by 4.5 percent as a result of several factors, including: first, the system of indexation of wages in various industries leads to wages in the business sector spilling over into the general government sector directly or indirectly (via their effect on the alternative wages of skilled workers; second, the wage and grade drift—including a 4.8 percent increase

on the pensionable wage granted to employees from November 1999—which solved part of the problem of wage erosion at a time of high inflation, did not slow down at the same rate as inflation, so that it raised both the nominal and the real wage.

A committee was set up in May to examine various aspects of the Minimum Wage Law in Israel. The members of the committee did not reach general agreement on the effect of the minimum wage on employment, inequality, and poverty, but they did on the need to increase compliance with the law and to improve enforcement. The committee finished its work in July, and submitted proposals on enforcement, the definition of wage, and methods of updating the minimum wage.

### The balance of payments

In the first half of 2000 the current-account deficit declined to \$ 1.1 billion, compared with \$ 1.5 billion in

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the same period in 1999. This decline was due to the \$ 240 million reduction in the deficit on the goods and services account, and the equivalent rise in income from unilateral transfers. Concurrently, there was a \$ 100 million increase in the deficit on interest and salary payments, which amounted to \$ 1.7 billion. In 2000:III there was an upward trend in the deficit as a result of the slower expansion of exports.

The trade deficit, which declined by 36 percent in the first half of the year, rose in 2000:III due to the continued increase in goods imports and slower rise of exports. The strong local currency and the rise in world oil prices had an adverse effect on the profitability of exports, and the decline was evident particularly in exports of traditional industries such as textiles, clothing, and leather, which fell by 6.7 percent in 2000:III after a 4.8 percent rise (seasonally adjusted) in 2000:II. By contrast, in 2000:III high-tech exports (computers, electronic components, and medical monitoring equipment) continued to expand, albeit more slowly than in 2000:II.

Manufacturing exports in general, the share of high-tech

industry in which has grown rapidly, was up by 27 percent in the period reviewed over the same period in 1999, almost all the increase occurring in 2000:II. Alongside the rise in manufacturing exports, goods imports also increased. Imports of production intermediates, which constitute a partial indicator of current economic activity, were up by 14.2 percent over the equivalent period in 1999; imports of capital goods, serving as an indicator of future activity, declined by 1.6 percent in 2000:II and rose by 2.5 percent in 2000:III. Consumer goods imports were 13 percent higher than in the same period in 1999, following a decline in 2000:II and a rise in 2000:III.

A cross-section of trade data by country shows that exports to the EU have been declining since 2000:I, alongside an increase in imports from those countries. Exports to the EU, which account for 36 percent of all exports, fell by 11 percent in the period reviewed, while imports from those countries, which account for 43 percent of all imports (excluding diamonds, seasonally adjusted), grew by 5 percent in this period.

**Table 4. Balance of Payments, Foreign Trade<sup>a</sup>, and the Reserves, 1998–2000**  
(\$ million, current prices)

	1998	1999	1999		2000			Apr–Sept		*
			III	IV	I	II	III	1999	2000	
<b>Monthly averages</b>										
Trade deficit	410	439	445	413	359	266	369	443	317	9
Goods imports	1,770	1,857	1,900	1,926	1,982	2,044	2,148	1,864	2,096	9
Consumer goods	323	331	341	332	364	361	384	330	373	9
Capital goods	378	447	472	470	489	481	493	453	487	9
Intermediates	1,067	1,078	1,082	1,123	1,129	1,201	1,266	1,079	1,233	9
Goods exports	1,359	1,418	1,455	1,513	1,624	1,778	1,779	1,421	1,778	9
Manufacturing	1,290	1,351	1,389	1,443	1,563	1,712	1,715	1,353	1,714	9
<b>Quarterly averages</b>										
Net current account	-241	-470	-1,081	701	-255	-888		-867		6
Financial account (excl. foreign-currency balances)	300	746	283	1,252	1,629	-414		634		6
Nonresidents' direct and portfolio investments	561	954	744	990	2,498	1,507		897		6
Israeli residents' direct and portfolio investments	247	315	301	400	-9	1,593		215		6
Net foreign debt (% of GNP)	12.80	10.76	11.79	10.32	9.58	9.06		11.61		6
End-period Bank of Israel reserves	21,828	22,071	21,854	22,515	22,677	22,186		21,893		6

\* Last month for which data available.

