The Economy: Developments and Policies[*]

In 2003 there was a turnaround in business-sector activity due to the global economic recovery and some improvement in Israel's security situation, supported by a change in the fiscal and monetary policy mix. GDP rose by 1.3 percent and business-sector product by 1.8 percent, after a 3 percent decline in each of the two preceding years. Nevertheless, the year as a whole, and especially the first half, was characterized by a moderate level of economic activity, a decline in per capita GDP, and a rise in unemployment. The CPI (Consumer Price Index) fell by 1.9 percent, significantly below the price-stability target, as a result of local-currency appreciation and the economic slowdown.

Until March there was uncertainty regarding the government's commitment to checking the expansion of the budget deficit and the public debt. In the context of the static security and political situation, this was also expressed in high real interest rates—both long- and short-term. In March, with the publication of the government's economic program, the approval of the US government loan guarantees, temporary renewal of the peace process, and subsequent rapid conclusion of the Iraq war, uncertainty abated and Israel's risk premium declined markedly alongside an improvement in the monetary indicators—inflation expectations and the nominal and real yield curves. Against this backdrop, the Bank of Israel was able to gradually and continuously reduce its key interest rate, which declined by 4 percentage points until the end of the year. These policy changes affected economic activity in 2003 in two directions: on the one hand, the sharp cuts in the government's current expenditure, which fell in real terms for the first time since 1985, reduced both government and private direct domestic demand in the short term because of the contraction of transfer payments and decline in the public-sector real wage. On the other, the coordinated economic policy mix led to a positive turnaround in firms' and households' expectations, contributing to a sharp rise in share prices, and this had a beneficial effect on private consumption in the second half of

[*] For tables and figures, please see end of text.

the year. The real interest rate, whose high level at the beginning of the year had hampered the recovery of investment, dipped towards the end of the year, supporting the stabilization of investment alongside initial signs of a rally in the second half of 2003.

The main challenge confronting economic policy is to stimulate sustainable growth while raising the employment rate and combating poverty, which expanded as a result of both the protracted economic slump and long-term factors partly arising from government policy. One aspect of this policy is the continued successful economic policy mix implemented in 2003, alongside a return to a declining budget deficit path through the reduction of current expenditure. This path supports low long-term interest rates and enables the Bank of Israel to set nominal interest at a rate that is consistent with low long-term real interest, supporting a return to growth while maintaining stability. Other important components include an increase in infrastructure investment and the implementation of structural changes which will increase competition. Another aspect is extending the policy adopted in the last two years to combat poverty. Till now this consisted of cuts in transfer payments and a reduction in the number of foreign workers. At the next stage the government will have to act so as to make the labor market more attractive to the low-income population. This can be done by: (i) further reducing the number of foreign workers; (ii) improving the education system serving the weaker segments of the population, and making it more efficient; (iii) reforming taxation and transfer payments, and introducing a negative income-tax program; (iv) establishing compulsory occupational pension plans. It is important to create mechanisms which will make a distinction between individuals who are capable of working and those who are not, to ensure that only the latter receive transfer payments.

1. MAIN DEVELOPMENTS

The deterioration in economic activity was checked in 2003 and a positive trend was evident in the second half of the year, due to the recovery of the global economy and some improvement in Israel's security situation. The turnaround was supported by a coordinated change in the fiscal and monetary policy mix. After declining for two years, GDP rose by 1.3 percent and business-sector product by 1.8 percent. Notwithstanding, the level of economic activity remained moderate in 2003; per capita GDP declined by 0.5 percent and the unemployment rate rose to 10.7 percent of the civilian labor force. The CPI dipped by 1.9 percent in 2003, below the price stability target, as a result of the economic slowdown and local-currency appreciation vis-à-vis the dollar.

After two years in which economic activity contracted due to the Intifada, which erupted in late September 2000, and the slump in world trade—especially in the high-tech industry—these two areas began to pick up in the course of 2003. The economic recovery in the US (Table 1b), which accelerated during the year, was first expressed

in the traditional industries, later extending to the high-tech industry, which accounts for a large share of Israel's exports. This year the rise in exports was the engine of the turnaround in GDP, contributing 2.5 percent to its growth differential. Concurrent with this development, Israel's security situation improved somewhat, in the context of the 'Hudna,' (ceasefire) which led to a temporary lull in terrorist attacks and a fall in their number relative to the two preceding years. This improvement was expressed in an increase in private consumption in the second half of the year and a recovery in the commerce and the catering and hotel services industries during the year; the recovery was not evident in all industries, however, chiefly construction.

Economic policy affected activity in two directions in 2003. First, until March there was considerable uncertainty regarding the government's commitment to the deficit targets in view of the ongoing economic slowdown, the security-political uncertainty, and expectations of a war in Iraq. This served to prolong the negative trends of the previous two years, among them the steep rise in the public debt/GDP ratio, increase in the statutory tax rate, and high real interest rates which, while maintaining financial stability, hampered the recovery of investment. All these were compounded by the moderating effect on domestic demand of government spending cuts which, while necessary in order to avert the risk of a financial crisis, with even worse implications for GDP, reduced demand in the short term. Second, in March, following the announcement of the government's economic program, which reduced the deficit from 7 to 4 percent of GDP by slashing current expenditure, the approval of the US loan guarantees, the temporary renewal of the peace process, and the subsequent rapid conclusion of the war in Iraq, uncertainty abated considerably. This led to a sharp fall in Israel's risk premium,[1] and was also expressed in all the main monetary indicators—inflation expectations and the nominal and real yield curves. In the context of the positive global developments and improvement in the domestic fiscal situation, which implied a reduction in real public expenditure for the first time since the ESP (Economic Stabilization Program) of 1985, as well as the cyclically-adjusted deficit[2] in 2003, the Bank of Israel was able to gradually and credibly reduce its key interest rate. The successful economic policy mix served to change firms' expectations, and this, together with the recovery on global stock markets, led to a sharp rise in the General Share-Price Index during the year. The recovery in the capital market,[3] alongside renewed expectations of future tax cuts, supported the surge in private consumption in the second half of the year. Furthermore, the decline in real interest bolstered the stabilization of investment during the year, together with initial signs of recovery in imports of investment goods in the second half of the year. The rise in wealth and expected disposable income was also bolstered by decisions that reduce public expenditure in the long run, such as contending with the pension funds' actuarial deficit by raising the retirement age and updating the transfer payments mechanism.

[1] The decline in the risk premium was evident in most emerging markets, but was especially marked in Israel.

[2] The general government deficit adjusted for the effect of the recession on tax revenues.

[3] The contribution of the recovery in the capital market to private consumption is estimated as 0.6 percent, on the basis of the calculation presented in Y. Lavi (2003), "Do Changes in Current Income Help to Explain Changes in Consumption in Israel?" *Israel Economic Review*, Vol. 1, no. 2, 113–135.

The unemployment rate, which continued to rise in 2003, averaged 10.7 percent of the civilian labor force. Although there was no significant recovery in the demand for labor, the unemployment rate did not increase substantially during the year. This was due in part to the expansion of employment in the knowledge industries,[4] as well as to the government's determination to reduce the number of foreign workers, making it possible for the first time in many years to replace them with Israeli workers, especially in construction. In 2003, after a long period in which public-sector employment expanded, this process came to a halt, adding 0.3 percent to the unemployment rate. In the labor market, too, there were indications of a turnaround in the second half of the year, mainly an increase in the real wage after a marked decline throughout the recession.

The current-account deficit of the balance of payments contracted in 2003, as a result of the recovery of exports. Another factor underlying the decline in the deficit was the low level of economic activity, which in 2003 was accompanied by a relatively slow rise in imports of goods and services. The improvement in the current account stemmed from the decline of the share of investment in total sources available, and a smaller decline in the share of savings. If the process of emergence from the recession takes hold, this trend may well be reversed because the end of a slump is generally characterized by a rise in investment. The indicators of real depreciation attest to a mixed picture; the recovery of the mixed and traditional industries (primarily in the first half of the year) was affected with a lag by the real depreciation of 2002, which was partly offset during 2003.

The CPI declined by 1.9 percent this year, significantly below the target of price stability, defined as 1–3 percent. The deviation from the inflation target is explained by the appreciation of the NIS vis-à-vis the dollar,[5] and by the moderate level of economic activity. The appreciation was the outcome of the trend reversal in capital inflows, mainly of short-term flows which are motivated by interest-rate differentials, but also in direct investment, influenced by the recovery of the high-tech industry. Capital inflows were stimulated by the decline in the risk premium in emerging markets in general, and in Israel in particular, as well as by interest rates, which were higher during the year than in the advanced economies.

Monetary policy served in 2003—and especially at the beginning of the year—to bolster the price and financial stability attained after the sharp interest-rate hikes in mid-2002, in view of the exceptional depreciation and belated response of fiscal policy in 2002. Its main goal was to attain the lowest interest rate possible to support economic recovery. In the first half of 2003, and especially the first quarter, it was still difficult to assess how imminent was the danger of exceptional depreciation as had occurred in 2002. It seemed at that time that the risk embodied in a too rapid interest-rate cut outweighed that of one that was too slow, as the former could undermine stability in the foreign-currency market, requiring a greater and more protracted interest-rate hike at a later stage. Consequently, the interest rate was reduced gradually, alongside constant

[4] Some manufacturing industry, computers, banking, insurance, financial institutions, and other business activities (see Chapter 2, "The Labor Market," of the Annual Report of the Research Department).

[5] There was considerable appreciation vis-à-vis the dollar in 2003 due to the marked weakening of the dollar against the euro. Changes in the dollar exchange rate have an extensive effect on prices in Israel because of the large share of housing in the CPI. A rise in housing prices is measured by the CBS (Central Bureau of Statistics) on the basis of rental contracts most of which, according to its survey, are specified in dollars.

monitoring of the response of inflation expectations and the foreign-currency market. In retrospect, this has not been sufficient to minimize the deviation from the calendar-based inflation target.

The lengthy economic slowdown caused poverty to increase (see box). This was also due to the cuts in transfer payments and other items, which impact on the poor in the short term. The government was obliged to make these cuts during the slump in order to avert the danger of a financial crisis, which could have had even worse repercussions. One of the main challenges facing the government was to curtail and even reverse the trend of the expansion of poverty (which could eventually impair growth) by increasing the employment rate. In order to achieve this, it is necessary to improve the policy of the last two years, which to date has involved cutting transfer payments and expelling foreign workers. It is particularly important to reinforce the economic incentives that will encourage those segments of the population which have not participated in the labor market for a long time to enter and remain in the labor force.

2. REAL ECONOMIC ACTIVITY

After a slump lasting more than two years, economic activity stabilized in 2003, and there was even a positive trend in the second half of the year, led by a rise in exports and private consumption. Business-sector product grew by 1.8 percent, after contracting by 3 percent in each of the preceding two years (Table 2a), and during the year production expanded in the high-tech industry and commerce and services. The main reasons for the recovery of demand were the rise in exports, which contributed 2.5 percent to GDP growth differential in 2003, as well as in private consumption, which contributed 0.6 percent (Table 2a and Figure 2). Nevertheless, the decline in domestic uses persisted because of the steep drop in gross domestic investment (including inventories) and the fall in domestic public consumption.

The principal reasons for the slump of the last two years were the decline in demand due to the Intifada, which began at the end of September 2000, and the slowdown in world trade, especially in the high-tech industry. There was a turnaround in both these spheres in 2003. First, the US economy rallied, and this trend intensified during the year. This recovery, expressed first in the traditional industries, later spread to the high-tech industry, which accounts for a large share of Israel's exports. Second, there was also some improvement in Israel's political-security situation, with a decline in the number of terrorist attacks and, in the background, the successful conclusion of the war in Iraq.

The 6.1 percent expansion of exports—after a cumulative 15 percent fall in the preceding two years—is explained by the economic recovery, especially in the latter part of 2003, in the US, Europe (to a lesser extent), and Japan, and was led by the rise in exports of the high-tech, mixed, and traditional industries, and in the services. However, the recovery in the advanced economies has not yet found expression in the expansion of world trade, which has risen by only 2.9 percent on average, similar to its 2002 rate. In addition, demand picked up initially for the products of the traditional

industries, in which Israel does not have a comparative advantage vis-à-vis abroad. Nonetheless, during the year the gradual recovery of the high-tech industry became evident, and this was also expressed in the Nasdaq, especially in the second half of the year. Trade figures show that high-tech exports rose significantly in 2003:IV.

Private consumption rose mainly in the second half of the year, against the backdrop of the slight improvement in consumer confidence (see Box 1.2 in Chapter 1, "Output and the Principal Industries," of the Annual Report of the Research Department) in the wake of the temporary cessation of terrorist attacks (the 'Hudna') and fewer incidents than in previous years. The improvement, evident in the recovery of commerce and catering and hotel services during the year, was also affected in two directions by macroeconomic policy: the cuts in transfer payments, public-service wage reductions, and increase in tax rates in 2002 reduced private consumption in the short term, while the real contraction of public expenditure after March, for the first time since the ESP of 1985, restored the downward deficit path, thereby rehabilitating firms' and households' trust in the government's determination to reduce expenditure on an ongoing basis, thus making future tax reductions possible. These changes, which supported the gradual and credible process of interest-rate reductions by the Bank of Israel, contributed to the sharp turnaround which began in the capital market and had a beneficial effect on private consumption.

