

# RECENT ECONOMIC DEVELOPMENTS\*

## Main developments

During April-September 2001 (the period reviewed) the recessionary trend intensified, as expressed by almost every economic indicator: after GDP had fallen in 2000:IV and recovered slightly in 2001:I, it contracted by 1.3 percent (in annual terms) in 2001:II, reflecting a slowdown in a wide range of industries. The composite index of the state of the economy declined by 4 percent in the period reviewed; goods exports (excluding ships, planes, and diamonds) were down by 11 percent from the previous six-month period; manufacturing output was 5.1 percent lower than in the preceding six-months, and commerce and services revenues were down by 2 percent in those months. Trend data on the unemployment rate indicate a 0.2 percentage-point increase in recent months, so that in August it stood at 8.9 percent.

Two main factors have affected economic activity since 2000:IV:

1. The renewed *intifada* influenced both the demand and supply sides. On the demand side, it caused tourist entries into Israel to drop by over 50 percent, expressed in a similar decline in income from tourism. The impact on tourism was also reflected in catering and hotel revenues, which were down by 10 percent over the equivalent period in 2000. Increased security uncertainty contributed to the drop in domestic demand, and especially in investment. On the supply side, the *intifada* caused the employment in Israel of workers from the territories to plummet by 80 percent. As a consequence, construction and agriculture, where workers from the territories account for one quarter of all employment, were badly hit.

2. The global high-tech crisis led to a collapse in various share prices and a steep drop in demand for technology-intensive products, as well as causing economic slowdowns in many countries, chief among them the US. The bursting of the high-tech share-prices bubble adversely affected the ability of Israeli firms—and particularly of start-ups—to raise capital. In 2001:II this category of investment was down by 30 percent from

2001:I, after having contributed 2 percentage points to GDP growth in 2000. The damage to the ability of start-ups to raise capital caused many of them to fold, setting off a negative economic chain reaction. The drop in demand for technology-intensive products harmed manufacturing exports classified as high-tech (about 50 percent of manufacturing exports), which were down by 18 percent from the previous six-month period. In addition, the export of start-up companies, which had reached a quarterly average of \$ 450 million in 2000, came to a complete stop.<sup>1</sup> The economic slowdown in the US and many other countries led to the contraction of world trade, which is expected to grow by 4 percent in 2001, compared with 12.4 percent in 2000. Some of the trade slowdown reflects a decline in the demand for technology-intensive products, but also apparently a general drop in demand, which hampers exports of non-high-tech goods, too.

As the direct effect of the *intifada* and the crisis in the high-tech industry influences different industries differently, it can be assumed that during the period reviewed it was the global slowdown and fall in demand for high-tech goods that caused the decline in economic activity to persist. This was expressed primarily in the steep drop in high-tech exports in 2001:II and 2001:III, compared with the continuation of a moderate level of economic activity, without any further significant deterioration, in investment in construction and tourism. An almost 1.5 percentage-point increase in the share of academic work-seekers in total work-seekers registered in the last few months reinforces that assumption.

With regard to fiscal policy, the domestic deficit (excluding net credit extended) was NIS 6.8 billion in January-September. On the basis of budgetary performance in the first nine months of 2001, it is assessed that the overall deficit (excluding net credit) will amount to 2.9 percent of GDP this year—a deviation of more than 1 percent from the target. The steeper rise in expenditure than in GDP is reflected in the estimate of general government expenditure for 2001— 55.1 percent of GDP—which is 2.5 percentage points above

<sup>1</sup> The effect on the current account was smaller, because the profits accruing to nonresident investors have to be deducted from exports of start-ups.

\* For diagrams (bilingual) please refer to end.

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the level in 2000. Tax receipts including national insurance contributions, (at constant prices), were up by only 0.7 percent in the period reviewed over the equivalent period in 2000—a rate that reflects the state of the economy. The decline in profitability led to a 15 percent drop in tax receipts from self-employed persons and a 4.1 percent decline in corporate tax receipts in that period.

As a result of the increased security risk in Israel, together with the sharp falls in the Nasdaq and the difficulty of issuing shares abroad, foreign direct investment plummeted by 70 percent in the period reviewed, and foreign portfolio investment was down by 75 percent from the

equivalent period in 2000. The decline in foreign-currency financing sources and the deterioration in the balance of payments current account created pressure for local-currency depreciation against the dollar, and this amounted to over 4 percent in the period reviewed.

On the basis of IMF estimates, the global economic growth rate in 2001 is expected to be 2.6 percent, compared with 4.7 percent in 2000.<sup>2</sup> The decline reflects a slowdown in almost all the advanced countries and contributed to a drop in world demand. In response to the slowdown, monetary policy was less tight or even expansionary, as expressed in interest-rate reductions in many countries. The US Federal Reserve lowered its basic

**Table 1. Indicators of Business Activity, 1999–2001**

(all data excluding construction are seasonally adjusted)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	4.3	5	8.7	-3.8	-3.8	-9.1	-6.5	7.6	-2.8	9
Large-scale retail trade	4.4	10.2	4.7	13	-7.8	9.4	5.8	10.9	4.6	9
Manufacturing production (excl. diamonds)	1.1	10	5.4	-6.2	-4.3	-14	-7.7	12.6	-6.3	8
Business-sector consumption of electricity	2.7	7.4	9.2	-6.5	9.6	-0.7	-7.9	10.1	1.6	7
Index of revenue in commerce	4.3	10.6	6.9	-6.5	-0.8	-1.7	0.7	13.6	-1.2	8
Index of total revenue	6.5	10.9	11.3	-4.3	-8.4	-4	0.3	13.2	-2.5	8
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	8.8	4.6	0.5	-44.8	0.8	-13.9	-10.4	21.5	-54.5	9
Immigrant arrivals	35.5	-21.6	22.8	-0.2	-32.3	-19.2		-12.3	-30.6	5
Residential starts	-14.4	18.9	6.6	-15.4	-16.7	-20		25.9	-39.9	6
of which: Government-initiated	-6.5	52.3	11.1	-30	-30.8	-44.6		79.3	-70.2	6
Residential completions	-14.4	-6	-7	-27.5	6.9	-20.4		12.5	-42.6	6
of which: Government-initiated	-5.7	-38.6	0	-18.6	-28.5	-11		-23.8	-48.2	6
Survey of companies (percent) <sup>b</sup>										
Product of manufacturing firms (not adjusted)	9	11	27	-12	-6 <sup>c</sup>	-16	-17			9
Product of manufacturing firms (adjusted)	9	11	15	-12	5 <sup>c</sup>	-18	-24			9
Net sales by commercial firms (not adjusted)	12 <sup>c</sup>	5	20	-25	-11 <sup>c</sup>	-33	-38			9
Net sales by commercial firms (adjusted)	12 <sup>c</sup>	5 <sup>c</sup>	8 <sup>c</sup>	-23	-7 <sup>c</sup>	-30	-44			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.

rate by a cumulative 4 percentage points from the beginning of the year, to reach its lowest level for forty years. The central banks of the UK and the EU reduced interest in the same period by 1.5 and 1.0 percentage points respectively. Since the Bank of Israel has reduced its key interest rate by 1.9 percentage points since the beginning of the year, the interest-rate differential between the NIS and the dollar widened by more than 2 percentage points.