<sup>a</sup> Foreign trade data are seasonally adjusted monthly averages (excluding ships, aircraft, diamonds, and fuel).

The slump in the New York Stock Exchange in March this year temporarily checked the stream of IPOs abroad by Israeli companies which had continued intensively since the end of 1999. In 2000:I nonresidents' investments in Israeli securities amounted to \$ 3.2 billion, compared with \$ 1.7 billion in 1999:IV. Although a large part of this amount was offset by the increase in residents' deposits abroad, capital inflow to Israel nonetheless increased, serving to create local-currency appreciation. The crisis in the US capital markets in 2000:II, which had some effect on Israel's capital market, too, significantly reduced trading volumes, obliging Israeli companies to wait for a more opportune moment to raise capital. Public offerings abroad by Israeli companies amounted to \$ 1.5 billion in the period reviewed, most of it in 2000:III. Capital outflow by residents was \$ 3.2 billion, the rise being due to an increase in the extent of foreign investments by residents, as well as to the expansion of capital flows that are sensitive to interest-rate differentials—which continued to contract—such as residents' deposits abroad and foreign-currency deposits in banks in Israel. Notwithstanding, net capital inflow to Israel was positive in 2000:III, exerting downward pressure on the currency-basket exchange rate and bringing it close to the lower limit of the exchange-rate band.

In the first half of 2000 Israel's net foreign debt fell by \$ 11 billion to stand at only \$ 9.7 billion. This decline was the result of a \$ 3.3 billion increase in Israel's assets abroad, primarily in the wake of the growth in residents' deposits abroad and loans extended by Israeli firms to firms abroad. As a share of GDP, the net foreign debt was 1.6 percent lower in 2000:II than in 1999:II, and in

the last five years it has fallen by a cumulative 15 percent. An estimate of Israel's exposure to exchange-rate risks, as expressed in its surplus of foreign-currency liabilities over foreign-currency assets, shows that during the period reviewed the business sector reduced its exposure to exchange-rate risk, while the non-business sector maintained the previous level of surplus foreign-currency liabilities.

The currency basket remained within the exchange-rate band in the period reviewed, without any intervention by the central bank in the foreign-currency market. The Bank of Israel's foreign-currency reserves amounted to \$ 22 billion at the end of September, after declining by \$ 440 million since the beginning of the year. This decline derives mainly from the fall in the volume of the commercial banks' foreign-currency deposits with the Bank of Israel and the strengthening of the dollar against the other currencies in which the reserves are held.

## Prices

Since the beginning of 2000 the rate of change of the Consumer Price Index (CPI) has fallen by 0.5 percent, and the general assessment is that the rate of price increases for the year will be considerably below the target. Prices declined by 4.8 percent in 2000:I, rose by 6.6 percent in 2000:II, and fell again by 3.3 percent in 2000:III. The rate of change of the CPI since the beginning of the year (in annual terms) has been -0.6 percent, and an inflation rate of less than 1 percent is predicted for 2000 by economic forecasters.

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

	1998	1999	1999		2000			Apr–Sept		*
			III	IV	I	II	III	1999	2000	
CPI	8.6	1.3	5.1	1.9	-4.8	6.6	-3.3	4.7	1.5	9
CPI excl. housing, fruit and vegetables	8.5	1.7	1.1	4.6	-0.4	6.5	-3.6	1.9	1.3	9
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	8.8	2.4	3.7	0.7	1.6	4.6	-1.3	2.9	1.6	9
Index of housing prices	8.8	-0.9	23.5	-12.1	-17.0	12.3	-5.8	15.7	2.9	9
Wholesale price index	8.2	3.5	7.3	6.3	-1.1	9.7	-1.6	5.6	3.9	9
NIS/\$ exchange rate	18.2	0.4	16.3	-5.0	-16.8	10.7	-6.5	11.0	1.7	9
NIS/currency-basket rate	20.6	-2.5	21.5	-7.4	-21.4	8.2	-14.6	10.6	-3.9	9

\* Last month for which data available.