The government's direct demand[6] dipped by 0.7 percent in 2003, after rising by 5.1 percent in 2002. This decline reflects the cuts announced in the fiscal package, which affected the various public expenditure items to a similar extent. The contribution of public consumption excluding defense imports to GDP growth was negative this year (–1.2 percent),[7] in addition to the restraining effect of the reduction in transfer payments, which had an adverse effect on private consumption. Nevertheless, it can be assumed that spending cuts will eventually have an expansionary effect, because of households' expectations that tax cuts will follow, increasing disposable income.[8] A comparison of the government's two last fiscal packages (Box 3.2 in Chapter 3, "The Budget and the General Government," in the Annual Report of the Research Department) shows that the second package embodied a NIS 12.2 billion reduction in the deficit relative to its previous path, almost all of it (NIS 11.9 billion) in spending cuts, mostly of current expenditure. This contrasted with the previous package, in which the deficit was cut by NIS 6 billion, mostly through tax increases. On the basis of studies undertaken abroad on the effect of fiscal consolidation, the composition of the reduction in 2003 is in line

[6] See Table A.1.3.6(1) in the Statistical Appendix.

[7] This contribution reflects the direct effect of domestic demand on GDP, assuming that there are no offsetting influences from other uses. A recent US study, Blanchard and Perotti (2002), "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output," *Quarterly Journal of Economics*, later extended to the EU, Perotti (2002), "Estimating the Effects of Fiscal Policy in OECD Countries" (mimeo), showed that primarily in the US a change in government spending affects GDP in the same direction in the first year. In Israel, Lavi and Strawczynski (2003) "The Effect of Policy Variables on Private Consumption; 1960–2000," *Economic Quarterly*, December (Hebrew), found that in annual terms an increase in public consumption is offset only partly by private consumption.

[8] The increase in wealth and change in expected income enable the expansion of consumption by consumers who do not suffer from a liquidity constraint (i.e., those who cannot increase consumption when unable to borrow. According to the study by Lavi (2003), they account for about 50 percent of private consumption.

with fiscal consolidation which has an expansionary effect. Assuming there is no further deterioration in the security situation, the expansionary effect is expected to be felt in 2004, assuming of course that the government attains its new fiscal targets and implements the consolidation program in full.

Apart from a temporary increase in 2002, gross domestic investment has been declining steadily, by a cumulative 33 percent, since 1997. This decline was due to three factors: (i) The process of adjustment of investment due to the cessation of immigration from the former USSR; (ii) the continued slump in demand, which signalled to firms that the expected recovery would be gradual, impelling them to respond by drawing down inventories; (iii) the high real interest rate, which was intended to attain price stability while maintaining financial stability but hampered the recovery of investment.[9] While it is difficult to assess whether the level of investment is consistent with producers' desired level of capital stock, it can be assumed that such a large cumulative decline ended the process of adjustment following the conclusion of the influx of immigrants from the former USSR. Since there was a trend reversal in the other two factors, it can be expected that in 2004 there will be a turnaround in investment too, the first signs of which can be seen in the second half of 2003 (rise in imports of investment goods, increase in residential investment and cessation of decline in inventories in 2003:IV).

Regarding profitability, suitable conditions were also created to support the recovery which emerged during the course of the year. The decline in wages for the second year in succession, expressing a combination of the ongoing recession and labor-market flexibility, prevented some dismissals, while minimizing the adverse effect on firms' profitability. These trends were expressed in the decline in unit labor costs and rise in return on capital (Table 3).

Long-term trends in total factor productivity

The decline in total factor productivity (TFP) in recent decades gives cause for concern (Table 3).[10] The decline in the last ten years was also affected by long-term factors, including the recession, which has persisted for over two years and is the longest in Israel's history.[11]

One way of improving productivity is by growth-sustaining macroeconomic policy (see section on Recommendations, below). Once the shocks which have affected the economy have passed, this will foster a positive business cycle while continually

[9] In a simulation of the development of business-sector investment in 2003 we found that a rise in short-term interest explains *ex post* some 25 percent of the fall in this investment, while most of the decline is connected with processes of adjustment of investment and capital stocks. This finding is based on an expansion of the work of Y. Lavi (1990), "The Effect of Interest Rates on Investment in Israel's Principal Industries, 1962–88," *Economic Quarterly* 143 (Hebrew).

[10] The decline in TFP began in the 1970s and characterized the advanced economies, but has not been apparent there during the last ten years.

[11] See the comparison between Israel's various recessions in Box 1.1 of Chapter 1 in the Research Department's Annual Report for 2002. Even if in 2004 it is possible to state that the recession came to an end in the second half of 2003 (see Box 1.1 of Chapter 1, "Output and the Principal Industries," in the Research Department's Annual Report), this recession will have been Israel's longest.

increasing demand, thus leading to the better utilization of factors of production. The engine likely to stimulate this process is the reduction of the debt/GDP ratio, which will make it possible at the initial stage to reduce the share of the deficit while stabilizing the debt/GDP ratio, and at a later stage to reduce the tax rate too, similar to the process implemented in the advanced economies during the last ten years.

Among the long-term factors which could contribute to economic growth are building up and improving human capital, the accrual of infrastructure capital, and the accumulation of R&D capital, in which Israel has a comparative advantage.

As regards building up human capital, policymakers concluded many years ago that the root of the problem in Israel's education system is not necessarily the lack of resources—which naturally also affects results—but the urgent need to make organizational changes which will serve to improve achievements; these last were found to be very poor, even by comparison with countries whose educational inputs are greatly inferior to Israel's.[12] One of the proposals currently being examined is based on decentralizing the education system while increasing the involvement of the regional and local authorities. Expenditure per pupil varies widely between regions, as does the share of government financing in local authorities and of parental participation in education costs.[13] In view of the financial crisis in the local authorities, it is urgently necessary to regulate the financial arrangements and areas of responsibility of the authorities and the central government in the various spheres, determining clear and transparent rules for the long term which will prevent the recurrence of a situation in which the energies of the local authorities are focused on struggling to obtain government finance.[14]

On the margin, building up human capital is affected by tax policy, and especially the tax rates on labor income—income tax and national insurance payments. The tax rate on labor income has been rising in the last six years, and its share in total tax receipts is very large in comparison with the advanced economies. There has recently been a shift in this sphere, due to a combination of capital taxation and the reform in the taxation of labor income. The reduction of tax rates on labor is highly important in view of the growing competition between countries due to growing globalization.

The policy component which has a positive and significant effect on total factor productivity is infrastructure investment. After many years of stagnation as regards the planning of mass transportation projects, several such projects have recently been brought forward; these include suburban railways in Jerusalem and Tel-Aviv as well as interurban railways, which will serve to augment productivity.

[12] For a general account of the subject, see "Proposal to Reorganize Public Education in Israel Through Decentralization and Regionalization," The Ninth Annual Economic Conference in Caesarea, the Democratic Institute, summer 2003 (Hebrew).

[13] For example, in Tel-Aviv Jaffa expenditure per pupil was NIS 13,440 in 2001, while in Nazareth it was NIS 2,380, and the average was NIS 7,215. Government funding in Um-el-Fahm constituted 97 percent, whereas in Kiryat Motzkin it was about 16 percent, and the average was 67 percent. Parental funding amounted to 12.3 percent in Kiryat Bialik, 0 percent in Safed, and the average was 8 percent (source: Table 1, "Proposal to Reorganize Public Education in Israel Through Decentralization and Regionalization," *op cit.*).

[14] For a more detailed account, see section 7 of Chapter 3, "The Budget and the General Government," in the Annual Report of the Research Department.

3. FISCAL POLICY

The government's overall deficit rose from 3.8 percent of GDP in 2002 to 5.6 percent in 2003—a 2.6 percent of GDP deviation from the deficit target.[15] However, this figure conceals the sharp shift in the deficit path since mid-2003 due to the implementation of the government's economic package: the deficit shrank from 7 percent or more of GDP in the first half of the year to less than 4 percent of GDP in the second half as a result of significant cuts in public spending, which fell in real terms in most of its components for the first time since the ESP of 1985.

Two main factors explain the rise in the deficit: (i) the persistence of the recession, which caused tax receipts to contract notably (by 0.9 percent of GDP);[16] (ii) the rise in interest payments, due in part to the significant increase in the public debt/GDP ratio, and in part to the technical aspect of the way interest payments were calculated in the budget (0.9 percent of GDP).

In order to analyze the effect of fiscal policy on GDP in 2003 it is necessary to distinguish between two aspects: (i) the effect on domestic demand, expressed directly in public consumption and investment, and indirectly via cuts in public-sector wages and in transfer payments, which reduced private consumption; this was expressed primarily in the short term; (ii) the positive impact on output, financial wealth, and households' expectations; some of this was expressed in 2003 while some is expected to be expressed in the longer term.

The government's domestic demand dipped by 0.6 percent in 2003; the real contraction in public-services wage payments amounted to 4 percent, and per capita transfer payments on current account fell by 4.5 percent (in real terms, adjusted by business-sector product prices). These effects moderated domestic demand, and contributed to the reduction of GDP in 2003.[17]

Notwithstanding, the economic package introduced in March denoted a policy switch supporting the shift to a sustainable growth path. Part of its impact on the economy was evident in 2003—primarily in the increase in the public's financial wealth, which served to expand private consumption in the second half of the year—but most of its benefits can be expected to be felt in the longer run, via several channels. First, the cuts in public spending, which were implemented mainly in current expenditure items, mark a change in direction from the various packages announced in recent years, which were based on tax increases. The reduction of the government's current expenditure makes it more likely that there will be an ongoing rise in households' disposable income,

[15] Because of accounting changes introduced in 2003, with the privatization of the Israel Railway, government transfers to the railway of NIS 400 million were not recorded as expenditure in the budget. Another NIS 650 million paid to the US government as a risk premium against the guarantees for the issuance of Israel government bonds was not recorded in the budget either. Had these amounts been recorded, the deficit would have risen by 5.8 percent of GDP.

[16] A comparison of the actual deficit with the budget deficit shows that the deviation from the target is explained by the gap between forecast and actual revenues. Nevertheless, the actual quantitative growth rate was in line with the rate forecast in the budget, indicating that last year's forecast of tax receipts was inflated.

[17] Another index summing up the government's direct effect on demand is the change in the cyclically-adjusted domestic deficit (the fiscal impulse), which fell by 1.7 percent of GDP in 2003 (Table 4).

as it will preclude the need to raise taxes in the future. Second, the reduction of the deficit during a recession signals the government's intention to return to a downward deficit path which will make it possible to stabilize the public debt/GDP ratio in 2005 and reduce it at a later stage. The fiscal index (Table 4), which indicates the extent of governmental adherence to a policy of price stability, was in fact expected to decline in 2004. The reduction of the deficit is a necessary precondition for the gradual, ongoing, and credible reduction during the year of the key interest rate by the Bank of Israel, thereby supporting an increase in investment by firms.[18] Third, the package contained elements connected with public spending in the long run, especially in the areas of pensions and benefits. Contending with the actuarial deficits of the pension funds removes part of the threat of an increase in public spending in the long run, signalling the government's desire to return to a process of reducing the share of public expenditure in GDP.

There has been a real change in public expenditure in 2003 in comparison with previous years, as Figure 3 shows. One of the most prominent aspects of this is the fact that the current expenditure items—civilian and defense expenditure, and transfer payments—declined by similar rates (about 1 percent) in 2003. This indicates that most of the cuts in public spending were made without setting clear priorities. In the future the development of public expenditure should reflect priorities, with the adjustment of its composition to the needs of the economy. A notable example of a significant reduction in budgetary needs can be found in the defense budget: the successful conclusion of the war in Iraq means that a former strategic threat to the State of Israel, justifying increases in defense spending in the past, appears to have been averted for the foreseeable future.

Another component which is expected to have a positive effect on long-term growth is infrastructure investment. Investment in the transport infrastructure stabilized in 2003, after soaring in recent years. However, its level is still low by international standards, especially in the area of mass transportation, and is not sufficient to close the gaps that have arisen in the past. A significant move in this sphere is the decision to substantially expand the long-term program to develop the railway; this was approved in 2003 and will be implemented in the next five years.

However, the government's decision to transfer large amounts to the Israel Railway and record them as a loan instead of as budgetary expenditure runs counter to accepted accounting practices,[19] and reduces the transparency of budgetary decision-making. The increase in investment should be transparent and undertaken concurrently with a review of the suitability of the railway lines intended to strengthen the link between urban centers and the periphery,[20] or of becoming profitable in the case of lines in the central region.

[18] The direct impact of fiscal policy on long-term yields is greater than it is in the medium and short term. See H. Ber, A. Brender, and S. Ribon (2003), "Does Fiscal Policy Affect Bond Yields? Evidence from Israel in the 1990s," *Economic Quarterly* (4), 623–678 (Hebrew). Since the decline in long-term interest rates is very relevant for investment, it is significant that the interest rate was reduced in the framework of a coordinated fiscal-monetary policy mix.

[19] According to Eurostat regulations, as long as the company concerned is not private and does not have a profit-based business plan, government transfers should be regarded as capital transfers.

[20] An example of a line of this kind is the new one between Beer-Sheba and Ashkelon, and the streamlining of the lines between those towns and Tel-Aviv.

4. THE LABOR MARKET

In 2003:IV the unemployment rate reached 10.9 percent of the labor force, significantly higher than its level (8.5 percent) before the recession, which began in 2000:IV. Nonetheless, the unemployment rate remained relatively stable during the year, even though the rise in GDP was below the increase in the labor force.