The CPI rose by 2.5 percent in the period reviewed, its steepest increase in a 6-month period in the last two years. The local-currency depreciation that began in June led the increase in prices, which exceeded the rate predicted at the beginning of the period. Concurrently, inflation expectations as measured from the capital market rose by over 1.5 percentage points, to stand at 3.2 percent in September.

On the basis of models developed at the Bank of Israel, forecasts by private entities, and recent developments, during 2000:III the path of inflation returned to the target range, after a long period in which it had been below it. It is this assessment that guided the Bank of Israel in its interest-rate policy: in the first part of the period (end-March to end-July) the interest rate was reduced by 1.2 percentage points, since when the interest-rate reductions have stopped. The lowering of the nominal

<sup>2</sup> These estimates were made before the terrorist attacks on the US on 11th September.

interest rate contributed to the continued reduction of the real interest rate—which had begun in 2001:I—in both the short and the long term. In 2001:III the real interest rate, as derived from short-term inflation expectations, stood at 3.6 percent—2 percentage points below what it was at the beginning of the year.

### The principal industries

The composite index of the state of the economy, which gives an up-to-date picture of real economic developments, fell in 2001:II and 2001:III (quarter-on-quarter) by 2.4 and 1.7 percent respectively. These declines are the largest for a decade, and reflect the economic slump evident in Israel in the wake of the renewed *intifada* and the global crisis in the high-tech industry.

Seasonally-adjusted data for 2001:II indicate that the economic slump that began in 2000:IV has persisted. After a 2.5 percent rise (in annual terms) in 2001:I, GDP contracted by 1.3 percent in 2001:II, while adjusted for start-ups it rose by 1.2 percent. An examination of business-sector product in 2001:II reveals an even gloomier picture: this fell by 3.6 percent from 2001:I, and adjusted for start-ups it remained unchanged. The drop in business-sector product was led by two uses—gross domestic investment, which dipped by 1.6 percent, and exports, which were down by 9 percent from the equivalent period in 2000.<sup>3</sup> Private consumption, by contrast, continued to grow at an annual rate of 3.0 percent.

Table 2. National Accounts, 1999–2001  
(seasonally adjusted)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	2.6	6.2	8.9	-9	2.5	-1.3		7.2	0.1	6
Business-sector product	2.4	8.3	10.9	-14	1.7	-3.6		10	-1.6	6
Business-sector product excl. start-ups	2	5.5	3.4	-10.8	3.4	-0.1		8.4	-1.2	6
Private consumption	3.2	6.6	8.1	-2.1	9.5	-4.2		8	2.6	6
Gross domestic investment	9.5	-4.1	-47.7	125.9	-8.7	-36.2		1.5	-8.9	6
Gross domestic investment excl. start-ups	6.8	-8.1	-3.9	15.6	-2.9	-31.2		-7.1	-7.2	6
Goods and services exports	11.6	23.9	57.2	-39.9	-1.9	-32.9		26.8	-11.2	6
Goods and services exports excl. start-ups	11.9	19.7	5.1	-24.8	6.9	-21.4		27.3	-9.7	6
Goods and services imports	14.8	12.2	20.8	9.4	-11.8	-18.3		10.7	-1.2	6
General government consumption	3.1	1.1	7.2	15.5	-2.4	15.4		-1.9	8.7	6

\* Last month for which data available.

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

The effect of the events of the last year on the fall in investment is notable. Housing investment dropped by 17 percent, largely due to the *intifada*; investment in start-ups plummeted by over 20 percent (*vis-à-vis* the equivalent period in 2000), as a direct result of the global high-tech crisis. The drop in investment in start-up companies is particularly evident in 2001:II—it fell by 30 percent from 2001:I. Investment in machinery and equipment declined by 6 percent. The drop in exports was due primarily to external events, and was most marked in high-tech products and start-up companies (see section on balance of payments). The effect of domestic macroeconomic factors, such as the real exchange rate and wages, appears to have been relatively small. As expected, for reasons of consumption smoothing, the effect of the slump on private consumption, and on current consumption in particular, was moderate: current consumption rose by 4 percent in 2001:II, while durables consumption was down by 5.5 percent from 2000:I.

Manufacturing indices clearly indicate a deterioration in economic activity: the index of manufacturing production, which began to decline in 2000:IV, was down by 4.6 percent in April–August from 2001:I. The index of production in the high-tech industry fell by almost 10 percent in 2001:II, compared with a moderate 1.1 percent decline in the production index of the traditional manufacturing industries. The gap in the development of high-tech and traditional manufacturing production indicates that the effect of external factors on manufacturing was stronger than that of domestic events.

The tourism industry was the main victim of the eruption of the *intifada*. The number of tourists' hotel bed-nights was down by 60 percent from the equivalent period in 2000. The dramatic drop in tourism led to price reductions which brought about a rise of just over 10 percent in the number of residents' hotel bed-nights.

The slump in the construction industry continued, alongside the slowdown in the other industries. This industry was affected mainly by the *intifada*, which influenced both the demand and the supply sides. On the supply side, the fall in the number of Palestinians employed, accounting for some 25 percent of the workforce in the industry before the *intifada*, had a drastic effect on construction capacity, at least in the short run. On the demand side, the security uncertainty adversely affected the demand for units: it is reasonable to assume that individuals who had planned to buy homes in areas

<sup>3</sup>The comparison with the equivalent period in 2000 is based on unadjusted data.

which have become more dangerous prefer to defer their purchase until the long-term effect of the *intifada* becomes clear. Another factor influencing the demand for housing was the significant drop for the second year in succession in the number of immigrants arriving in Israel. Since the beginning of 2001 (until July) 24,000 immigrants have reached Israel, compared with 32,000 and 37,000 in the equivalent period in 2000 and 1999 respectively. Alongside these factors, the lowering of mortgage interest and the government's plan to encourage demand for new units in selected areas have partly offset the decline in demand. The result of the fall in supply and demand was a 35 percent decline in residential starts and completions in 2001:II compared with the annual average for 2000. Another indicator of the drop in construction activity is the 10 percent fall in home-purchase transactions implemented in the first seven months of 2001 relative to the 2000 average.

Reports by firms in the framework of the survey of companies undertaken by the Bank of Israel indicate that in 2001:III the trend decline in the activity of all the principal industries—manufacturing, commerce, construction, transport and communications, hotels, and business services—continued. According to the survey, with the exception of construction, the declines in the various industries were steeper than those recorded in the previous recession, which ended in 1999. In manufacturing, sales in general, both domestic and abroad, dropped; in hotels, bed-nights plunged (compared with 2000:III); in construction, the decline was evident in both structures and infrastructure; in transport, both land and sea transport activity fell, while in air transport and communications it rose. The survey data also indicate that the main obstacles to the expansion of output in all the principal industries are on the demand side.