The period reviewed can be divided into two: in 2000:II the inflation rate rose in the wake of the depreciation of the NIS against the currency basket as a result of the fall in share prices on the New York stock markets and the publication of the proposals of the tax-reform committee. All this occurred against the backdrop of the seasonal rise in the CPI due to the Passover festival. In 2000:III, on the other hand, prices fell following the appreciation of the NIS (apparently due to extensive capital inflow and the dissipation of expectations that the tax-reform recommendations would be implemented) and the marked reduction in purchase tax on some consumer durables. Note that the effect on prices of the reduction of purchase tax is not immediate as many importers still have stocks bought before the reduction, so that the effect is expected to continue in the coming months, too. The cumulative contribution to the rate of price increases in 2000 of the reduction of purchase tax is expected to decelerate it by 0.5 percent.

An examination of inflation expectations during the year shows that they were within the range of the inflation target only in 2000:II, while for the rest of the period they dipped below it. As of May inflation expectations fell more quickly than the rate at which the Bank of Israel's key interest rate was reduced, so that real ex ante expected interest in that period averaged 6.7 percent, identical with the average real interest rate in 1998 and 1999.

The rate of change of the core CPI (excluding housing, fruit and vegetables) was 1.3 percent during the period reviewed, similar to the rate at which the total CPI rose. This was because for most of the period the fruit and vegetables component and the housing component changed in opposite directions. The housing component, which has the greatest weight in the CPI (about one fifth) made a marked contribution to the decline in the CPI in the 2000:I and 2000:III, falling by 17 and 5.8 percent respectively (in annual terms). In 2000:II, however, this item rose by 12.3 percent. The exchange rate has a notable effect on this component, but the rate of change of the housing-price index from April to September was greater than that of the dollar exchange rate, indicating that the real-estate market was rallying to some extent.

The fuel and oil index has fluctuated widely recently, rising by 13.2 percent in 2000:II and 2000:III due to the unexpected increase in demand and change in production quotas by the members of OPEC. The increase in the oil price affects the CPI, principally via the prices of electricity and transport, and despite promises by OPEC to increase the quotas in October 2000, oil prices are not expected to fall significantly.

In the framework of the National Budget for 2001 the inflation target was altered to 2.5–3.5 percent. This range is 0.5 percent below the target set previously, and sends a message to the public that the government and the Bank of Israel are intent on attaining price stability more rapidly. The inflation target for 2002 has been determined as 2–3 percent, and from 2003 it will be 1–3 percent, the range defined as price stability.

## The general government

Data on the government's activity in Israel and abroad in 2000 indicate that the budget deficit is expected to be far below the deficit ceiling of 2.5 percent of GDP set for this year.<sup>4</sup> Public consumption in the first half of 2000 was up by 3 percent over the equivalent period in 1999 (seasonally-adjusted data, constant prices), and total domestic expenditure, which also includes transfer payments and government investments, was higher by a real 5.7 percent in 2000 than in the same period in 1999, amounting to NIS 132.2 billion (in nominal terms).

The budget surplus amounted to NIS 466 million in the period reviewed, following a surplus of NIS 1.41 billion in 2000:I and reflecting a marked increase in tax receipts. Revenues in the first nine months of the year were NIS 9.4 billion higher than forecast on the basis of the seasonal path (a difference of 11.1 percent), and data from the State Revenue Administration indicate that total tax revenues are higher by a real 16.5 percent since the beginning of the year than in the equivalent period in 1999. Most of the increase derives from net income-tax receipts, which rose by a real 24.3 percent and amounted to NIS 62.1 billion. The increase in income-tax receipts reflects the sharp rise in real wages, so that a large part of it is expected to persist. The rise in import-duty receipts excluding VAT also exceeded expectations.