Three factors serve to explain the development of unemployment in the course of 2003. The first is economic activity; the moderate increase in business-sector product together with the cuts in government spending moderated the rise in the demand for labor, so that the increase in employment in this sector was below the population growth rate. Only in the second half of the year were initial signs of a possible turnaround and a rise in the real wage evident. The second is substitution between Israeli and foreign workers; after a protracted period in which Israel's government announced that its policy was to reduce the number of foreign workers, this fell in 2003 for the first time, by about 30,000 during the year, i.e., 15 percent of their number in the business sector and 1.5 percent of total employees in this sector. The reduction in the number of foreign workers made it possible to employ Israelis, thereby contributing to the decline in the unemployment rate. The third factor is the flexibility of the labor market; for the first time since the ESP (1985), the real wage declined in 2002 and 2003, by 6.7 and 2.4 percent respectively; this decline was led by the business sector, but extended to the public sector in 2003. The wage reduction was the result of the protracted economic slump, and was expressed in a fall in unit labor costs; the recession led for the first time to cuts in the nominal wage, thereby moderating the adverse effect on firms' profitability as well as the need for dismissals in response to the contraction in demand.

Public-services employment expanded by only 0.7 percent in 2003, below the population growth rate and far less than the average growth rate of public-services employment evident since the mid-1990s. The government thus contributed, for the first time, to the increase in unemployment—0.3 percent of the labor force—after serving to expand employment in previous years. This development is the outcome of the economic package, which was implemented in May 2003, and comprised dismissals and the encouragement of early retirement; the latter was intensified by of fears that retirement terms and pensions would be reduced.

The number of Palestinian workers employed in Israel rose in 2003, constituting an expression of relative security calm. After a significant drop in their numbers in 2001 as a result of the Intifada, there was an average increase of 5,000 Palestinian workers in 2003.

There were signs of a turnaround in the labor market, too, the most prominent among them being the recovery of the demand for employees in knowledge industries, contributing about 0.2 percent to the decline in unemployment. There was also a swing in the real wage trend in the second half of the year, which *ex post* greatly moderated the decline in unit labor costs.

In the last few years a process of cutting transfer payment has been under way which, alongside the reduction in the number of foreign workers, is intended to increase the employment of unskilled Israelis. This policy is motivated by the realization that reliance on transfer payments could perpetuate poverty among the population with a

low level of education, while absorption in the labor market is the most efficient way of emerging from the cycle of poverty. But one of the problems with which policymakers have had to contend with in this sphere is the unbalanced composition of economic growth: in 2003, despite the significant substitution mentioned above, the low-skill-intensive industries contributed to the rise in unemployment, while the increased demand for labor was concentrated in the high-skill-intensive ones. This trend will persist if the process of returning to export-led growth continues,[21] compounded by the difficulties experienced by the relevant segments of the population in adapting to the new policy after a very long period of rising transfer payments. Hence, the urgent need to adopt additional policy measures which will provide direct support for the return of unskilled workers to the labor market—such as the introduction of a negative income tax program. The government should create a mechanism which will differentiate between those who are able but unwilling to work and those who are unable to do so for objective reasons (e.g., physical handicaps). As long as no such mechanism exists, the cuts in transfer payments could reduce individuals who are unable to work to poverty.

Box
The Development of Poverty in Israel[1]

The proportion of impoverished families (those whose disposable income is below the poverty threshold) was 18.1 percent of all families in Israel in 2002—about 339,000 families.[2] These families accounted for 21.1 percent of the total population (about 1.32 million persons) and for 29.6 percent of children (about 618,000 children). The average deviation of income from the poverty line in 2002 (excluding residents of East Jerusalem) was 29 percent.

The proportion of impoverished families is significantly higher in Israel than in other advanced economies, as is the incidence of poverty among individuals and children. While the share of families with children within the poor population in Israel is particularly high by international standards, the proportion of the elderly is similar to that in western countries.

Poverty has been more widespread in Israel since the 1990s than it was in the 1980s; the rise in its incidence began in the mid-1980s, as unemployment grew and there was an influx of immigrants. The incidence of poverty declined in 1995–97, when there was a rise in the level of income support payments to the weaker segments of the population as well as in eligibility for child allowances. Since 1997 there has been relative stability in the proportion of impoverished families, although since 1999 the proportion of impoverished individuals—especially children—has risen. This trend intensified in 2002, with the reduction in child allowances.

[21] This excludes tourism, which is closely connected with the security-political situation.

Poverty rates in Israel vary between groups, but most poor people have several employment, demographic, and sectoral characteristics in common. Their most obvious employment characteristic is a household without a breadwinner, and another is the low level of education. Prominent among the sectoral characteristics is the large proportion of Arabs and ultra-orthodox Jews, while the demographic characteristics feature large and single-parent families as well as a large number of old people. In many cases there is a correlation between some of the characteristics, and together they serve to deepen poverty in certain groups.

The incidence of poverty in households whose head is of working age but does not work is particularly high even after receipt of national insurance payments, and was 63 percent in 2002, 3.5 times the incidence of poverty in the population as a whole. The existence of more than one breadwinner is almost certain to ensure that a household is not included in the population defined as impoverished: the incidence of poverty among these families was only about 2 percent in 2002, compared with 16 percent among families with a single breadwinner. The problem of poverty generally occurs because of the lack of a breadwinner or the existence of only one. The intensity of the problem in Israel is high because of the low level of employment.

The gap in participation rates between Israel and the OECD countries reflects mainly the growing difference among men, while the gap is smaller for women, and is even contracting over time. Particularly low employment rates characterize persons with a low level of education, ultra-orthodox Jews, and Arab women (most of whom have a low level of education).[3] Beyond the individual characteristics of each individual and his or her motivation and ability to work, the various transfer payments—those conditional on absence of employment or means tests and those which are unconditional—serve as a disincentive to work, especially among men.[4] Note that despite the strong association between employment and the chance of being above the poverty line, 45 percent of impoverished families whose head is of working age do have a breadwinner, albeit usually only one.

High poverty rates are evident among *large families*. The disposable income of almost half the families with four or more children is below the poverty line. The number of children affects the probability that a family will be poor, but this does nor rise monotonically with the number of children.[5] This is explained mainly by the structure of child allowances, which in the past ensured that income for the fourth and subsequent children kept them above the poverty line. Changes have recently been made in the structure of these allowances, and additional changes are to be introduced gradually in the coming years. The poverty rate among large families rose during the 1990s due to the ongoing decline in the average number of breadwinners in these families.

Another segment of the population with particularly high poverty rates—44.7 percent in 2002—is the *non-Jewish* population, which is characterized by persistent poverty to a greater extent than the Jewish population.[6] Particularly acute poverty is to be found in the Arab population for all family sizes, and is due primarily to employment-related factors: a high unemployment rate, low female participation rate, and low wages for employed persons. Among the demographic factors responsible for the high poverty rate among this group are the large number of children, the high rate of households living in small, remote settlements, and the relatively low level of education. This segment also suffers from discrimination in employment.

The direct effect of measures introduced in 2003

In the last two years a comprehensive program of reducing transfer payments was implemented (slashing child allowances, cancelling pension updates, reducing most allowances by 4 percent, cutting income support payments, and making conditions of eligibility for unemployment relief more stringent), and expelling illegal foreign workers, in order to increase the participation rates among impoverished families. Although this program should have been accompanied by an increase in direct incentives for households' participation in the labor market, no such steps have been taken (see section on Recommendations). In the short term, however, this measure is expected to increase poverty.

According to estimates made by the National Insurance Institute regarding the direct effect of the economic measures on poverty,[7] both the incidence of poverty and the poverty gap are expected to increase significantly in 2003.

[1] Based on Daniel Gottlieb and Nitza (Kaliner) Kasir (2003), "Poverty in Israel, and the Strategy for Combating it," (mimeo, Hebrew).

[2] Including residents of East Jerusalem. The poverty rate excluding residents of East Jerusalem was 17.7 percent in 2002. The rest of this analysis excludes these residents, because of paucity of data.

[3] For more detailed information, see Bank of Israel, "Program for Stimulating Employment," March 2003.

[4] See A. Brender, O. Peled-Levi, and N. (Kaliner) Kasir (2002), "Government Policy and Labor Force Participation Rates of the Prime Age Population: Israel and the OECD Countries in the 1990s," *Bank of Israel Economic Review* 74, 7–62 (Hebrew); and D. Romanov and N. Zussman (2004), "Income Maintenance Allowances in Israel: Ideal vs. Actual," *Israel Economic Review* Vol. 2, no.1 (forthcoming).

[5] See K. Flug and N. (Kaliner) Kasir (2003), "Poverty and Employment, and the Gulf Between Them," *Israel Economic Review*, Vol. 1, No. 1, 55–80.

[6] See M. Waknin and M. hayo (2000), "Persistent poverty in Israel: Preliminary Results from the File Merging the Population and Housing Censuses, 1983–96," *Economic Quarterly*, 597–628 (Hebrew).

[7] National Insurance Institute, *Annual Report*, 2003.

5. THE BALANCE OF PAYMENTS

The current-account deficit of the balance of payments continued to contract in 2003, and amounted to 0.2 percent of GDP. This is the result of the recovery of exports, which rose by 6.1 percent, and the continued moderate level of economic activity, expressed in a decline in imports. The fall in the number of foreign workers contributed over $ 300 million to the reduction of the current-account deficit.

Goods exports rose in 2003, after plummeting in 2001 and 2002. The trend change evident in global demand during the year appears to have contributed to the cessation of the decline in exports and the start of their recovery. A comparison of the development of exports from Israel and imports to the US and the EU, weighted by Israel's export industries, shows that the effect of the recovery of demand in those countries on Israel's exports was less than expected. The decline in the share of Israel's exports in the imports of the EU (from non-EU countries) in the last eighteen months is notable, despite the strengthening of the euro. This gives rise to at least two hypotheses as to why exports have been slow to rally. First, the security situation has harmed Israeli brands, and second, the expansion of Israel's exports in recent years was based on specific high-tech industries, and the rate of recovery of demand for them has been slow. IMF data on world trade, which compare 2003 and 2002 averages, attest to the slow expansion of trade—2.9 percent—in 2003. A more significant growth rate—5.5 percent—is forecast by the IMF for 2004.[22]

Services exports rose significantly in 2003, but their level was far below the peak of 2000, due to the deep crisis in tourism and in exports of software and R&D. The number of tourist bed-nights in hotels rose by 15 percent in 2003, and the upward trend peaked in 2003:III, the period of the Hudna (ceasefire). The decline in software and R&D exports persisted throughout 2003, albeit less intensely than in the two preceding years.

Goods imports (at current prices) began to rise in the second half of the year. The trend was led by imports of primary commodities, which are used in current production, as well as of investment goods, which could serve as an indicator of expectations regarding emergence from the recession. Imports of consumer goods, which are a small component of goods imports, displayed the upward trend apparent since the beginning of 2003.

The various indices of the development of the real exchange rate do not attest to a uniform trend, so that it is difficult to analyze its effect on economic activity. According to the real exchange rate, measured as the ratio between export prices and prices of business-sector product (including housing services), there was local-currency appreciation of 1.9 percent. The weakening of the dollar relative to the euro, by an annual average of 20 percent, and the gap between the countries to which Israel exports and those from which it imports, contributed to the differences between the two indices of the real exchange rate. The index of the real exchange rate based on Purchasing Power Parity (PPP) vis-à-vis Israel's main trading partners attested to local-currency

[22] In 2002 and 2003 world trade expanded by about 3 percent, at constant prices—less than in 1995–2000 (when it averaged 8 percent).

depreciation of 2.5 percent.[23] Since the effect of real depreciation is felt with a lag, the recovery of the mixed and traditional industries (in the first six months) would appear to have been influenced positively by the real depreciation that occurred in 2002.

Israel's term of trade, defined as the ratio between export and import prices (excluding diamonds, ships, and planes), deteriorated by 3.7 percent. In view of Israel's large trade deficit with Europe and balance with the US, the weakening of the dollar against the euro has an adverse effect on Israel's terms of trade. Calculations made by the Bank of Israel show that the strengthening of the euro against the dollar contributed between 2 and 2.5 percent to the deterioration in the terms of trade.

6. MONETARY POLICY, PRICES, AND THE CAPITAL MARKET

The CPI declined by 1.9 percent in 2003—significantly below the price stability target of 1–3 percent—and was the lowest since the establishment of the State of Israel.[24] The two main causes of this were local-currency appreciation against the dollar and the continued economic slowdown. Monetary policy in 2003 served to bolster financial and price stability, while reducing the interest rate in order to support real economic activity without imperiling stability. Against the backdrop of the improvement in the financial and monetary indicators of the inflation environment, the Bank of Israel began reducing the interest rate in 2003:II by 4 percentage points, to reach 5.2 percent at the end of the year.

Most of the decline in the CPI in 2003 occurred in 2003:II and 2003:III, in the context of the significant local-currency appreciation against the dollar (Figure 4). The economic slump also contributed to the slower rate of price increases throughout the year. The housing index, which accounts for 23 percent of the CPI, declined by 6.7 percent in 2003 as a result of local-currency appreciation against the dollar and the fall in prices quoted in dollars. Excluding housing, the CPI dipped by 0.5 percent. As regards the components of the CPI, most of them appear to have gone down during the year. Only prices of fruit and vegetables, which are influenced primarily by the weather, rose (4.2 percent), as did those of food (0.3 percent), while housing maintenance costs remained unchanged.