Indices of revenues are consistent with the general economic slowdown. The index of revenue in commerce and the services was down by 3 percent in April–August 2001 over the same period in 2000. The decline was led by a 10 percent drop in the revenue of the hotel and catering services industry in that period—due to the decline in tourism—and by an almost 8 percent fall in the revenue of business services. The latter may be due to a decline in firms' expenditure on IT services as well as in hiring via manpower companies.

### The labor market

In 2001:II the unemployment rate stabilized at 8.6 percent—the level to which it had dipped in 2001:I.

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Trend data for July–August indicate a 0.2 percentage-point rise in the latter part of the period reviewed. The stabilization of the unemployment rate in 2001:II reflects an unchanged participation rate and significant rise in business-sector employment, despite the various indicators of the moderation of economic activity. This may be partly explained by the steep drop in the number of workers from the territories since 2000:IV, which has had an adverse effect on the industries in which these workers are employed but is not expressed immediately by a rise in the unemployment rate.<sup>4</sup> The 10 percent increase (15,000) in the number of foreign workers, and the 20,000 additional permits issued since the beginning of the year attest to the only partial replacement of workers from the territories by foreign workers. The drop in demand would appear to have contributed to the fall in the total number of workers from the territories and foreign workers. These explanations are consistent with the fact that the two industries that have been hardest hit—hotel and catering services and construction—are those most dependent on these categories of workers.

Another explanation for the fact that the unemployment rate did not rise despite the economic situation is the

upward trend in the share of workers who are temporarily absent from work, whether because they are on vacation, reserve duty, sick leave, or away (up to 30 days). The share of workers who are temporarily absent—6.9 percent in 2001:II (seasonally adjusted)—is 0.8 percentage points higher than it has been in the last three years, and this could affect the estimated unemployment rate, as persons using vacation time after being given notice may be registered in the labor force survey as temporarily absent from work even though in effect they are work-seekers. At a rough estimate, if it is assumed that a rise in absenteeism expresses an increase in unemployment, the unemployment rate is higher than the official figure by between 0.2 and 0.4 percentage points. An examination of the by-industry development of employment in 2001:II shows that in the hotel and catering industry the number of employed persons was down by 5 percent from 2000:II—a direct outcome of the drop in tourism. The global crisis in the high-tech industry led to a 1.7 percent decline in total employment in the electronic components, communications equipment, and medical monitoring industry. Employment in R&D dipped

<sup>4</sup> The unemployment rate refers to Israelis only.

Table 3. Indicators of Labor Market Developments, 1999–2001  
(seasonally adjusted)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
	('000s)									
Civilian labor force	2,344	2,436	2,452	2,458	2,477	2,489		5	2.2	6
Israelis employed	2,136	2,223	2,233	2,240	2,263	2,275		5.4	2.2	6
Business sector	1,491	1,559	1,570	1,568	1,568	1,592		5.5	2.1	6
General government	646	662	661	666	691	694		5.1	2.9	6
Average hours worked per employee	37	38	38	38	37	38		3	-1.1	6
Business sector	40	41	41	40	40	40		0.8	-0.6	6
General government	31	31	32	31	31	32		-1.4	2.8	6
Labor input of Israelis employed	79,577	83,999	84,405	84,266	84,099	85,417		9	1	6
Business sector	59,406	63,427	63,901	63,517	62,750	64,000		9.2	0.6	6
General government	20,172	20,571	20,505	20,748	21,349	21,417		8.3	2.1	6
Claims for unemployment benefit	108	106	103	106	109	111		-6.5	7.9	6
Work seekers	158	165	171	167	169	176	198	5.7	13.1	8
Real wage <sup>b</sup> per employee post (NIS)	4,304	4,564	4,581	4,682	4,701	4,740	4,640	5.1	4.6	7
of which: Business sector	4,410	4,691	4,691	4,837	4,860	4,838	4,770	5.6	4.1	7
Unemployment rate (%)	8.9	8.8	8.9	8.9	8.6	8.6				6

\* Last month for which data available.

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

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

in 2001:II (unadjusted data), but in comparison with 2000:II it still rose by 3.7 percent, due to the increase in the number of employees prior to the crisis. Employment in the IT (information technology) services industry was up by 12 percent (compared with 2000:II), due to the reduction and abolition of in-house IT departments in firms, greater resort to outsourcing, and lower prices. The drop in employment in industries with a large share of graduates is also reflected in the data on work-seekers: the number of graduates unemployed was up by more than 20 percent over the equivalent period in 2000, and their share in total unemployment has risen by 1.5 percent since the beginning of the year, to stand at 12 percent.

The economic slowdown, alongside the internalization of the low-inflation environment, led to the continued moderation of the rate at which the real wage rose in 2001:II, and it went up by 1.3 percent (relative to 2001:I, seasonally adjusted, in annual terms). An examination of wage changes over a whole year reveals that despite the economic slowdown, now in its third successive quarter, there is still no moderation wage increases. The wide quarterly fluctuations in wages within industries makes it impossible to determine with certainty which industry is leading the moderation of wage increases, though it is reasonable to assume that in R&D and IT services, which are affected by the global crisis and in which wages are relatively flexible, there are wage reductions which contribute to the moderation of the rise in the real average wage. This comes in the wake of two years in which these industries contributed significantly to the rise in the average wage.

At the beginning of the period reviewed both the minimum wage and the wage of senior officials rose by 10.2 percent, similar to the rise in the average wage in 1999 and 2000. On the basis of the decision of the ministerial economic committee, the wage of senior officials will henceforth be updated once a year, in accordance with the rise in the CPI.

## The balance of payments

The deficit in the current account in 2001:II totaled \$ 1 billion, up from \$ 750 million in 2000:II. The slowdown in world trade, led by that in the US economy and the crisis in high-tech industries, severely affected Israel's exports. Exports of goods in the period reviewed (excluding diamonds, ships and aircraft, at current prices) fell by 11 percent from their level in the previous half year, after five years in which they had risen at more than 5 percent every half year. The decline in exports in the first two

quarters was led by a fall in exports of the high-tech industries. The crisis has affected most of the two-digit high-tech exporting industries: exports of office machinery, computers, and electronic components went down by more than 25 percent, and those of electronic communications equipment and medical control equipment by 13 percent.

Goods imports (excluding diamonds, fuel, and ships and aircraft, at current prices) were 7.5 percent lower in the period reviewed than in the previous half year. The reduction in imports after two years of relatively rapid increases, is explained by the recession in Israel. Raw material imports (excluding diamonds and fuel), which reflects domestic production, fell by 18 percent, and imports of consumer goods by 6.2 percent. Imports of capital goods, however, rose by 0.2 percent (excluding ships and aircraft).