The conclusions of the committee set up to recommend tax reforms were published in 2000:II. The objects of the reform were to amend distortions in the existing tax system, reduce inequality in the distribution of income, enhance economic efficiency by increasing the incentive to work, and encourage better diversification of the asset portfolio. All this is to be done while expanding the tax base and reducing the marginal tax rate. These recommendations have not yet been implemented, and

<sup>4</sup> The Bank of Israel's realized profits are not included in the new definition of the deficit for 2001. In terms of the new definition, the target for 2001 is 3.6 percent of GDP.

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

	1998	1999	1999		2000			Apr–Sept		*
			III	IV	I	II	III	1999	2000	
1. Government domestic expenditure	38.1	37.2	36.2	38.4	38.6	35.8	36.2	36.1	36.0	9
2. Government receipts	34.9	34.3	34.4	34.1	40.2	36.5	36.6	33.3	36.5	9
3. Domestic budget deficit (1 – 2)	3.2	2.9	1.9	4.4	-1.6	-0.6	-0.4	2.8	-0.5	9
4. Government and Jewish Agency domestic deficit <sup>a</sup> (5 + 6)	3.6	3.5	1.2	7.0	-3.6	-2.6	1.1	2.2	-0.7	9
5. Government net borrowing from the public	2.7	2.1	2.3	2.4	2.1	2.0	-2.8	2.5	-0.4	9
6. Public-sector injection (9 – 8 – 7)	0.9	1.5	-1.1	4.6	-5.7	-4.6	3.9	-0.3	-0.3	9
7. Bank of Israel injection	-1.1	-0.4	0.4	-1.4	4.9	6.0	-3.5	-0.9	1.2	9
8. Private-sector foreign-currency conversions	0.3	-0.1	-0.1	0.0	-0.3	-0.1	-0.1	0.0	-0.1	9
9. Change in monetary base	0.1	0.9	-0.8	3.2	-1.0	1.4	0.3	-1.3	0.8	9

\* Last month for which data available.

<sup>a</sup> Including non-budgetary injection.

it is not clear at present whether taxes will be reformed, even if only in part.

The government debt accounted for 99 percent of GDP in the first half of 2000, its lowest level since the 1985 economic stabilization program. The debt/GDP ratio is one of the most important indicators of the desirability of investing in a country, so that a decline in it can help to improve Israel's international standing, especially vis-à-vis foreign investors. The adoption of the European standard of a debt/GDP ratio of 60 percent is not expected in the near future, but the reduction of the debt could improve Israel's risk rating, encourage investment, and reduce the annual debt-servicing payments which constitute a burden on the budget. Israel's debt-servicing payments are currently NIS 20 billion, constituting 5 percent of GDP.

During September the government approved the budget for 2001. The targets set include the reduction of the overall deficit (excluding credit extended) to 1.75 percent of GDP, and its contraction in the subsequent two years by at least 0.25 percent a year, so that in 2003 it will not exceed 1.25 percent.<sup>5</sup> It was also decided that

<sup>5</sup> The calculation of the deficit in Europe includes nominal interest payments on the debt, while in Israel only real interest is included. Thus, a 1.25 percent deficit as calculated in Israel is expected to be below the deficit ceiling set in the Maastricht agreement—3 percent of GDP (assuming an inflation rate of 2 percent).

as a share of GDP, government expenditure (which is very high by international standards) will be reduced alongside the reduction in tax rates; this should enable the business sector to increase the extent of its activity. The budget for 2001 was up by 2.75 percent in real terms over that for 2000, amounting to NIS 240 billion (after being approved by the Knesset). In spite of the absolute increase in the budget, as a share of GDP it is expected to decline if the 4.5 percent growth in GDP forecast for 2001 materializes.