Observation of inflation rates since 1999, when the inflation rate declined to an environment of price stability, shows that in every year since then, with the exception of 2002,[25] actual inflation was below the target rate. The rate of price increases for 12 months never exceeded 2 percent (again, with the exception of mid-2002), even though the inflation targets were higher. Inflation rates for 6 months (in annual terms) varied widely in line with the CPI, due mainly to exchange-rate fluctuations and seasonal factors—but even then the rate of price increases was generally below the inflation target. Over and above the volatility that is characteristic of the development of prices, making it difficult to attain the inflation target in a narrow band, the persistent

[23] The index of the real exchange rate according to PPP is based on data for the first three quarters.

[24] With the exception of 1949. In 1967 the CPI rose by 0.2 percent, and in 2000 it remained unchanged.

[25] The rate of price increases in 2002 was 6.5 percent, compared with a target of 2–3 percent, largely because of rapid local-currency depreciation in the first half of the year.

undershooting of the target appears to indicate that the Bank of Israel has attached undue significance to preventing shocks to the exchange rate and hence adopted a conservative policy, with a general tendency to reduce the interest rate gradually. In accordance with the government's 2000 decision, the inflation target for 2003 and subsequently is an annual 1–3 percent, a range defined as price stability. The target is no longer defined on a calendar basis, as was the case until 2002, but rather in continuous terms. This definition allows for temporary deviations of the inflation rate from its target, thereby preventing undue 'noise' in monetary policy and according greater flexibility.

The background factors of monetary policy throughout most of 2003 were very different from those in 2003:I. At the beginning of the year the economic environment was characterized by enormous uncertainty, in view of apprehensions regarding war in Iraq, and the election and establishment of a new government in Israel, so that it was not at all clear that the commitment to lowering the deficit would be maintained. In March, with the publication of the government's economic package, the approval of the US government's loan guarantees, the (temporary) renewal of the peace process, and the subsequent rapid conclusion of the war in Iraq, uncertainty abated considerably, and this improvement was clearly expressed in all the main monetary indicators—inflation expectations, nominal and real yield curves, and Israel's risk premium.

Inflation expectations, which were above the target at the beginning of 2003, declined to the middle of the target range, as did expectations for longer terms, while those for the medium term (5 years) remained above the target. The moderation of expectations is expressed in a decline in real yields and a steeper fall in nominal yields. Real yields moderated to 4 percent at the end of 2003, their lowest level in recent years (except for the first half of 2002). Long-term nominal yields dipped by 4 percent to reach their lowest level since long-term unindexed bonds were first issued. As of March, Israel's risk premium also declined significantly, due to the dissipation of the aforementioned factors causing uncertainty, and in the context of the downward trend in the risk premium of emerging markets.

In view of the moderate rise in actual prices at the beginning of the year, the improvement in these indicators enabled the Bank of Israel to embark on the gradual reduction of its key interest rate. After a 0.2 percentage-point reduction in January and absence of change in the following two months, the interest rate was reduced by increasing amounts—rising from 0.2 percentage points in April to 0.5 percentage points in July—and by 0.4 to 0.5 percentage points by January 2004. Altogether, nominal interest was lowered from 9.1 percent at the end of 2002 to 4.3 percent in March 2004.

Alongside the declining trend in the nominal interest rate, expected real interest on the Bank of Israel's sources (nominal interest *less* 12-month inflation expectations) was reduced from 7 percent in 2003:II to 5 percent at the end of the year. But since real prices fell in this period, the real interest rate *ex post* (adjusted by actual price changes) was much higher.

The reduction of interest during the year was expressed in the contraction of the interest-rate differential vis-à-vis abroad by some 3 percentage points, although at the end of 2003 it was still above its 2000–2001 average. The contraction of the interest-rate differential increases the tendency for capital outflow, which exerts pressure for

local-currency depreciation, and this could adversely affect the stability of the foreign-currency market. Consequently, in an economy like Israel's that is open to capital flows, the interest-rate differential is a factor that has to be taken into account when deciding by how much to reduce the interest rate. The process of interest-rate cuts was made easier by the decline in Israel's risk premium in 2003, as this moderates the contraction (or expansion) of the effective yield gap between local and foreign currency.

The significant deviation of the inflation rate from its target raises the question whether it would have been possible for monetary policy to prevent it, at least in part. Monetary policy acted in 2003—mainly at the beginning of the year—to bolster the price and financial stability attained after the sharp interest-rate hikes of mid-2002. The objective was to achieve this at the lowest interest rate possible, so as to boost economic recovery. In the second half of the year it was still difficult to assess the extent to which the inflation environment had returned to the level prevailing before its acceleration in 2002, and how far the persistence of the recession was expressed in prices. At that time the risk involved in the rapid reduction of the interest rate—which could have undermined the stability of the foreign-currency market, eventually requiring a larger interest-rate hike over a longer period—appeared to outweigh apprehensions that the interest rate would be reduced too slowly. The reduction of interest in the middle of the year was accordingly relatively moderate. In effect, there was significant real local-currency appreciation against the dollar—as a result of the impact of policy and external factors (the weakening of the dollar)—which, according to the Research Department's price equation, explained some 40 percent of the decline in prices.[26] The effect of the slump, which explained about fifty percent of the decline in prices, was also apparent.[27] Finally, according to the equation, the real interest rate explained about 10 percent of the fall in prices.[28] It would appear in retrospect that the deviation from the inflation target could have been reduced only to a small extent by reducing the interest rate more rapidly without seriously imperiling stability.[29]

The money supply (M1) rose by 9 percent in 2003. After expanding very rapidly until mid-2002—by over 20 percent (in 12 months)—it slowed to contract by 5 percent in mid-2003. As of July, M1 expanded again, largely due to the ongoing reduction in

[26] The equation is based on multiplying the coefficients representing the various factors by the change in the actual variable; thus, for example, the contribution of appreciation is calculated as a multiple of the coefficient of the exchange rate in the regression of the change in the NIS/currency basket exchange rate. These exchange rates are based on *ex post* values, and differ from the forecast used in making monthly interest-rate decisions during the year.

[27] In the equation, the variable representing the slowdown is the unemployment rate. Another customary index in this context is the output gap (Figure 6). Note, however, that care should be taken in interpreting the output gap itself as explaining price developments in the coming years, because part of the gap between actual and potential GDP may reflect the output lost permanently during the recession.

[28] Some of the effect of the interest rate may have been expressed in real NIS/currency-basket appreciation (see next note).

[29] Reducing the interest rate causes local-currency depreciation, most of the effect being expressed in the quarter after the reduction, see Y. Djivre and S. Ribon (2003), "Inflation, Unemployment, the Exchange Rate, and Monetary Policy in Israel, 1990–99; a SVAR Approach," *Israel Economic Review*, Vol. 1, No. 2, 71–100. On the basis of the model presented in the article, depreciation is immediately translated into price increases. Accordingly, only the interest-rate cuts made in the first three quarters of the year affected prices in full in 2003. Interest-rate cuts made in 2003:IV are expected to affect prices primarily in 2004. Using coefficients, it is possible to estimate the extent of the deviation from the price stability target, and this was only 0.4 percent.

nominal interest, and to a lesser extent also because of the stabilization of economic activity after the contraction of the preceding two years. M2, the wider monetary aggregate, which also includes short-term, unindexed local-currency deposits, expanded moderately during the year, by less than 2 percent, primarily because of the contraction of local-currency deposits for between 3 and 12 months, and also as a result of the substitution of bank deposits by Treasury bills (which are not included in M2), the stock of which in the hands of the public rose by almost 50 percent. In spite of the slower rate of inflation, long-term, CPI-indexed deposits rose by over 15 percent in 2003, mainly in the latter half of the year. This expansion may reflect the relatively high real interest rate that prevailed during this period—about 6 percent. Deposits denominated in and indexed to foreign currency expanded by 5 percent in dollar terms—similar to the rate of the preceding two years—but their local-currency value contracted by about 0.5 percent because of local-currency appreciation.

The balance of nondirected credit fell by 2 percent during 2003, a notable contraction in view of its 10 percent expansion in the preceding two years, which were also a time of economic slowdown. Some of the contraction in the stock of credit is explained by local-currency appreciation, which eroded the local-currency value of foreign-currency credit. Note, nonetheless, the low rates of change—in the stock of unindexed credit (only 2 percent), CPI-indexed credit (a 5 percent decline), and foreign-currency credit (an increase of only 2 percent in dollar terms). The contraction of credit expresses not only the moderate level of activity, which reduces the desire of firms to take credit for current activity and investment, but also the increase in risk which banks ascribe to extending credit, as the recession persisted, lowering their readiness to offer credit.

The capital market in 2003

2003 was a stormy year for Israel's capital market. The trend of contraction of capital raised continued and even intensified, in view of the moderate level of economic activity; this was expressed in near-stagnation in fresh sources of capital raised, with a marked decline in bank credit. As of 2003:II, however, share prices rose sharply, contributing to the marked increase in the real value of the public's asset portfolio. In addition, some tax reforms were introduced in 2003, primarily in the capital market, as well as in the pension funds.

(i) Sources of finance for private-sector activity

Developments in the sphere of capital raised for private-sector activity were primarily the accentuation of developments evident in 2002. The marked decline in capital raised, which had begun in 2001 and intensified in 2002, accelerated further in 2003, when total capital raised from all sources (i.e., the banks, stock markets in Israel and abroad, and nonbank financial intermediaries) amounted to only NIS 6 billion (a record NIS 94 billion was raised in 2000, by comparison). This decline, which encompassed capital raised from all sources, excluding bond issues, reflects primarily the continued recession and consequent contraction in demand for financing economic activity. As was the case in 2002, it appears that, concurrent with the contraction in demand, supply-side changes also served to reduce capital raised in 2003.

As stated, the decline in capital raised extended to all sources of finance other than bond issues on the TASE (Tel Aviv Stock Exchange), which rose slightly. The fall in bank credit taken in Israel had the most dominant effect as regards all capital raised, as it had in 2002, and in the first nine months of 2003 bank credit contracted by NIS 1.5 billion.[30] This decline, which continued the marked slowing in the growth rate of bank credit in 2002, is particularly notable in view of the rapid growth rate of credit throughout the 1990s, even in years when economic activity declined, and far exceeded the change in business-sector product. The decline in bank credit in the last two years led to a steep drop in its share in total financing, after its expansion in 2001 had served to moderate the effect of the decline in the supply of credit from other sources.

The contraction of bank credit in 2003 stemmed from a combination of factors, which contributed to a decline in demand, on the one hand, and a fall in supply, on the other. The main reason for the contraction in demand was the continued recession and low level of economic activity, expressed in the fall in demand for credit in 2003. Although economic activity slowed in 2001, the slowdown in the rate at which bank credit expanded was relatively moderate. In 2002 the growth rate of bank credit slowed markedly, and that of capital raised contracted by two thirds. This belated response can be attributed to the uncertainty regarding the length and intensity of the recession: at the beginning of a slump it is reasonable to expect that demand for credit will increase, in view of financing difficulties which could be perceived as temporary. In 2001 this effect emerged with the bursting of the high-tech bubble in stock markets in Israel and abroad, leading to the cancellation of projects intended to raise capital for various channels, and the expansion at the initial stage of the demand for bank credit. As the nature of the recession became clearer, it was necessary to adjust demand and activity to the moderate level of the economy and expected level of income, whereupon the demand for credit fell in 2002 and 2003.

Despite the pivotal nature of the effect of demand factors on bank credit in 2003, they do not explain the full extent of its contraction, especially in view of the improvement in the level of activity during the year. Hence, some of the decline in credit would appear to be the result of the contraction of supply, as can be inferred *inter alia* from the rise in the real cost of bank credit. The contraction in the supply of credit is the outcome of the deterioration in the banks' financial results and the various restrictions on the extension of credit: the deterioration in the financial results of the major banks in 2002, the increase in their doubtful debts, and the convergence to the minimum capital ratio limited their ability to increase the credit they extended to their customers, and caused them to make it more difficult to obtain credit. Several indicators attest to the rise in credit risk, among them the deterioration in individuals' repayment ability, the very low ratio between the market value of banks' shares and equity in their balance sheets, and high loan-loss provision.

The development of capital raised from banks was not uniform throughout the year. In 2003:I both credit taken from banks in Israel and direct credit taken from banks abroad contracted markedly. In 2003:II this trend accelerated, and new capital raised was significantly less even than previous credit repayments, so that both outstanding

[30] This includes the effect of local-currency appreciation on the revaluation of credit denominated in and indexed to foreign currency.

bank credit and outstanding direct foreign liabilities shrank to NIS 5 billion each. This trend reversed in 2003:III, and capital raised, through credit from banks in Israel as well as direct borrowing abroad, rose considerably, but was not sufficient to offset its fall in 2003:II.

Capital raised on stock markets in Israel and abroad continued to decline in 2003, despite the rise in share prices resulting in part from the reduction in the risk premium and improvement in the Israel's security situation. The TASE was used primarily for raising capital by means of bonds, while capital raised via shares and other financial instruments ceased almost completely. Capital raised in the US also came to a virtually stop, and did so completely in Europe. Credit taken via venture capital funds and other nonbank intermediaries also halted, while grants from the Ministry of Industry and Trade rose slightly. All in all, the picture obtained from the figures regarding capital raised is consistent with the low level of economic activity throughout the year, as well as with the surge evident towards the end of the year in share issues on US stock markets, together with a renewed rise in the number of IPOs.