The deterioration of the terms of trade, which started in 2001:I, persisted in 2001:II. The terms-of-trade index, excluding ships and aircraft and diamonds, went down in 2001:II by 0.7 percent; 0.3 percentage points of the drop was due to the rise in fuel prices. With the deterioration in the terms of trade, prices of both exports and imports fell. These price changes, which were relatively small, had only a minimal effect on the trade balance.

The services account showed a \$ 0.5 billion deficit in 2001:II, contrasting with the \$ 230 million surplus in 2000:II. The deterioration was caused by the huge drop in income from tourism, which plunged by more than 50 percent. The factors-of-production account showed an improvement of \$ 400 million relative to the equivalent quarter in 2000, due to a reduction in wage payments to Palestinian workers and a reduction in the rate of interest on foreign currency, which reduced domestic banks' interest payments to nonresidents.

The security situation combined with the sharp decline in the Nasdaq index and the difficulty in issuing shares abroad led to reduced investment in Israel by nonresidents. Investments in the equity portfolio (shares and tradable bonds), which are naturally sensitive to the situation in the world's capital markets, declined to only \$ 250 million in the period reviewed, a fall of 75 percent from their level in the equivalent period in 2000. Direct investment, which has risen relatively steadily since 1995, went down by 70 percent, to \$ 1.1 billion. This reaction by foreign investors, who had provided an attractive source of finance for Israeli companies, obliged the latter to cut expenditure and reduce staff, which had a chain effect on economic activity. The decline in

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Table 4. Balance of Payments, Foreign Trade,<sup>a</sup> and the Reserves, 1999–2001  
(\$ million, current prices)

	1999	2000	2000		2001			Apr–Sept <sup>b</sup>		*
			III	IV	I	II	III	2000	2001	
<b>Monthly averages</b>										
Trade deficit	431	308	294	315	300	318	384	275	351	9
Goods imports	1,851	2,092	2,163	2,165	2,128	2,010	1,959	2,108	1,985	9
Consumer goods	328	375	385	389	421	367	392	374	380	9
Capital goods	445	493	496	509	520	519	512	489	515	9
Intermediates	1,076	1,221	1,280	1,264	1,186	1,123	1,052	1,243	1,088	9
Goods exports	1,420	1,784	1,869	1,851	1,828	1,693	1,575	1,834	1,634	9
Manufacturing	1,352	1,723	1,805	1,794	1,774	1,629	1,520	1,769	1,575	9
High tech	619	917	975	999	977	822	809	952	815	9
<b>Quarterly averages</b>										
Net current account	-761	-354	-147	-159	-64	-996		-443		6
Financial account (excl. foreign-currency balances)	633	588	477	564	-426	-83		510		6
Foreign direct investment	722	1098	1904	246	1102	762		1794		6
Foreign portfolio investment	678	1253	739	693	438	481		519		6
Israeli residents' direct and portfolio investment	267	1,178	1,934	946	480	554		1,818		6
Net foreign debt (% of GNP)	9.82	6.48	7.06	6.36	7.16	7.33		7.34		6
End-period Bank of Israel reserves	22,515	23,164	22,076	23,164	23,840	23,074	24,477	22,076	24,477	9

\* Last month for which data available.

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

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

foreign-currency sources affected Israelis' foreign-currency activities in three ways: 1) Israelis' investments abroad fell significantly, from \$ 2.4 billion in April to September 2000 to \$ 0.8 billion in April to September 2001; 2) the flow of foreign-currency credit from the domestic banks rose by \$ 0.5 billion, serving as an alternative to raising capital abroad as a source of finance; 3) foreign-currency deposits in domestic banks, which totaled \$ 1.4 billion net in April to September 2000, halted in the period reviewed.

The changed trend in capital flow was also reflected by the exchange rate in the last few months. In the period reviewed the NIS depreciated by 4 percent against the dollar, and by a similar amount against the currency basket, a fast rate of depreciation relative to that of the last two years.

Despite the worsening of the security situation and the crisis in high-tech industries in Israel and world wide, the rating companies S&P and Fitch reaffirmed Israel's rating at A-. The monthly magazine Institutional

Investor (which publishes a country grading every half year based on country risks), graded Israel in the 35th position in September, a drop of one position from its position in March, and three below its position in September 2000. A comparison of the differential between the yield on Israel government bonds and that on US government bonds, which serves as another measure of Israel's credit risk, showed that the differential had not changed on bonds due for redemption in 2005.

## Global developments

Preliminary assessments of the rate of growth of the global economy in 2001 indicate a rate of 2.6 percent, 2 percentage points below the growth rate in 2000. The slowdown in global growth was led by the deceleration in the US economy, and low levels of domestic demand in Europe. The close trading and financial ties between industrialized countries themselves and between them and developing countries, ties which had strengthened

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over the last decade, lead to the rapid spread of the crisis world wide.

The crisis in high-tech industries lowered expectations of profit, led to sharp falls in stock exchanges around the world and in investments, and was a major factor in reducing demand. Tight monetary policies adopted in the US and the EU countries towards the end of 1999 and in 2000 in response to excess demand at that time also contributed to the drop in demand, with the sharp rise in fuel prices in the second half of 2000 adding to the effect. The decline in demand was reflected by the slow rise of 4 percent in international trade, the lowest since 1993.

As expectations of a slowdown in the US became firmer, the US Federal Reserve started cutting the rate of interest

aggressively. Since the beginning of the year the short-term dollar interest was cut by 4 percentage points, and is currently at its lowest level for almost forty years. The Bank of England and the European Bank cut their interest rates since the beginning of the year by 1.5 percentage points and 1.0 percentage points respectively.

The drop in demand of the industrialized countries had an adverse effect on many developing countries whose growth depends on their exports. Growth of exports of goods and services of emerging economies is expected to be 3 percent in 2001, compared to an average rate of growth of 9 percent since 1996. The developing countries also suffered the effect of the difficulty in attracting foreign investment, so that the downward trend of capital flow to them evident since 1998 has persisted.

**Table 5. Indicators of Economic Development in Advanced and Developing Countries,<sup>a, b</sup> and Forecast for 2002**

	1999	2000	Estimate 2001	Forecast 2002
<b>Annual rate of change<sup>c</sup></b>				
<b>World GDP</b>				
Total	3.6	4.7	2.6	3.5
Advanced countries	3.4	3.8	1.3	2.1
Developing countries	3.9	5.8	4.3	5.3
<b>World trade</b>				
Total	5.3	12.4	4	5.7
Advanced countries				
Imports	7.7	11.5	3.6	5.3
Exports	5	11.5	3	5.2
Developing countries				
Imports	2.1	16.6	6.4	8
Exports	4.6	15.1	5	6.6
<b>Inflation (CPI)</b>				
Advanced countries	1.4	2.3	2.4	1.7
OECD (excl. Turkey)	1.4	1.7	2.1	1.9
<b>Prices of unprocessed goods (US\$)</b>				
Oil	37.5	56.9	-5	-8.6
Other	-7	2.6	-2.6	4.5
<b>Short-term interest<sup>d</sup> (%)</b>				
Dollar deposits	5.5	6.6	4.1	3.7
Yen deposits	0.2	0.3	0.2	0.1
DM deposits	3	4.6	4.3	3.9
<b>Unemployment rate</b>				
OECD countries	6.8	6.3	6.3	6.3

<sup>a</sup> According to "World Economic Outlook," Israel is classified as an advanced country.