### The money and capital markets

During the period reviewed the Bank of Israel reduced nominal interest by a cumulative 1 percent—from 9.9 percent in March to 8.9 percent in September. The downward trend of interest which has been evident since 1999 was made possible by the decline in the inflation environment in line with the targets set for it. This trend was interrupted between May and July, when the interest rate was unchanged due to the sharp local-currency depreciation that caused inflation expectations to rise to the upper limit of the target range (3–4 percent). During this period two main factors operated to cause depreciation. First, falling share prices on world stock markets, and in New York in particular, significantly reduced the extent of IPOs abroad by Israeli companies, so that investment by nonresidents, which had reached a

peak of \$ 2.1 billion in March, declined to an average level of only \$ 520 million in 2000:II. Second, the publication of the recommendations regarding tax reform, suggesting inter alia that a uniform tax rate be imposed on investments in Israel and abroad, as well as that short- and medium-term savings be taxed, led the public to increase its demand for foreign currency. Note, furthermore, that the interest-rate spread between Israel and abroad had been narrowing significantly until then as a result of both the reduction of the domestic interest rate and the increase in interest rates abroad. As a result of all these factors, the dollar exchange rate soared in May, reaching NIS 4.19, but the dissipation of expectations that the tax reform would be implemented and the revival of nonresidents' investment in Israel served to cause local-currency appreciation and reduce inflation expectations.

Local-currency appreciation against the currency basket intensified in September, and the difference between the NIS/currency basket exchange rate and the lower limit of the exchange-rate band narrowed to only 1.1 percent—the smallest since August 1998. If the exchange rate drops to the lower limit of the band the Bank of Israel would have to intervene and buy foreign currency in return for local currency. This would oblige the central bank to sterilize the amounts of local currency that would be injected into the market, and would be accompanied by a rise in the interest rate—actions which bear heavy costs.

As stated, from May until the end of the period reviewed inflation expectations declined by a cumulative

1.6 percent, to stand at only 2.2 percent in September. The rate at which expectations fell outstripped that at which the nominal interest rate was reduced, and expected real interest (as derived from the Bank of Israel's key interest rate) rose gradually to an average of 7.1 percent in 2000:III. Expected real interest, which has a negative effect on the viability of investment, is still higher than in previous years, and apparently acts to reduce the extent of investments. Ex post real interest, which impacts on firms' profitability, fell in 2000:II and came close to expected real interest, but rose again in 2000:III as a result of price decreases.

The narrow money supply (M1) grew by 15 percent in the period reviewed, and its growth rate in the last twelve months was 10.1 percent at the end of September. The expansion of M1 was slowed by the government absorption of NIS 8.3 billion since the beginning of the year. During the period reviewed SRO deposits contracted by 31 percent, after rising by 59 percent in 2000:I. Most of the steep increase in SRO deposits, which is characteristic of periods of uncertainty, occurred in 2000:II as a result of the fall in share prices and publication of the recommendations of the committee on tax reform, but as local currency rallied in 2000:III these deposits declined, alongside a rise in longer-term assets such as resident time deposits and Treasury bills. M2 grew by 17.2 percent from April to September, and the broadest aggregate, M3, which also includes foreign-currency assets, rose by 14.7 percent in this period. The rate at which unrestricted bank credit expanded was more moderate in the period reviewed

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

Rates of change	1998	1999	1999		2000			Apr–Sept		*	
			III	IV	I	II	III	1999	2000		
	(average)		(compared with preceding quarter)							(during period)	
M1 <sup>a</sup>	12.0	9.5	28.7	5.3	8.0	10.6	14.4	16.6	15.0	9	
M2 <sup>b</sup>	22.6	21.0	17.8	19.6	29.1	12.8	19.7	18.5	17.2	9	
M3 <sup>c</sup>	22.1	21.8	19.2	20.4	27.3	12.4	16.6	20.4	14.7	9	
Nondirected bank credit	15.9	17.9	15.1	20.5	14.3	12.6	11.5	16.4	13.2	9	
Unindexed local-currency	16.3	18.0	5.3	20.2	52.9	25.0	15.5	8.6	21.0	9	
CPI-indexed	14.1	18.3	18.4	17.8	-2.2	6.0	14.4	17.4	10.4	9	
Foreign-currency-indexed and denominated	17.9	17.3	23.7	24.4	-3.8	5.4	2.6	25.1	6.5	9	

\* Last month for which data available. Some data for 2000:III are based on preliminary data.