(ii) The public's asset portfolio

The value of the public's asset portfolio rose in real terms in 2003, due primarily to the marked increase in share prices in Israel and abroad. The decline in the CPI also played a part, albeit a smaller one, in increasing the real value of the portfolio. The real value of the shares in the hands of the public, both in Israel and abroad, rose by approximately 53 percent. The index of the top 25 shares on the TASE rose by an average of 18 percent, and by 56 percent over the year as a whole (Figure 7).

An examination of the composition of the portfolio shows that, as expected, the proportion of Israeli shares rose markedly, reflecting the surge in the stock market. This followed a similar decline in 2002, which derived primarily from the erosion of the real value of shares after their prices fell and the CPI rose. The share of residents' financial assets abroad dipped slightly but remained at the high level that has characterized it since most of the restrictions on capital flows were removed in 1999.

7. OBJECTIVES AND POLICY RECOMMENDATIONS FOR THE FUTURE

The main objective of macroeconomic policy is to bolster the return to sustainable growth led by the business sector, enabling the employment rate to rise while combating poverty. The latter has become a major problem in recent years, as a result of both long-term factors and the protracted recession.

In order to restore sustainable growth it is necessary to ensure the persistence of price stability, continued reduction of the public debt/GDP ratio, and stability in the current account of the balance of payments. The macroeconomic framework which will support these conditions comprises a declining public debt and deficit path and a Bank of Israel interest rate that is consistent with price stability. A mix of this kind will support a low level of long-term interest, thereby serving to expand investment alongside a return to sustainable growth once the global economic recovery becomes entrenched and Israel's security-political situation improves. This involves revieweing interest-

rate differentials vis-à-vis abroad while maintaining the lowest real interest rate possible that is consistent with the price stability target.

a. Fiscal policy

The absence of a fiscal consolidation in the past obliged policymakers to adopt restrictive measures just at a time of economic slump. The cuts in the government's current expenditure in 2003 reduced aggregate demand, serving in the short run to have a pro-cyclical effect and deepening the recession; however, the cuts prevented the economy from descending into financial crisis, making it possible to maintain a credible and coordinated macroeconomic mix in 2003 that supported a return to sustainable growth.

The government decided to adopt a deficit target of 4 percent of GDP for 2004 and a new set of targets for 2005 and subsequent years according to which public expenditure would rise by no more than 1 percent a year, with a maximum overall deficit target of 3 percent of GDP. According to an up-to-date assessment, the 2004 deficit is expected to be above the target, even with the full commitment of the inflation reserve, and assuming that revenues exceed the forecast—a real 7.5 percent growth rate, 5 percent of it from tax receipts.[31] Although a reserve of NIS 1.2 billion was set aside this year to enable the deficit target to be met in the event of macroeconomic shocks, it has been fully committed at a relatively early stage of 2004. Furthermore, since there are no specific deficit targets for 2005 and subsequent years, other than the ceiling of 3 percent of GDP, the return to the declining deficit path is by no means assured.

In March 2004 the government recently reduced V.A.T.; this raises the question whether it is advisable to reduce taxes in order to stimulate both the demand side and the GDP supply side. Note that steps were taken in 2003 aimed at restoring confidence in fiscal policy by means of the economic recovery package. Tax cuts which cast doubts on the government's adherence to the deficit target could undermine its credibility; this is particularly the case in view of the recurring deviations from the deficit targets in the last few years because of unrealistic revenue forecasts. Furthermore, against the backdrop of the recent changes in taxation decisions,[32] only a reduction that is consistent with the deficit target will be considered credible, i.e., to a rate that has a positive effect on GDP and will not have to be abolished at a later stage. Although tax reductions are financed in part by the rise in GDP they generate, in the first year after their implementation they increase the deficit.[33] Hence, and in view of the fact that Israel's public debt/GDP ratio is very high by international standards while the tax burden is in line with that in advanced economies, greater emphasis should be placed on the objective

[31] Attaining this target is harder than it seemed to be when the budget was approved; this is because of the expected fall in tax receipts due to the recent decision to reduce V.A.T. to 17 percent and cut taxes on various goods.

[32] Two examples are the cancellation of the decision to abolish the ceiling on National Insurance payments and the postponement of the restoration of V.A.T. to 17 percent to March 2004.

[33] A 1 percent of GDP tax reduction—assuming it is permanent—increases the deficit by 0.7 percent of GDP in the first year of its implementation. This is based on the calculations in Y. Lavi and M. Strawczynski (2001), "The Effect of Policy Variables and Immigration on Business Sector Product and its Components (Factor Inputs and Total Factor Productivity); Israel, 1960–95," *Bank of Israel Economic Review* 73, 109–142 (Hebrew).

of reducing the debt in the medium term and avoiding specific tax reductions, which could prevent attainment of the deficit target. The reduction of the public debt will assume particular importance in the coming five years, when the government will have to restore confidence in its intention to undertake fiscal consolidation similar to that implemented in many advanced economies in the mid-1990s.

The real decline in civilian expenditure and transfer payments to the weaker segments of the population in 2003, just when unemployment rose, illustrates the difficulty of setting the government's priorities. A possibility which is often mentioned is to finance some of the needs in this sphere by switching to selective transfer payments. A move of this kind has to be examined within a comprehensive framework of rationalizing transfer payments, rather than as a one-off decision dissociated from other relevant considerations. It is necessary to refer also to the insurance aspect of transfer payments, as well as to ensure that some of the sources obtained as a result are devoted to providing incentives for an ongoing rise in the labor-force participation rate. Incentives of this kind should be directed especially at individuals with low earning ability who have left the labor force or tend to participate in it to a minimal extent (see section d below)—as has been done in advanced economies. Only a consistent and ongoing effort in this direction will attain the objective of raising the employment rate, which is low by international standards.

As regards 2005, an analysis of the long-term budget framework on the basis of the current trend of expenditure and the decisions made to date shows that these decisions are in line with the new expenditure target of a real 1 percent increase in government expenditure in 2005. However, because of the drop in revenues in 2005 due to the introduction of another stage in income tax reform, the deficit is expected to deviate by about 1 percent of GDP from the 3 percent target determined for 2005. Consequently, in order to remain within the deficit ceiling it will be necessary to make a significant fiscal adjustment in 2005, too, so that expenditure declines by another 1.5 percent (instead of increasing by a real 1 percent), otherwise the government will have to increase its revenues by raising taxes.

As far as 2005–2010 are concerned, the government must be prepared to apply the new target set for expenditure, in contrast with the situation that prevailed when the Budget Deficit Reduction Law was in force. It is incumbent upon the government to set deficit-reduction planning targets alongside the expenditure targets, thereby ensuring the continuous reduction of the public debt/GDP ratio,[34] so that it will be possible in the long run to reduce the ongoing debt-servicing burden. A comprehensive framework of this kind will provide the means for coping with priorities in the various spheres, e.g., security, education, health, and the infrastructure. If the decision to restrict the rise in public spending to only 1 percent of GDP is implemented, real per capita public expenditure (in CPI terms) will be 10 percent less in 2010 than in 2002. This calculation

[34] The management of public expenditure on the basis of existing decisions means an annual average increase of 2.4 percent in 2005–2010. This rate of increase in public spending, which is 0.5 percent higher than the population growth rate, will make it possible to reduce the deficit to 1 percent of GDP by 2010 (see Bank of Israel, *Economic Developments and Macroeconomic Policy, 2003–2005*, October 2003, Table 3). Nonetheless, a scenario of this kind could imperil the fiscal consolidation plan if macroeconomic shocks occur.

indicates that meeting the target of increasing expenditure by 1 percent in real terms by 2010 requires significant fiscal adjustment, regarding which no specific decisions have yet been made. In order to attain the targets set, it is necessary to cut expenditure by NIS 20 billion in the next five years, i.e., by 14 percent of total spending excluding payments of interest, principal to the National Insurance Institute, and the government's pension obligations, in comparison with the expenditure path expected on the basis of the decisions made to date. In order to make the government's new targets credible as the second half of the decade approaches, the government's fiscal program should be drawn up at the earliest possible date.

One of the main principles according certainty to macroeconomic policy, and one which is very important for the development of the business sector, is to adapt the budget framework to the economy's changing circumstances in real time. The 2004 budget plan was the first to include a reserve for coping with macroeconomic shocks, even though this reserve was small—NIS 1.2 billion—and was allocated already at the beginning of the year. It is also important to adjust its size so that it will be possible to contend with possible deviations during the year. In addition, a long-term budget framework should be created that will take any future government decision into account, in order to meet the new targets set for the medium term.[35]

A noteworthy aspect of the new program is the section comprising decisions that affect public expenditure in the long run—including the decision to index most national insurance allowances to the CPI instead of to the average wage, and to gradually raise the retirement age to 67 for men and 62 (eventually 64) for women. This reduces the danger that public spending will rise in the long run because of the actuarial deficit of the pension funds. Changes whose implementation is spread over several years embody significant benefits. First, their gradual implementation enables individuals who are affected by public expenditure to alter their behavior gradually; second, decisions of this kind help to entrench fiscal consolidation, thereby obviating the need to make urgent decisions at a time of crisis, without degrees of freedom and without a set of priorities, as was the case in 2003. Notwithstanding, in comparison with advanced economies which are undergoing a similar process, the rate set by Israel for the adjustment of the retirement age is faster than that in the rest of the world, even though the problem of the aging population is more acute in those countries than in Israel.[36]

In 1994–2002 the general government's current expenditure (excluding interest payments) went up by an annual average of 6 percent in real terms (adjusted by the business-sector deflator), above the rate at which it rose in the equivalent period in 2002. This increase in public spending implies an annual per capita 3.5 percent rise in current per capita expenditure. Public expenditure fell in real terms in 2003, and in 2004 it is expected to remain unchanged. Sharp shifts of this kind could cause serious and unexpected damage to individuals who are dependent on public expenditure, as

[35] A budget framework of this kind is presented in Chapter 2 of Bank of Israel, *Economic Developments and Macroeconomic Policy, 2003–2005*, October 2003. The last IMF delegation also recommended that a long-term budget framework should be prepared enabling medium-term budgetary planning to be undertaken.

[36] See Table 3.6 in Chapter 3, "The Budget and the General Government," in the Annual Report of the Research Department.

well as to the general public which consumes public services. It is advisable in the future to create conditions that will obviate the need for sudden changes in public spending, such as those made in the last two years, because of the ongoing slump and high public debt preventing implementation of a countercyclical policy. Reinforcement of the long-term planning approach will help to smooth shocks of the kind that have been in evidence of late.

In the framework of long-term planning, it is important for the government to aspire to improve efficiency in public-services employment. Till now efforts to achieve fiscal restraint have been based on wage reductions, but without making significant decisions about the number of persons employed in the long term. In this respect, too, reaching long-term agreements with the unions could improve efficiency while minimizing the shock to the public services.

b. Infrastructure investment and competition

Mass transportation systems are used far less intensively in Israel than in the industrial economies. The transport infrastructure is drastically short of capital. In order to close this gap Israel must invest over 1.8 percent of GDP a year in this infrastructure, about one third more than the amount currently invested. In general, the projects should be undertaken jointly with the private sector.

As regards the financing of infrastructure projects, a special opportunity presented itself with the receipt of the US loan guarantees. In view of the high yield on such projects, which help to increase business-sector product, a special mechanism should be created to ensure that some of the money from the loan guarantees is used to finance infrastructure projects. The viability of these projects should be assessed in the framework of a set of priorities, instead of the method actually used, namely, removing the transfers for the Israel Railway from the national budget, thereby preventing application of budgetary monitoring and the determination of priorities for meeting targets. It is recommended that the ability of pension funds to invest should be expanded (beyond the increase already made in the wake of the reduction of earmarked bonds), enabling them to invest in high-yield, long-term infrastructure projects. The cessation of issuance of earmarked bonds for additional pension channels will create an opportunity to utilize this channel.

In recent years progress has been made in some mass transportation projects, such as the metro (light railway) in Jerusalem and the Tel-Aviv conurbation, and the development of the railway, in accordance with the decision of the socio-economic cabinet and as approved by the Knesset. Nonetheless, not all the projects are going ahead as fast as they should, and this could constitute an obstacle once sustainable growth resumes. It is therefore recommended that a special ministerial committee be set up for the infrastructure which will be responsible for the implementation of projects and monitor their progress. It is also recommended that at the time the budget is prepared a special government session should be held at which the implementing entitities concerned—in the spheres of roads, water, electricity, gas, and other infrastructures—will report on the progress of their projects. Quarterly progress reports should also be submitted to the government and the public.

In many economic spheres, including electricity, ports, air freight, bus services, and oil refining, there is hardly any competition. Price of services ought to reflect their cost, averting the cross-subsidization of one service by another, or of one consumer by another. The existence of monopoly profit, which could be expressed in various items on firms' balance sheets—particularly wages—should also be prevented; this could be achieved by opening additional market segments to competition, or by increasing supervision by independent authorities.