<sup>b</sup> The data do not take the effect of the terrorist attacks on the US and the subsequent war into account.

<sup>c</sup> Apart from interest and unemployment rates, which are shown as percentages.

<sup>d</sup> 3-month rate.

SOURCE: "World Economic Outlook" (IMF), September 2001, and OECD "Economic Outlook," June 2001.

The terrorist attacks on the US and the subsequent war against terrorism had an immense effect on private forecasters' estimates of growth for 2001 and their forecasts for 2002. The J.P. Morgan investment house reduced its growth forecasts for the US for those two years by 0.6 percentage points and 1.9 percentage points respectively. Forecast growth for the EU for 2001 and 2002 was cut by 0.3 and 0.6 percentage points respectively. The Economist, which averages the predictions of several forecasters, lowered its growth forecasts by similar amounts. According to the most up-to-date forecasts, growth rates for industrialized countries in 2002 will be close to those in 2001, i.e., 1.0 percent in the US and 1.5 percent in the EU.

### The general government sector

In January to September 2001 the domestic cash-basis deficit (excluding net credit advanced) was NIS 6.8 billion, compared to the estimated budget deficit for the year of NIS 2.5 billion. Based on the budget performance in the first nine months of the year, it is assessed that the total deficit in 2001 (excluding credit advanced) will amount to 2.9 percent of GDP, a deviation of more than 1 percentage point from the target.

Price rises in 2001, which were about 2 percent below what was forecast at the time the budget was prepared, played an important role in explaining the deficit. In general, deviation from the price level on which the budget is based need not affect the deficit significantly, as it has a symmetrical effect on the expenditure side and on the income side, but while the low level of price rises reduced income, the government exploited the price reserve for a real rise in expenses over the planned level. Income was also adversely affected by the postponement of the planned auction of third generation cellular wave bands and from slower than expected land sales, which was connected with the world wide crisis in the communications market and the slowdown in the domestic market. The fact that expenditure grew faster than did GDP was reflected in an increase of the government's domestic expenditure in the period reviewed to 38.5 percent of GDP, from 34.6 percent in April to September 2000.

Revenues from income tax on wages and salaries (derived data) rose by 4.8 percent in the period reviewed compared with the equivalent period in 2000, due to a 3 percent increase in the number of earners and a 1.3 percent rise in the real wage (these data relate to 2001:II only). Revenues from income tax on the self-employed

fell by 15 percent due to the drop in demand and decline in profitability. Corporation tax revenues went down by 4.1 percent in the period reviewed from the level in the equivalent period in 2000, after rising by 50 percent in that year. It is reasonable to expect that in the light of the crisis in high-tech industries and the losses it is causing companies the decrease in corporation tax revenues will continue. Indirect taxes on civilian imports fell by 16 percent in April to September 2001, reflecting the fall in imports, particularly of durables.

In September the government authorized the budget for 2002. A one-time increase in the total deficit, to 2.4 percent of GDP (excluding credit advanced) was decided upon, with a return to the downward path in 2003, so that in 2005 the deficit will not exceed 1 percent of GDP. The budget is based on a forecast growth rate of 4 percent for 2002. If this forecast is not realized and growth turns out to be below this figure (which is very likely to be the case) the government is committed to taking corrective measures to meet the target deficit. The explicit aim of the increase in the deficit is to enable infrastructure investment which boost growth and to enable the allocation of resources for defense purposes in view of the deterioration in the security situation. In practice the addition to infrastructure investment total only a quarter of a percent of GDP. The operative significance is an increase of 22 percent in investment in the railways and roads infrastructure (NIS 750 million), an increase of NIS 250 million in investment in the water and drainage infrastructure, and a rise of NIS 1.3 billion in the defense budget over and above the increase built into the original budget for 2001.

### Prices and monetary policy

In the period reviewed the Consumer Price Index (CPI) rose by 2.5 percent, having risen by 0.8 percent in the equivalent period in 2000. The rise of this magnitude in a half-year period was the highest for two years. Based on rises in the CPI in the last few months, inflation expectations derived from the capital market, and private forecasts of inflation, the inflation path seems to be returning to the target range of 2.5 percent to 3.5 percent inflation in 2001, after a prolonged period when inflation was lower than the target.

In 2001:II the index rose mainly due to seasonal factors and the rise in fuel prices. These rises were consistent with those forecast at the beginning of the quarter. By contrast, in 2000:III it was prices of housing and of fruit and vegetable which pulled the index upwards. Price

Table 6. Selected Price Indices, 1999–2001  
(annual rates of change during period, percent)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
CPI	1.3	0	-3.3	1.9	-1.9	6.6	3.6	1.5	5.1	9
CPI excl. housing, fruit and vegetables	1.7	0.9	-3.6	1.5	-3.5	6.6	0.4	1.3	3.5	9
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	2.4	0.6	-1.3	-2.2	-1.6	5.9	1.1	1.6	3.5	9
Index of housing prices	-0.9	-2.4	-5.8	3.2	7.4	1.6	12.6	2.9	7	9
Wholesale price index	3.5	2	-1.6	1.4	-4.2	5	-5.5	3.9	-0.4	9
NIS/\$ exchange rate	0.4	-2.7	-6.5	4.3	8.4	-0.2	16.3	1.7	7.7	9
NIS/currency-basket rate	-2.5	-6.3	-14.6	6.2	7.2	-6.3	24.6	-3.9	8.1	9

\* Last month for which data available.

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

increases in 2000:III were above the forecasts at the beginning of the period, partly due to the depreciation of the NIS in June to Sep-tember, by 4 percent against the dollar and by 5.6 percent against the currency basket.

Inflation expectations (gross) in the period reviewed calculated from the capital market rose by half a percentage point on average from their level in the preceding half year, to 2.3 percent. The rise in expectations continued almost throughout the period, reaching 3.2 percent in September. In October they declined by half a percentage point. The rise in inflation

expectations over the period reviewed can be explained by the effect of the depreciation of the NIS on inflation and by the fact that expectations are adaptive.<sup>5</sup> Assessments of inflation for 2001 by private forecasters (commercial banks and other private entities) rose from 2 percent during the period to about 3 percent at its end, a change which also indicates price increases in excess of those expected in 2001:III.