<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 deposits.

<sup>c</sup> M2 plus foreign-currency-indexed and denominated deposits.

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

	1998	1999	1999		2000			Apr–Sept		*
			III	IV	I	II	III	1999	2000	
Nominal interest										
Nondirected										
local-currency credit	16.5	16.7	16.3	15.8	14.4	13.4	13.1	16.7	13.3	8
Average monetary loan	12.0	12.4	12.0	11.5	10.4	9.5	9.1	12.2	9.3	9
SROs	10.2	10.7	10.2	10.1	9.0	8.1	7.8	10.5	8.0	8
3-month Eurodollar	5.4	5.3	5.3	6.0	6.0	6.5	6.6	5.1	6.5	9
Yield to maturity on										
Treasury bills	11.3	11.4	11.3	10.9	9.1	9.0	8.8	11.4	8.9	9
10-year bonds	4.9	5.2	5.2	5.3	5.3	5.2	5.7	5.2	5.5	9
5-year bonds	5.1	5.6	5.6	5.9	5.8	5.7	6.2	5.5	6.0	9
General Share-Price										
Index (points)	137.7	181.4	187.7	210.4	254.8	251	262.4	184.4	256.7	9
Expected inflation (gross)	6.2	5.3	5.4	3.9	2.6	3.4	2.4	5.7	2.9	9
Interest derived from										
expected inflation (gross)	4.7	5.7	5.7	6.4	6.1	5.5	6.2	5.3	5.8	9

\* Last month for which data available.

than in the same period in 1999—13.2 percent. From its composition it is evident that in the last six months the share of unindexed credit expanded by 2 percent, and that of credit indexed to the CPI and indexed to and denominated in foreign currency declined.

In September, in the context of Israel's relative economic stability of late, it was decided to implement another stage in the process of foreign-currency liberalization—insurance companies and pension funds were permitted to invest up to 5 percent of their assets abroad. This brought the terms of their foreign-currency activity into line with those of the provident funds. In addition, the ban on residents' futures transactions with nonresidents for a period of longer than thirty days was rescinded, enabling the public to better diversify its asset portfolio, while reducing the risk deriving from shocks in the domestic capital market. This step will be more effective once taxation is equalized on investments in Israel and abroad (as recommended by the tax-reform committee).

The surge in the capital markets evident in 1999, when the General Share-Price Index rose by a cumulative 64 percent, ended at the end of 2000:I. The collapse of

high-tech and internet share prices in March this year affected stock markets world-wide, including in Israel, where share prices also fell, albeit more moderately. Since then the Tel Aviv Stock Exchange has evinced considerable volatility, encompassing all trading sectors, and this can be attributed to the instability of the Nasdaq and the Dow-Jones indices. Note, however, that the wide fluctuations have caused many investors to abandon this arena, as turnover on the stock market indicates that the public is less heavily involved than it was at the same time last year.

The composition of the asset portfolio of mutual funds indicates that since January 2000 the share of unindexed assets has risen by 4.5 percent, while that of assets indexed to the CPI and to foreign currency has dipped by between 2 and 2.3 percent respectively (as expected in a period of declining inflation expectations). In the bond market the share of unindexed bonds has risen markedly since the beginning of the year, compared with a more moderate increase in that of bonds indexed to the CPI and to foreign currency. The real yield to maturity on 12-month Treasury bills rose by 0.5 percent in the period reviewed, and reached 6.1 percent.