Another area in which many shortcomings were found in the past is water. Although there has been some improvement in this sphere in the last two years due to abundant rainfall, this should not allow the subject to be removed from the public agenda. It is important to ensure that water is correctly priced, making it possible to channel demand for it economically, but at the same time its supply should be improved to avoid causing irreversible damage to existing sources.

c. Monetary policy and the reform of the capital market

The guiding principle of monetary policy is to bolster price stability while keeping an eye on expected inflation. During 2003 the consistent and gradual reduction of the Bank of Israel's key interest rate became possible, and this was translated into a decline in real interest while maintaining financial stability. A necessary precondition for this was a coordinated macroeconomic policy mix, including both the reduction of government current expenditure and the contraction of the budget deficit. This mix has served to reduce long-term interest and increase the chances that investment will rally. In view of the significant decline in the interest-rate differential vis-à-vis abroad till now, adhering to the principle of gradualness will be particularly relevant in 2004.

The main lesson that can be learned from the economic crisis that affected Israel in the last two years is that in a situation of domestic and external shocks particular care should be taken in implementing the fiscal and monetary economic policy mix, especially in view of the rapid response of the increasingly perfect financial markets. The successful attempt, as of March 2003, to reduce interest while keeping the foreign-currency market stable and reducing inflation expectations, emphasizes the importance of deploying a coordinated macroeconomic policy. Reversion to an uncoordinated policy mix, such as that of 2002, which had an adverse effect on the credibility of economic policy and eventually obliged policymakers to use a policy of restraint, thereby exacerbating the recession, should be avoided. Moreover, the uncoordinated policy of 2002 prevented interest rates in Israel from converging with those abroad, after the successful disinflationary process begun in 1997. This convergence will be possible only if the budget deficit declines consistently in the next few years,

The main objective of monetary policy must be to maintain price stability, and subject to this the Bank of Israel will be able to support other objectives too, in accordance with the government's economic policy. This should be done while maintaining its complete independence in selecting and implementing the monetary instruments required to maintain price stability, on the basis of the recommendations of the Lewin Commission.

One of the Lewin Commission's main recommendations was that the decision regarding short-term interest should be made by a Monetary Policy Council, headed by the Governor of the Bank of Israel. This should consist of independent experts who are not tainted by conflict of interests, are chosen in a transparent process, and are approved by the government.

Despite the measures adopted to augment liberalization of the economy, there is still undue government intervention in the financial sphere. The sharp rise in the public debt in the last two years, to 108 percent of GDP (measured in accordance with the method used under the Maastricht Accord), actually increases the government's role as chief player in the financial arena, and its actions will have a direct effect on the development of the financial markets. Since a further rise in the public debt is expected in 2004, the government must ensure that its composition is such that its average term is long, thereby reducing risks.

A compulsory occupational pension should be introduced, thereby increasing pension coverage for segments of the population which are currently not insured, and in the long run creating an additional incentive to enter the labor market. The ceiling for obligatory pension saving must be set while taking individuals' living standards at pensionable age into account, on the one hand, and the cost to the employer and employee, on the other. Note, in this context, that high-income employees enjoy tax benefits on pension savings, while low-income employees do not, as their wages are too low to be eligible.[37] Occupational pensions should not be based on the earmarked bond system, as this accentuates the distortion of the capital market. Against the backdrop of the sharp changes in the parameters affecting the pension system (e.g., life expectancy), it is advisable to adopt mechanisms for continuously monitoring the new system as regards its actuarial balance. Changes should also be made in the regulations governing investment by pension funds, in order to deepen the capital market.

The implementation of further tax reforms in 2003 constituted an important aspect of the appropriate tax policy for the long term. The imposition of the capital gains tax made it possible to ease the heavy tax burden on labor. Action should also be taken to prevent discrimination between different investment channels by minimizing the tax distinctions between them, as well as by imposing a nominal tax on all assets,

d. Reducing poverty and stimulating employment[38]

Combating poverty

As in the EU and many other countries in the framework of the UN, it is desirable that Israel adopt a long-term target for combating poverty. This relates to reducing its incidence and lowering the income gap to the level evident in the early 1990s. It is recommended that Israel, like other countries, sets a long-term (10-year) convergence target. Alongside attainment of these targets, efforts should be made to ameliorate the situation of the poorest segments of society.

[37] A proposal for a compulsory pension law currently before the Knesset overturns the principle of horizontal equity regarding pension saving benefits.

[38] For a more detailed analysis, see D. Gottlieb and N. (Kaliner) Kasir (2003), *Poverty in Israel and Strategies for Reducing it*, Bank of Israel (mimeo; Hebrew).

Improving the measurement of poverty

The poverty line in Israel is currently measured relative to the median income. The database necessary for creating an appropriate poverty index should be built. It is also important to hasten the implementation by the CBS of follow-up studies of household income and expenditure. These will make it possible to track the persistence of poverty in households over time, thereby distinguishing between temporary and permanent poverty. It is also necessary to adapt surveys to adequately represent the specific segments of the population which are characterized by a high poverty rate.

At present, sources of income that are taken into account in comparing households' standards of living, both with one another and against the poverty line, do not include significant nonfinancial income, such as imputed residential income, reductions in municipal rates, and rent subsidies. The calculation of sources of income should be extended to incorporate these sources of income.

Additional indicators: employment, health, and education

An operative target should be set for the *employment rate* which, within the next ten years, should gradually approach the average employment rate in the OECD countries. In the area of *health*, it is proposed that targets be determined for long-term improvements in such spheres as life expectancy, infant mortality rates, and mortality rates from infectious diseases among vulnerable groups. In the area of *education*, too, long-term objectives should be set for such areas as persons completing twelve years of education in the 22–35 age-group, the proportion of individuals eligible for a matriculation certificate, and the improvement of the educational level of the adult population (particularly in view of the extension of working age).

Tools for attaining the targets: impoverished families whose head is of working age

Policy regarding foreign workers: it is proposed that the cost of employing foreign workers be increased substantially, in line with the provision removed from the Economic Arrangements Law for 2004 determining that the tax rate on employment of foreign workers should be gradually raised to 40 percent—i.e., the difference between employing an Israeli and a foreign worker. It is recommended that this tax not be imposed on foreign care-givers. However, it is important to encourage Israeli workers to enter this field, in the spirit of the government's decision that elderly people in need of home help should be allocated hours of care from an Israeli worker. It is also recommended that some of the wages paid to foreign workers be placed in a bank deposit in their name, and be made available to them when they leave Israel. It is further recommended that the employment permit be given directly to the employee, and not to the employer.

It is necessary to continue reducing the number of permits issued and improve enforcement of the restriction on the number of foreign workers, while upholding their human rights. It is important to include households employing foreign workers without a permit in the enforcement efforts. In view of the low level of compliance with the labor laws by employers of foreign workers, it is necessary to increase enforcement of

the Minimum Wage Law and other labor laws. In order to make the enforcement efforts more transparent, it is important to publish a periodical report specifying the efforts involved.

Employment tests, placement, and the establishment of employment centers: it is advisable to improve employment and income tests and their implementation. All the components of the income tests should be implemented, and this applies particularly to imputed housing income for home-owners, rent subsidies, and other benefits. Recently, albeit after a long delay, there has been some improvement in the process of establishing employment centers, which will improve the classification and placement of low-income individuals. Access to the employment centers should be extended to all those in need of their services.

Tax incentives for low-income individuals in order to stimulate employment: it is proposed that tax credits taking the number of children into account be awarded. Tax credits for low-income working families have been successful in increasing employment in several countries, including the US, the UK, and Ireland. It is also proposed that the Capital Investments Law be amended so that the subsidy makes allowance for the expansion of employment, and not merely for the accumulation of physical capital.

Introduction of compulsory occupational pensions: it is proposed that compulsory occupational pensions be introduced, and that this insurance be restricted to a wage ceiling, because the deduction reduces current income, increases employment costs, and includes tax benefits for employers. The ceiling must be set in such a way that the future pension derived from it, together with the national insurance old-age pension, provide a reasonable standard of living.

Education: the benefits granting priority to improving the educational level of low socio-economic groups and schools should be increased. The following measures are proposed: enlarging the increment paid to graduate teachers in schools in disadvantaged areas; rewarding teachers on the basis of the achievements of their pupils or the schools in which they teach; for schools in disadvantaged areas, it is proposed that the number of pupils per class be reduced, and the number of hours increased. In view of the size of the education budget, additional costs arising from these proposals can be offset by reducing other items. A core program should be implemented for all education frameworks, in line with the recommendations of the Katz Commission (2002), focusing on spheres that are essential for participation in the labor force, such as Hebrew/Arabic, English, Mathematics, and Science.

Households whose head is of working age but of limited earning ability, and care for the disabled elderly

It is proposed that income support payments be increased, taking the number of children into consideration.

It is recommended that adult further education frameworks be extended to 8, 10, and 12 years of schooling.

It is proposed that the elderly be able to take loans in the form of current income flows against loan repayments in the future from the sale of assets (apartments or plots of land)—a system known as 'reverse mortgage.' The conditions should be created to enable a market for such mortgages to develop.

It is proposed that the income of elderly persons whose total income is particularly low be augmented by increasing income support payments in stages, in accordance with income levels. In order to calculate the amount of the increment, the minimum income required to meet an elderly person's basic needs should be determined.

Table 1a
Israel: Basic Economic Data,[a] 1986–2003

	1986–1989	1990–1992	1993–1996	1997–1999	2000	2001	2002	2003
Mean population ('000s)	4,407	4,911	5,473	5,975	6,289	6,439	6,570	6,690
Population growth rate (percent)	1.6	4.3	2.6	2.5	2.7	2.4	2.0	1.8
Israelis employed ('000s)	1,416	1,569	1,895	2,078	2,216	2,265	2,284	2,330
GDP (NIS billion, 2003 prices)	270	320	390	451	498	494	490	496
GDP growth rate (percent)	3.7	6.6	5.7	3.0	7.5	–0.9	–0.8	1.3
Per capita GDP ($'000s, current prices)	8.7	12.2	15.2	17.3	18.3	17.5	15.8	16.3
Unemployment rate (percent)	7.1	10.5	7.8	8.4	8.8	9.3	10.3	10.7
Inflation rate (during year, percent)	18.2	15.0	11.1	5.7	0.0	1.4	6.5	–1.9
Current-account deficit (percent of GDP)	0.2	1.0	4.6	1.9	0.6	1.6	1.3	0.2
Foreign-exchange reserves ($ billion)	5.2	6.0	8.3	21.9	23.3	23.4	24.1	26.3
Net external debt (percent of GDP)	47.0	29.7	24.2	11.3	3.2	0.2	–2.9	–6.0

[a] Annual averages.
SOURCE: Based on Central Bureau of Statistics data.

Table 1b
Basic Economic Data: International Comparison, 1993–2003

(percent)

	2002				2003				1993–2003 average			
	Israel	US	EU	OECD	Israel	US	EU	OECD	Israel	US	EU	OECD
Population growth rate[a]	2.0	1.1	0.4	0.8	1.8	1.1	0.4	0.8	2.5	1.2	0.3	0.8
GDP growth rate[b]	–0.8	2.4	1.1	1.8	1.3	2.9	0.7	2.0	3.8	3.2	2.0	2.6
GDP growth rate (during year)[c]	0.7	2.8	1.1		1.9	4.3	0.8					
Per capita GDP growth[a]	–2.8	1.4	0.7	1.0	–0.5	1.8	0.3	1.2	1.0	1.9	1.7	1.8
Per capita GDP ($'000s, current prices)[a]	15.8	36.2	23.6	27.5	16.3	36.9	23.7	27.8	16.4	32.0	22.6	26.0
Unemployment rate[b]	10.3	5.8	7.7	6.9	10.7	6.1	8.0	7.1	8.9	5.3	9.0	6.9
Inflation rate (average)[b]	5.7	1.6	2.3	2.5	0.7	2.3	2.1	2.5	6.6	2.5	2.3	4.0
Inflation rate (during year)	6.5	2.4	2.6	2.7	–1.9	1.8	1.6	1.9	6.1	2.4	2.3	3.9
Current-account deficit[b] (percent of GDP)	–1.3	–4.6	0.7	–1.1	–0.2	–5.0	0.1	–1.4	–2.5	–2.8	0.4	–0.5
Net public debt[b] (percent of GDP)	86.4	44.4	48.7	46.2	92.6	46.9	50.1	48.6	86.7	51.7	50.4	46.9

[a] Figures for the US, EU and OECD countries for 2003 are based on the 2002 figures.
[b] Figures for the US, EU and OECD countries for 2003 are estimates.
[c] Figures for the US and the EU refer to GNP.
SOURCE: OECD *Economic Outlook, 2003*; *World Economic Outlook, 2003*, and Bank of Israel annual reports.

Table 2a
Sources and Uses, 2000–2003

	2000	2001	2002	2003	Contribution to growth
Sources and uses					
GDP	7.5	–0.9	–0.8	1.3	
Business-sector product	9.8	–2.6	–2.8	1.8	
Private consumption	7.6	3.2	0.1	1.7	0.6
of which excl. durables	6.4	4.5	1.0	1.8	0.3
Public consumption	2.2	3.4	5.7	–1.8	
of which domestic consumption	2.6	2.5	5.1	–0.6	–1.3
Gross domestic investment	–2.9	–4.9	–12.4	–13.4	0.4
of which Fixed investment	1.7	–4.8	–9.2	–5.0	
Exports	24.0	–11.5	–3.0	6.1	2.5
of which excl. diamonds	26.3	–10.9	–7.0	6.3	
Imports	12.2	–4.5	–2.3	–2.3	
of which excl. defense imports, ships, planes, and diamonds	15.0	–4.2	–0.7	–2.2	
Domestic uses	4.5	1.0	–0.6	–1.3	–0.4

SOURCE: Based on Central Bureau of Statistics data.