In the light of assessments at the beginning of the period reviewed that inflation in 2001 was likely to be below the

<sup>5</sup> This means that although the expectations relate to a year forward, they are heavily influenced by developments in the last few months.

Table 7. The Budget and its Financing, 1999–2001  
(cash flows, as percent of GDP)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
1. Government domestic expenditure	36.7	36.4	34.1	38.4	33.2	39.9	37.2	34.6	38.5	9
2. Government receipts	33.8	35.9	34.5	33.8	34.6	34.7	35.3	35.1	35	9
3. Domestic budget deficit (1 – 2)	2.9	0.5	-0.4	4.6	-1.4	5.2	1.9	-0.5	3.5	9
4. Government and Jewish Agency domestic deficit <sup>b</sup> (5 + 6)	3	-0.4	0.3	4.5	-2.5	3.7	1.8	-1.3	2.8	9
5. Government net borrowing from the public	2	0.2	-2.6	-0.4	0.9	4.8	1.3	-0.4	3	9
6. Public-sector injection (9 – 8 – 7)	1	-0.6	2.9	4.9	-3.5	-1	0.6	-0.9	-0.2	9
7. Bank of Israel injection	-0.1	0.6	-2.9	-5.3	5.4	2	-2.1	1.5	0	9
8. Private-sector foreign-currency conversions	-0.1	-0.1	-0.1	0	-0.5	-0.2	-0.2	-0.1	-0.2	9
9. Change in monetary base	0.9	0.1	0.3	-0.4	2	1.1	-1.6	0.8	-0.3	9

\* Last month for which data available.

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

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

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Table 8. Monetary Indicators and Nondirected Bank Credit, 1999–2001  
(percent change, annual terms)

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*	
			III	IV	I	II	III	2000	2001		
Rates of change	(average)		(compared with preceding quarter)							(during period)	
M1 <sup>b</sup>	9.6	11	13.9	6.5	11.2	21.7	29.0	14.2	24.5	9	
M2 <sup>c</sup>	21.8	20	19.6	22.7	19.7	12.8	14.6	16.1	13.2	9	
M3 <sup>d</sup>	22.5	19.1	16.6	18.3	22.1	12.1	12.3	14.1	12.1	9	
Nondirected bank credit	16.7	13.1	11.3	10.9	11.5	9.5	12.6	12	12.2	9	
Unindexed local-currency	18.2	25.2	14.9	15.8	22	10.5	8.5	20.8	7.6	9	
CPI-indexed	15.4	6.9	13.5	-2.7	0.3	6.2	13.1	8.5	12.0	9	
Foreign-currency-indexed and denominated	17.3	9.5	3.1	30.6	17.1	13.3	17.8	6.7	19.0	9	

\* Last month for which data available. Some data for the last quarter are based on preliminary data.

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

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

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

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

target, the Bank of Israel continued cutting its published rate of interest by 0.2–0.3 percentage points a month. This occurred also regarding the interest rate for August, when it was assessed that inflation in 2001 and 2002 would be within the target ranges. In September, when inflation expectations derived from the capital market, assessments by private fore-casters, and inflation-predicting models developed by the Bank of Israel all predicted that inflation would be within the target range

in 2001, but at the upper limit of the range in 2002, the Bank decided to leave its declared rate at 6.3 percent.

Despite the cuts in the Bank of Israel's interest rate, the differential between it and interest on the euro and the pound sterling did not contract, and between the NIS and the dollar the differential actually widened by 2 percentage points due to the big cuts in the rates in the US and more moderate cuts in Britain and the EU.

Table 9. Interest Rates, Yields, and the Share-Price Index, 1999–2001

	1999	2000	2000		2001			Apr–Sept <sup>a</sup>		*
			III	IV	I	II	III	2000	2001	
Nominal interest										
Nondirected										
local-currency credit	16.4	12.9	12.6	11.8	11.1	10.3	9.6	12.9	10	8
Average monetary loan	12.5	9.3	9.1	8.4	7.7	7	6.2	9.3	6.6	9
SRO deposits	10.7	8	7.7	7	6.5	5.9	5.2	8	5.6	8
3-month Eurodollar	5.3	6.4	6.6	6.6	5.2	4.1	3.3	6.5	3.7	9
Yield to maturity on										
Treasury bills	11.4	8.8	8.8	8.3	7.3	6.6	6.4	8.9	6.5	9
10-year bonds	5.2	5.5	5.7	5.7	5.4	4.9	4.6	5.5		9
5-year bonds	5.6	6	6.2	6.2	5.7	5	4.3	6	4.6	9
General Share-Price Index (points)	181.4	248.6	262.4	226.4	202.5	196.5	194.7	256.7	195.6	9
Expected inflation (gross)	5.3	2.5	2.4	1.6	1.8	1.4	2.8	2.9	2.1	9
Interest derived from expected inflation (gross)	5.7	6	6.2	6.5	5.3	4.9	3.6	5.8	4.2	9

\* Last month for which data available.

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

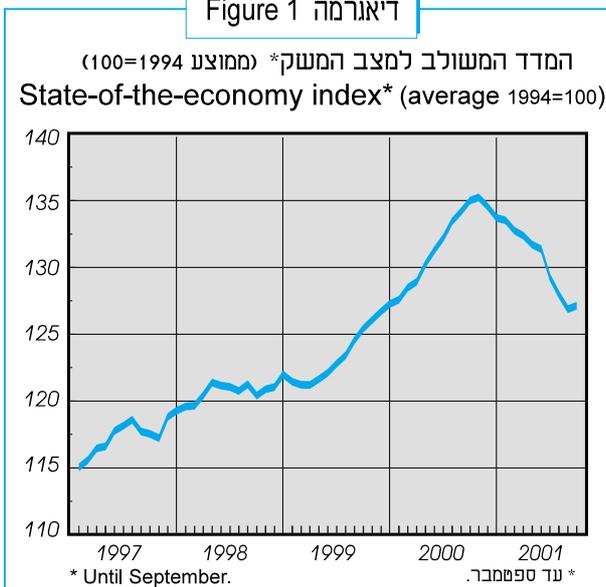
Real interest, which had started to come down in 2001:I, continued to do so in the period reviewed. Real short-term interest derived from inflation expectations went down in the period reviewed from over 5 percent to 3.3 percent. The reduction is the direct outcome of the continued cuts in the Bank of Israel's short-term nominal interest rate, even when the inflation rate was no longer falling. Long-term real interest declined more slowly, by a little over 1 percentage point, because it is less closely connected to the Bank of Israel's rate, and it is affected by additional macroeconomic factors such as the budget deficit and interest rates abroad. These changes in interest rates are reflected in the yield curve, which for the first time in a long period slopes upwards from left to right.