## The Factors Leading the Emergence from two Recessions: 1988–89 vis-à-vis 1996–99

The economic slump that has been evident in the last few years is similar to the one that prevailed at the end of the 1980s: both of them were characterized by a low level of production, which encompassed all the principal industries. In contrast with the recovery in the 1990s, however, the current emergence from recession was based on exogenous demand and the acceleration of high-tech activity, while traditional industries responded with a lag.

The reasons for the recession at the end of the 1980s were mainly the belated effects of the economic stabilization program implemented in 1985, and were largely supply-side related. They included the steep rise in real wages that derived from the faster than expected reduction of inflation, and the protracted real appreciation that significantly eroded producer profitability, leading to the contraction of production alongside restructuring and increased efficiency. Additional reasons for the slump were the Intifada (uprising), which prevented Palestinian workers from reaching their places of employment, the decision to stop producing the Lavi fighter plane, and the reduction of the workforce in the defense industry in general. The turnaround occurred at the end of 1989 and in 1999, when the influx of immigrants from the former USSR began. At that time the expansion of economic activity derived from the notable increase in the population, leading to a shift in demand, and especially in residential construction investment. The latter caused the output of the traditional industries (particularly those supplying construction inputs, e.g., mining and quarrying, and non-metallic minerals) to rise markedly, concurrent with the expansion of government demand in order to provide services to the growing population and the increase in the extent of transfer payments to immigrants. The acceleration of demand did not affect exports, whose contribution to GDP growth in 1990 was small due to the drop in tourism in the wake of the Gulf War. In the first year of the emergence from recession, economic activity relied on a marked improvement in the utilization of factors of production, as capital stocks and the civilian labor force rose moderately.

### Indicators of Economic Activity<sup>a</sup>

	Residential construction investment: total	Manu- facturing production index: total	Manu- facturing production index: high-tech	Public consumption	Manu- facturing exports	Business- sector product
1988–89	0.7	-0.7	-	-0.7	1.9	0.6
Emergence from recession <sup>b</sup>	10.6	0.8	1.8	3.5	2.2	2.1
1988–89 <sup>c</sup>	-1.6	0.3	1.0	0.8	1.6	0.6
Emergence from recession <sup>d</sup>	-1.2	3.2	10.8	-0.1	5.6	1.9

<sup>a</sup> Average monthly rates of change; seasonably-adjusted figures.

<sup>b</sup> For all four quarters of 1990.

<sup>c</sup> From 1996:III to 1999:II.

<sup>d</sup> From 1999:III to 2000:II.

The recession at the end of the 1990s derived mainly from the slowing expansion of domestic demand due to the turndown in the business cycle, conclusion of the immigrant-absorption process, and tight fiscal and monetary policy, in response to the expansion of the current-account deficit. The slowdown also stemmed in part from the structural change that was the result of globalization, and exposure to competition from abroad, as the traditional tradable industries cut back their activities considerably, laying off unskilled workers, who were unable to find employment. The emergence from the recession in the second half of 1999 rested mainly on the acceleration of exports, which found a favorable international climate, such as positive developments in the area of world trade, global economic growth, as well as positive domestic conditions, such as the surge in the capital markets, real depreciation during 1999, political-defense calm (causing incoming tourism to flourish), and primarily unique technological know-how developed in Israel and sold abroad.

The current emergence from recession differs from the previous one in that it is led not only by a rise in domestic demand, but to a great extent by exogenous demand. The government's role in the increase in economic activity has been small, and the activity of the traditional industries is at a relatively low level. The construction industry, which led the economy in the 1990s, has responded with a lag, and only after a lengthy period of contraction is an increase in the extent of its activity beginning to emerge (as indicated by the Survey of Companies). The expansion of the high-tech industry has been rapid, by contrast, and its share in total manufacturing exports is continually rising. Exports will apparently continue to lead growth as long as the growth of global demand persists and the variables serving to increase export profitability endure.