Table 2b
Development of Sources and Uses, 2002 and 2003

	2002				2003				Change
	I	II	III	IV	I	II	III	IV	during 2003
Sources and uses									
GDP	1.4	0.7	1.1	–0.6	3.3	–1.1	2.8	2.5	1.9
Business-sector product	–0.4	–1.0	1.0	–0.9	4.9	–0.5	3.1	3.6	2.8
Private consumption	–0.2	–1.5	–3.6	2.0	–4.1	11.9	6.4	2.7	4.1
of which excl. durables	–0.4	–1.6	0.7	0.5	–2.7	10.0	3.5	3.5	3.5
Public consumption	7.3	4.8	1.9	0.8	0.1	–10.3	–0.3	–8.7	–4.9
Gross domestic investment	2.6	5.1	8.3	–24.4	–30.9	–13.1	16.5	–4.5	–9.6
of which Fixed investment	–7.0	–7.6	–4.1	–5.1	–3.8	–1.2	–12.2	–1.3	–4.7
Exports	–3.8	6.0	–0.6	8.1	9.1	1.2	21.2	–7.8	5.4
of which excl. diamonds	–11.8	1.3	–0.1	14.7	7.4	–2.9	25.5	–8.1	4.7
Imports	4.7	5.0	–5.1	–0.5	–15.3	3.0	19.3	–6.0	–0.5
of which excl. defense imports, ships, planes, and diamonds	0.9	–8.1	–8.6	–7.0	–7.5	9.8	11.4	–4.6	1.9
Domestic uses	4.9	–0.7	0.2	–3.1	–4.5	0.1	6.0	–3.0	–0.4

SOURCE: Based on Central Bureau of Statistics data.

Table 3
Business-Sector Terms of Production, 1990–2003

(percent, in annual terms)

	1990–92	1993–96	1997–99	2000	2001	2002	2003
Growth rates							
Business-sector product	8.1	6.9	3.1	9.8	–2.6	–2.8	1.8
Domestic labor inputs	5.5	7.4	2.6	4.4	–1.9	0.3	0.1
Labor supply[a]	5.2	4.1	4.0	3.2	1.7	1.4	1.5
Gross capital stock	3.0	7.6	8.8	7.3	6.6	5.0	3.4
Total factor productivity	3.5	–0.9	–1.6	3.6	–3.5	–4.2	1.7
Rate of change							
Return on gross capital[b]	13.6	13.8	11.7	13.4	10.1	8.9	10.2
Real wage in business sector	–1.6	0.5	3.4	6.6	3.3	–6.7	–2.4
Unit labor cost (business sector)	–3.7	1.2	0.8	–1.2	6.8	2.0	–3.6
Real minimum wage	–1.8	1.2	4.6	4.9	7.9	–3.1	1.4

	1961–70	1971–81	1982–92	1993–2003
Total factor productivity in manufacturing	5.8	1.6	0.9	0.6

[a] Civilian labor force *plus* foreign and Palestinian workers.
[b] Before tax.
SOURCE: Based on Central Bureau of Statistics data.

Table 4
Main Indicators of Fiscal Policy, 1995–2004

(percent of GDP, in annual terms)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Overall public-sector deficit	4.6	5.9	4.5	3.7	4.2	2.1	4.1	4.5	6.1	
Public-sector domestic deficit	5.7	6.9	5.7	5.0	5.3	3.6	5.3	5.6	6.9	
Net overall public-sector debt	89.0	86.8	84.4	83.2	83.4	78.8	84.5	86.4	92.6	
Gross overall public-sector debt	109.2	106.6	103.9	106.7	101.4	91.4	96.4	104.9	107.4	
Total public-sector expenditure[a]	55.3	54.7	53.6	53.0	52.1	51.1	53.8	55.2	54.0	
Total taxes[a]	39.8	38.5	39.2	38.3	38.5	40.0	40.0	39.3	38.7	
Ceiling on domestic budget deficit[b]	3.9	3.7	3.0	2.8	3.1	3.6	1.8	3.9[c]	3.0	4.0[d]
Actual domestic budget deficit	4.3	4.2	3.3	3.2	3.3	0.7	4.6[e]	3.8[e]	5.6	4.5[d]
Fiscal impulse[f]						–0.4	0.6	0.2	–1.7	
Fiscal index[g]	95.4	95.8	94.7	93.5	93.0	92.5	92.8	93.4	93.2	92.4

[a] From 1995, expenditure and taxes include health insurance tax and government transfers to the health funds in accordance with the National Health Insurance Law.

[b] From 2001, the deficit ceiling as prescribed by law.

[c] The target set in mid-2002, when the budget was approved by the Knesset, was 3.0 percent of GDP.

[d] Estimate based on Bank of Israel, *Economic Developments and Macroeconomic Policy, 2003–2005*, October 2003.

[e] The US economic aid was not received in 2001; if it had been, the total budget deficit would have been 4.0 percent of GDP. The aid was recorded in 2002, and reduced the deficit by 0.6 percent of GDP. However, aid of $ 431 million, which was expected in 2002, was not received even though forecast income for 2002 included it. If it had been received in 2002, the deficit would have been 0.4 percent of GDP lower. Hence, on the basis of aid of $ 600 million originally intended for 2002, the deficit that year would have been 4.2 percent of GDP.

[f] The change in the general government's cyclically-adjusted domestic deficit excluding the Bank of Israel, as in Table 3.14 (in the second part of this report).

[g] The fiscal index summarizes the changes in the cyclically-adjusted domestic deficit (weighted at 0.85) and the net public-sector debt (weighted at 0.15) in the last three years, according significant weight (0.5) to the present. The methodology is based on M. Dahan and M. Strawczynski (1999), "Fiscal Policy and Inflation in Israel," in L. Leiderman (ed.) *Inflation and Disinflation in Israel*.

SOURCE: Based on the National Budget and Central Bureau of Statistics data.

Table 5
The Labor Force and Employment, 1990–2003

(rates of change, percent)

	1990–92	1993–96	1997–99	2000	2001	2002	2003
Working-age population (15+)	5.1	3.0	2.7	2.9	2.6	2.2	1.8
Civilian labor force	5.0	3.6	2.9	3.8	2.8	1.9	2.5
Business-sector employment[a]	5.8[b]	6.7	3.2	3.3	0.0	–0.6	1.0
Public-sector employment[a]	4.7[b]	3.4	3.8	2.9	4.4	3.1	0.7
Total Israelis employed	5.2[b]	5.1	2.0	3.9	2.1	0.9	2.0
Unemployed	14.0[b]	–10.1	13.5	3.4	10.0	12.1	6.6
Foreign workers	172.2[b]	70.1	10.4	7.0	14.4	3.31	–13.7
Palestinian workers	3.9	–15.3	26.4	–14.9	–49.0	–37.0	29.2
Working-age population/total population	69.2	70.3	71.0	71.3	71.5	71.6	71.6
Participation rate in civilian labor force[c]	51.9	53.5	53.5	54.2	54.3	54.1	54.5
Unemployment rate	10.5	7.8	8.4	8.8	9.3	10.3	10.7
Employment rate	46.2	49.2	49.1	49.4	49.2	48.5	48.6
Non-Israelis in business sector	9.0	9.2	14.9	15.2	14.1	13.6	12.4

[a] Including foreign and Palestinian workers.

[b] Excluding 1990.

[c] Civilian labor force *divided by* working-age population.

SOURCE: Based on Central Bureau of Statistics data.

Table 6
Balance of Payments, 1990–2003

($ billion, in annual terms)

	1990–92	1993–96	1997	1998	1999	2000	2001	2002	2003
Import surplus	6.2	9.7	9.3	7.2	7.8	7.2	8.2	7.9	6.5
Current account	–0.7	–3.9	–3.3	–1.1	–1.5	–0.7	–1.8	–1.4	–0.2
Implied capital imports[a]	0.3	–19.7	12.7	3.0	2.4	1.4	1.6	0.6	1.5
Capital transfers	0.9	0.8	0.7	0.6	0.6	0.5	0.7	0.2	0.4
Investment in Israel by nonresidents[b]	0.3	1.7	3.3	2.2	4.5	9.4	4.1	2.1	4.0
Direct investment in Israel by nonresidents	0.4	0.9	1.6	1.7	3.1	5.0	3.5	1.6	3.7
Portfolio investment in Israel by nonresidents	0.0	0.8	1.7	0.4	1.5	4.4	0.6	0.4	0.4
Rise (–) in foreign-exchange reserves[c]	0.4	–1.5	–9.4	–1.9	–0.9	–0.8	0.1	0.7	–1.3
Foreign-exchange reserves[d]	6.0	8.3	20.3	22.7	22.6	23.3	23.4	24.1	26.3
Net external debt	17.0	19.2	14.7	11.3	7.3	3.7	0.2	–3.0	–6.8

[a] Including errors and omissions.
[b] Direct and portfolio investment.
[c] Excluding revaluation differentials.
[d] Held by Bank of Israel and central monetary institutions at end of period.
SOURCE: Based on Central Bureau of Statistics data.

Table 7
Saving, Investment, and the Current Account, 1990–2003

(percent of total revenue, in annual terms)

	1990–92	1993–96	1997	1998	1999	2000	2001	2002	2003
Gross saving rate	20.1	19.6	20.0	20.4	20.3	19.5	17.6	15.8	14.6
Public	–0.5	–0.2	–1.0	–1.1	–1.5	–0.1	–1.8	–2.1	–4.1
Private	20.6	19.7	21.1	21.5	21.8	19.6	19.3	17.9	18.6
Gross investment	21.1	23.6	22.6	21.2	21.6	20.1	19.0	17.0	14.6
of which Business sector	12.7	15.5	14.7	14.2	14.6	14.2	13.5	12.7	12.2
Current account of balance of payments	–1.0	–4.0	–2.6	–0.8	–1.3	–0.6	–1.5	–1.2	–0.1

SOURCE: Based on Central Bureau of Statistics data.

Table 8
Indicators of Price Developments, 1992–2003

(percent, in annual terms)

	1992–95	1996	1997	1998	1999	2000	2001	2002	2003
Year-end									
CPI	10.8	10.6	7.0	8.6	1.3	0.0	1.4	6.5	–1.9
CPI excl. housing	9.2	9.8	6.8	8.6	2.0	0.6	0.4	6.1	–0.5
CPI excl. housing, fruit & vegetables, clothing & footwear	9.5	10.5	7.8	8.5	2.2	0.9	0.4	6.8	–0.5
Wholesale price index	9.0	7.0	5.9	8.2	3.5	2.0	–1.9	6.9	3.3
NIS/exchange rate currency basket[a]	8.5	3.0	3.7	20.6	–2.5	–6.3	3.7	14.2	–0.5
NIS/dollar exchange rate	8.0	5.0	7.9	18.2	0.4	–2.7	4.8	9.8	–6.4
Average									
CPI	11.3	11.3	9.0	5.4	5.2	1.1	1.1	5.7	0.7
CPI excl. housing	9.7	9.8	8.4	5.3	6.0	2.0	0.4	4.1	2.4
CPI excl. housing, fruit & vegetables, clothing & footwear	9.9	10.5	8.9	6.0	6.4	2.2	0.4	4.5	2.7
Wholesale price index	9.2	8.6	6.3	4.2	7.1	3.6	–0.1	3.9	4.4
NIS/currency basket exchange rate	8.7	3.5	4.3	9.6	8.3	–4.7	1.4	14.2	1.2
NIS/dollar exchange rate	7.3	5.9	8.2	10.2	8.9	–1.5	3.1	12.7	–4.0
Real exchange rate in export terms[b]	–2.6	–5.8	–2.7	0.2	2.3	–2.6	–1.2	5.8	–1.9
Real exchange rate in import terms[c]	–1.8	–8.6	–6.5	–2.8	0.3	–0.6	–1.4	7.2	1.9
Terms of trade[d]	–0.8	3.1	4.0	3.1	2.0	–2.0	0.2	–1.3	–3.7
Volume increase in world trade	6.5	7.0	10.4	4.4	5.8	12.6	0.1	3.2	2.9

[a] Average of last month of period vis-à-vis average of last month of preceding period.
[b] Ratio of export prices excluding diamonds to index of business-sector product prices including residential services.
[c] Ratio of import prices excluding diamonds to business-sector price deflator including residential services.
[d] Import-export price ratio, excluding diamonds.
SOURCE: Based on Central Bureau of Satistics data.

Table 9
Monetary Indicators, 1990–2003

(percent, in annual terms)

	1990–1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
M1[a]	24.0	3.9	15.9	13.2	12.1	9.6	11.0	14.2	15.6	0.3
Total bank credit[a]	35.9	47.2	24.6	19.1	16.1	16.7	13.0	10.8	10.5	1.7
Nominal Bank of Israel interest rate	14.1	15.8	16.4	14.8	12.6	13.0	9.8	7.1	7.3	7.9
Expected inflation[b]	13.9	10.1	11.2	9.2	6.1	5.3	2.6	1.9	3.3	2.7
Nominal interest on SRO deposits (CDs)	11.5	13.3	13.8	12.2	10.3	10.7	8.0	5.6	5.8	6.4
Nominal interest on non-directed credit in NIS	21.4	20.2	20.6	18.7	16.2	16.4	12.9	10.0	9.9	10.8
Average currency-basket interest rate[c]	6.3	5.3	4.6	4.9	4.9	4.5	5.5	3.6	2.1	1.5
Real yield on 5-year bonds	2.4	4.3	4.6	4.1	5.1	5.6	6.0	4.9	4.8	4.9
Real Bank of Israel interest rate[d]	1.1	5.2	4.7	5.1	6.1	7.3	7.0	5.1	3.9	5.1
General Share-Price Index[e]	32.5	14.8	–1.6	36.1	2.9	65.7	0.5	–6.9	–20.2	55.7

[a] Rise in annual average. M1 = cash in the hands of the public *plus* demand deposits. From 1996, this includes mortgage banks.