The change in the yield curve affected the rate of increase of the monetary aggregates. The narrow money supply (M1) continued expanding rapidly, by 19 percent,<sup>6</sup> over the last twelve months. This rate is far in excess of the

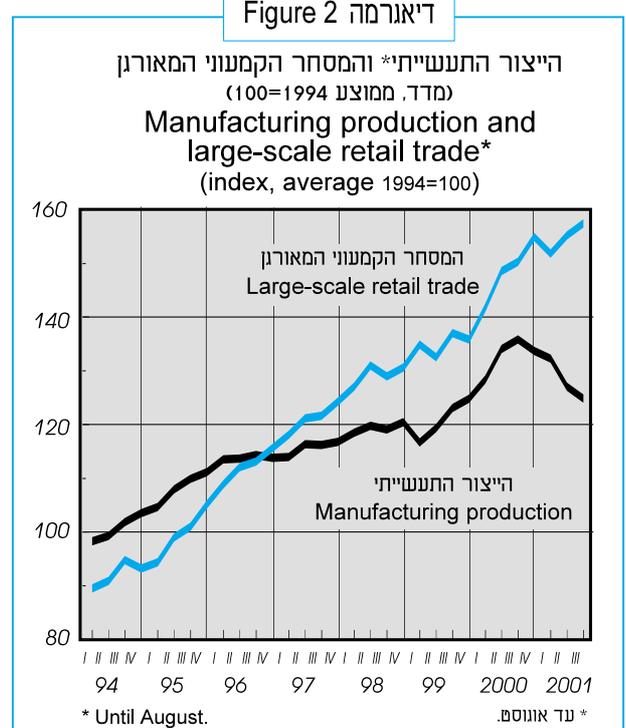
nominal growth of GDP, but it must be borne in mind that cuts in interest rates encourage the expansion of the money supply at the expense of interest-bearing deposits. The reduction of short-term interest in the period reviewed led to a relatively small rise of 8.8 percent in interest-bearing deposits for periods of up to a year, compared with rises of 27 percent in 1999 and 20 percent in 2000. At the same time long-term deposits paying unindexed interest continued to expand. Another effect of the change in the yield curve was to halt the decline in investment in savings schemes, a decline which persisted for almost two years. The return to investing in savings schemes apparently also stemmed from the ending of the reduction in inflation and from the switch by some investors into indexed assets.

<sup>6</sup>The money supply increased by 27 percent, in annual terms, in the period reviewed, apparently due to the effect of the summer months and the Jewish festivals.

דיאגרמה 1 Figure 1



דיאגרמה 2 Figure 2



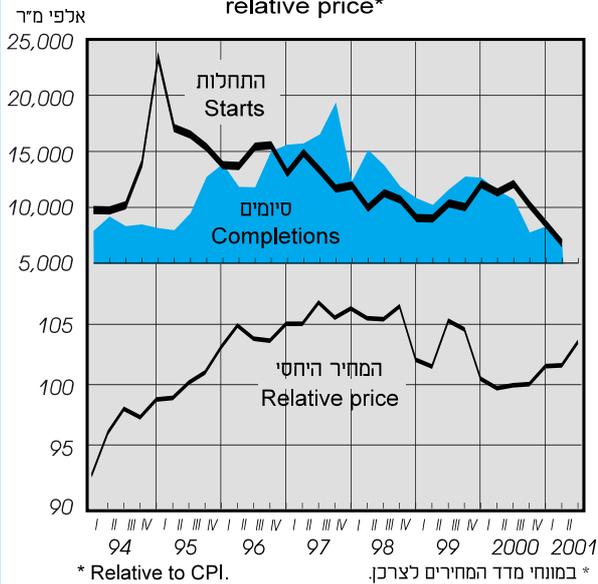
דיאגרמה 3 Figure 3

הריבית וסביבת האינפלציה  
Interest and the inflation environment



דיאגרמה 4 Figure 4

מספר ההתחלות והסיומים של יחידות דיור והמחיר היחסי על הדיור\*  
Housing units: starts and completions, and relative price\*



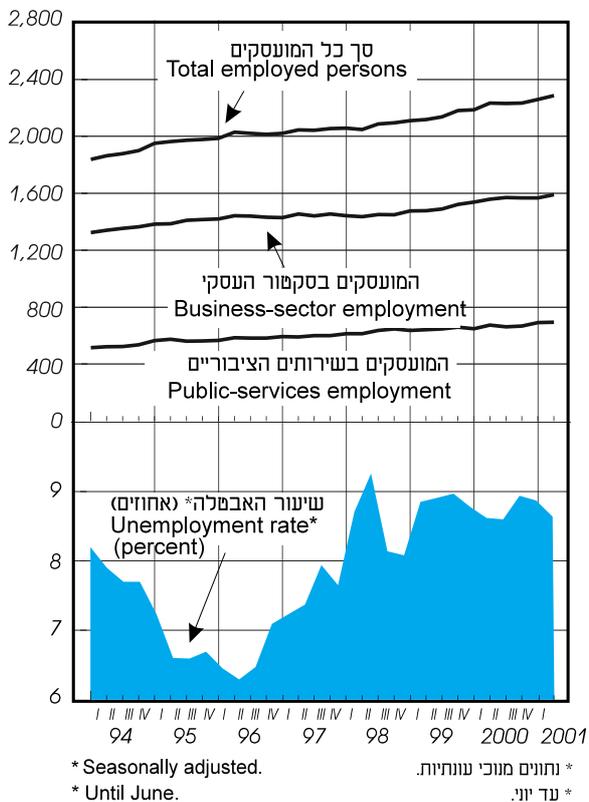
דיאגרמה 5 Figure 5

התיירות (מדד, ממוצע 1989=100)  
Tourism (index, average 1989=100)



דיאגרמה 6 Figure 6

שוק העבודה\* (אלפים)  
The labor market\* (thousands)



דיאגרמה Figure 7

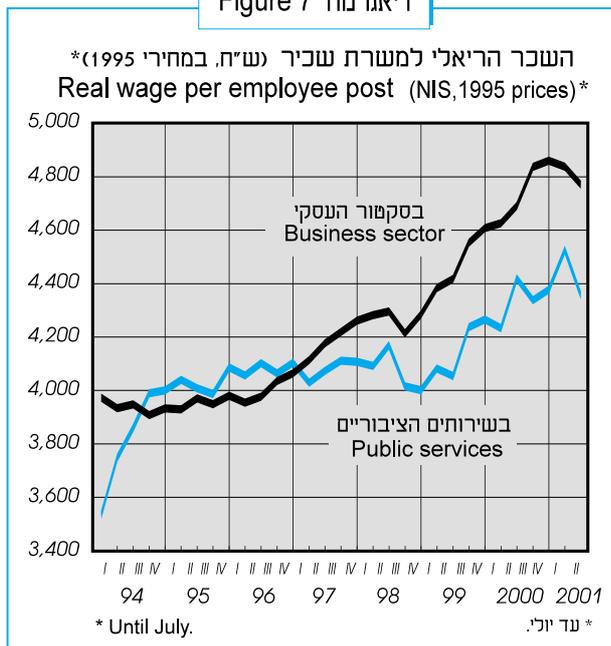
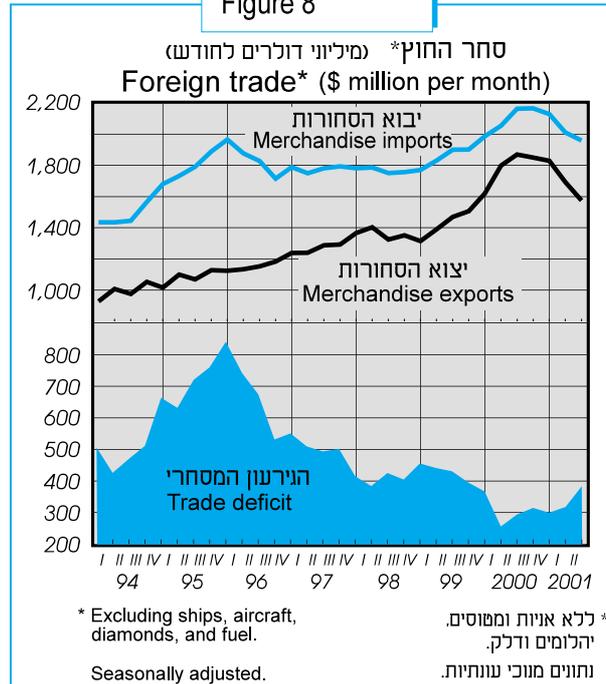
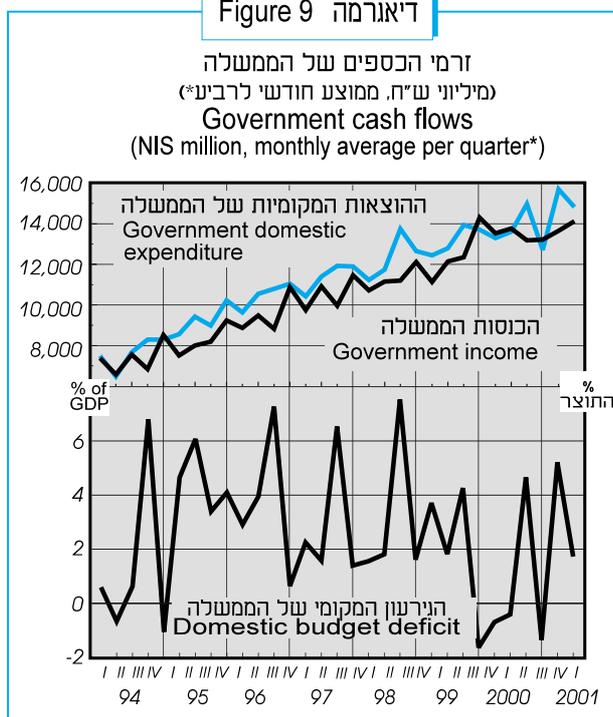


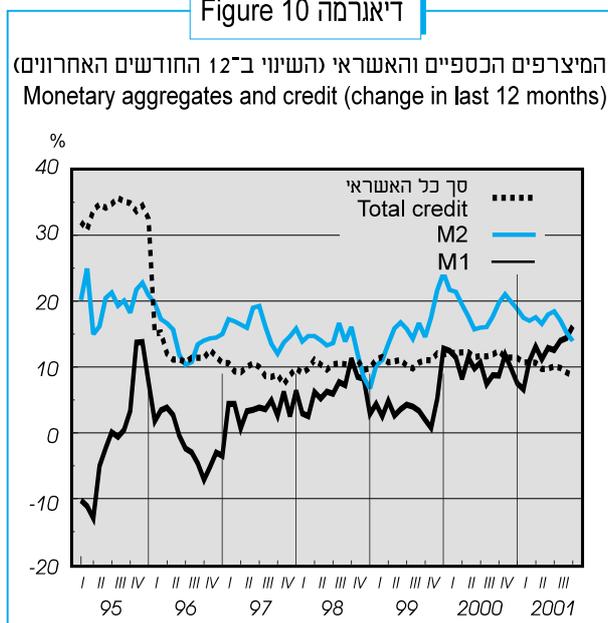
Figure 8



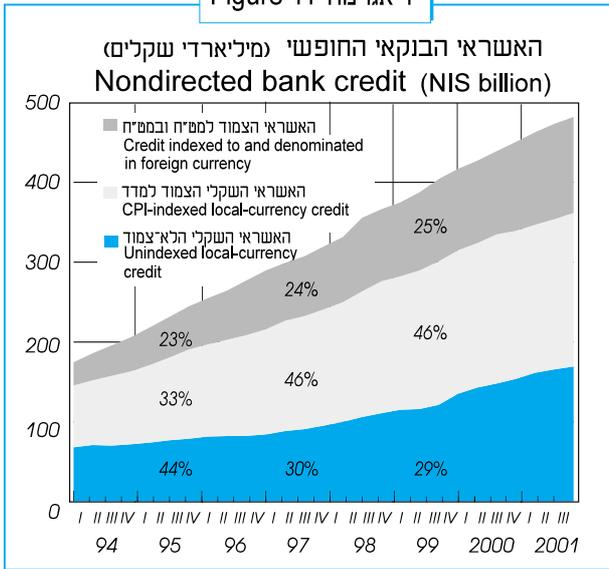
דיאגרמה Figure 9



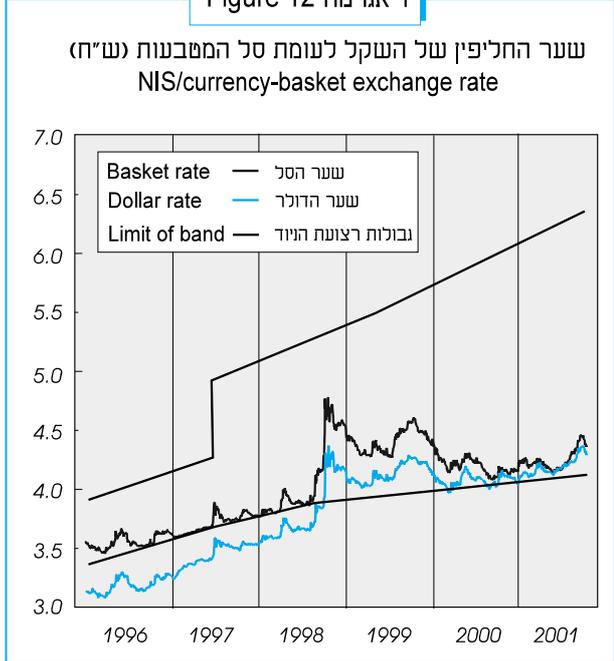
דיאגרמה Figure 10



דיאגרמה Figure 11



דיאגרמה Figure 12



דיאגרמה Figure 13