[b] 12-month inflation expectations estimated from the capital market, assuming full tax exemption.

[c] Based on 3-month Libid rate.

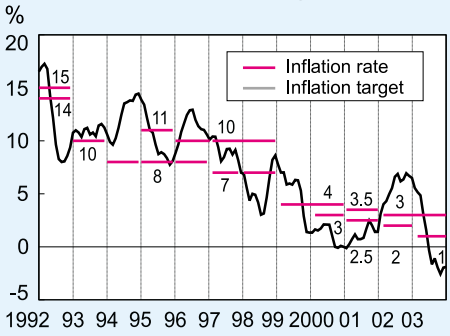
[d] Until 1997, daily average of effective marginal interest on monetary loan at quota; from 1998, average of effective interest at daily auction of banks' deposits in Bank of Israel *less* expected inflation for 12 months, as derived from capital market.

[e] Index of all shares and convertible securities, rate of change during the year.

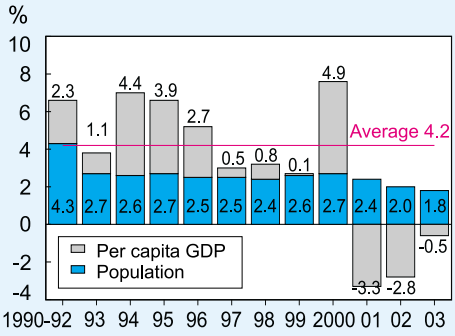
SOURCE: Based on Central Bureau of Statistics data.

Figure 1: Key Economic Indicators, 1990–2003

Inflation Rate and Target

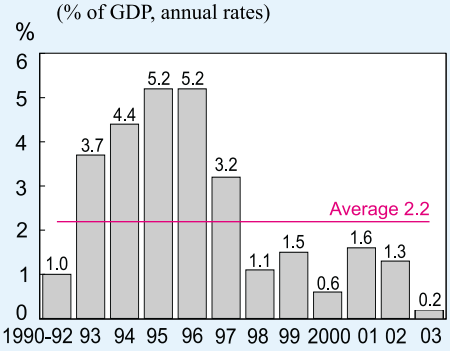


Growth Rate of GDP



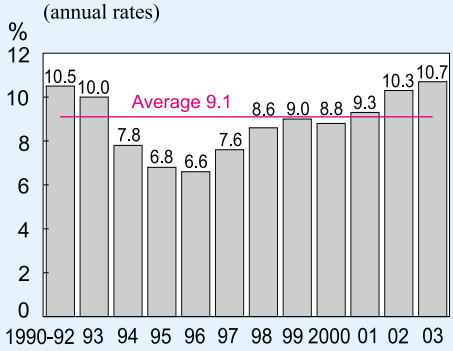
Balance of Payments Current-Account Deficit

(% of GDP, annual rates)



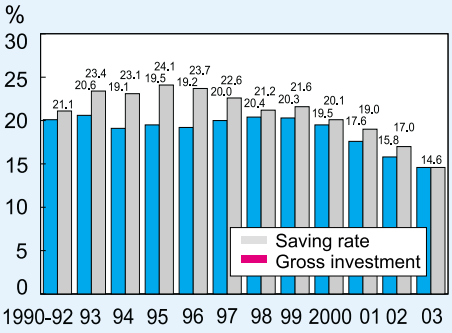
Unemployment Rate

(annual rates)



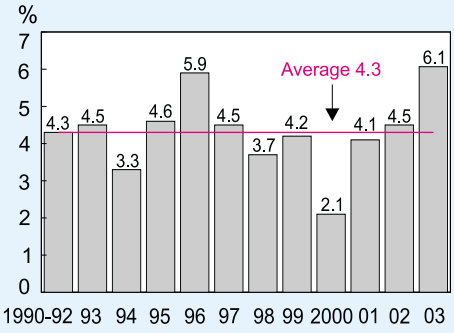
Gross Saving Rate and Investment,

(% of total income, annual rates)



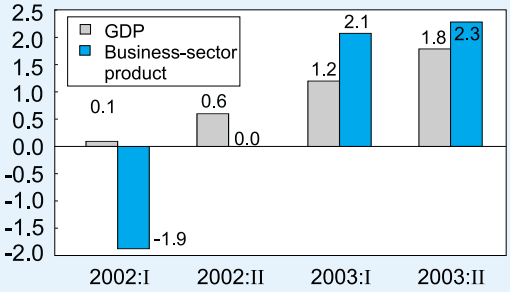
Public-Sector Overall Deficit,

(% of GDP, annual rates)

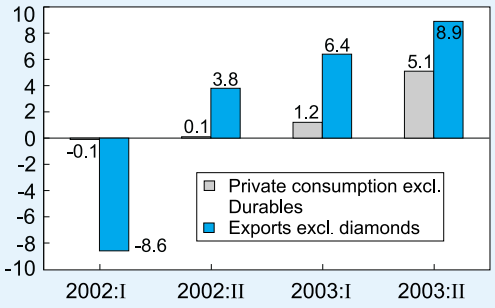


SOURCE: Based on Central Bureau of Statistics data.

Figure 2
a. GDP and Business-Sector Product
(seasonally-adjusted data, rate of change over preceding 6 months, in annual terms)

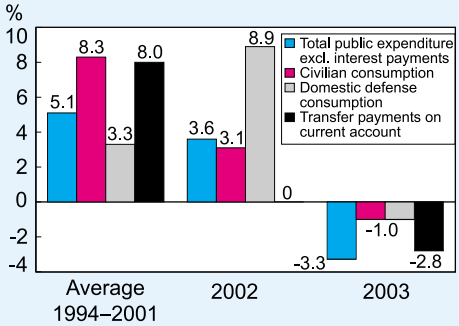


b. Exports and Private Consumption
(seasonally-adjusted data, rate of change over preceding 6 months, in annual terms)



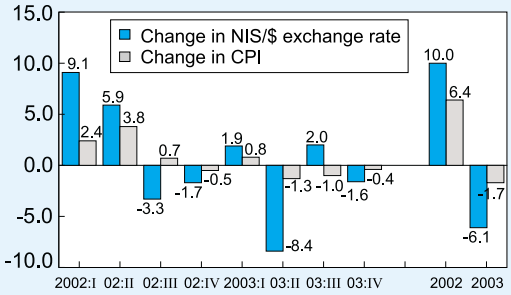
SOURCE: Based on Central Bureau of Statistics data.

Figure 3
Total Public Expenditure, Real Rates of Change, 1994–2003
(deflated by index of business-sector product prices)



SOURCE: Based on Central Bureau of Statistics data.

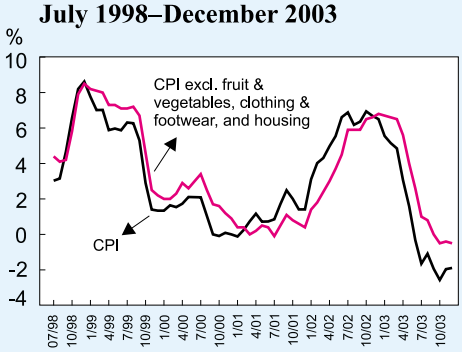
Figure 4
Change in Exchange Rate and CPI, 2002–2003



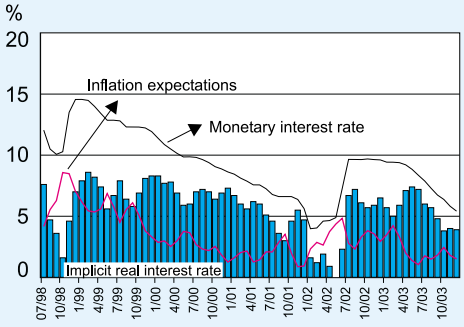
SOURCE: Based on Central Bureau of Statistics data.

Figure 5

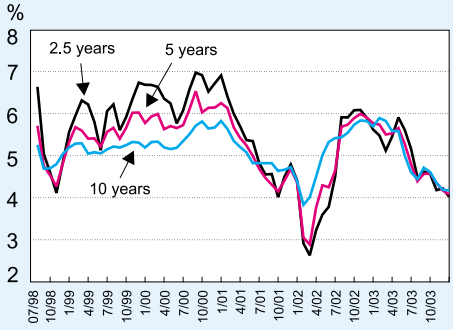
a. Rates of Change of Selected Price Indices in the Last 12 Months, July 1998–December 2003



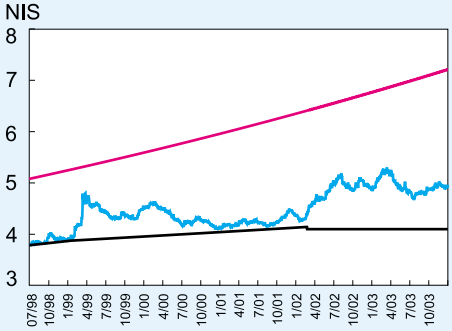
b. The Bank of Israel's Interest Rate, Inflation Expectations, and Implicit Real Interest, July 1998–December 2003



c. Real Indexed Interest Rates, July, 1998–December 2003



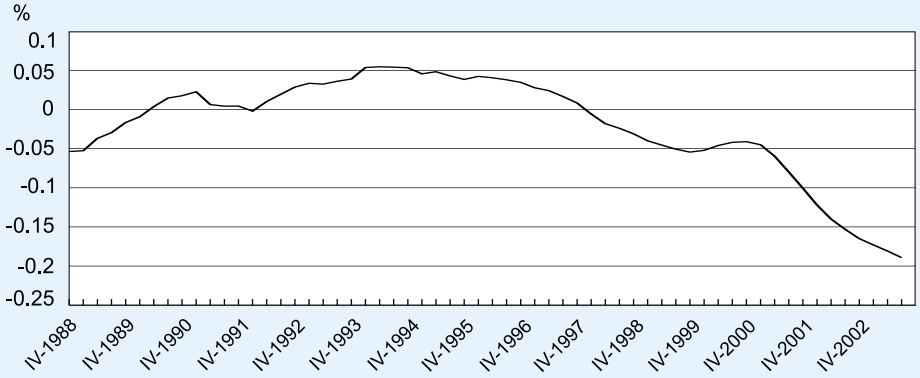
d. NIS/Currency-Basket Exchange Rate, July 1998–December 2003



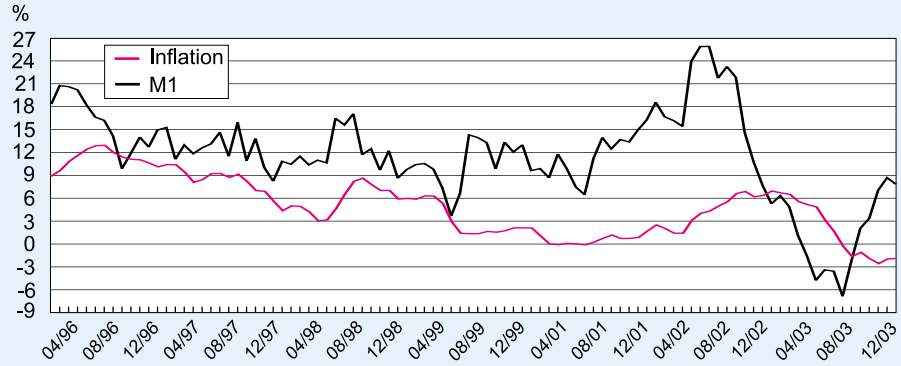
SOURCE: Bank of Israel.

Figure 6

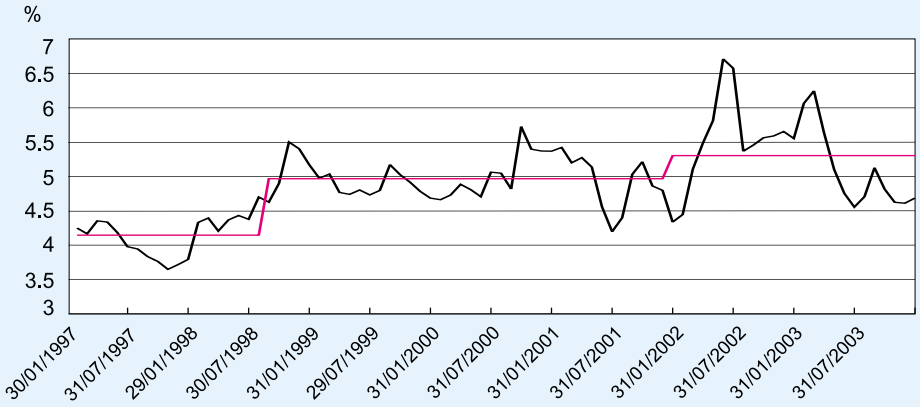
a. Output Gap (4-quarter moving average)



b. Money Supply and Prices (rate of change in previous 12 months)

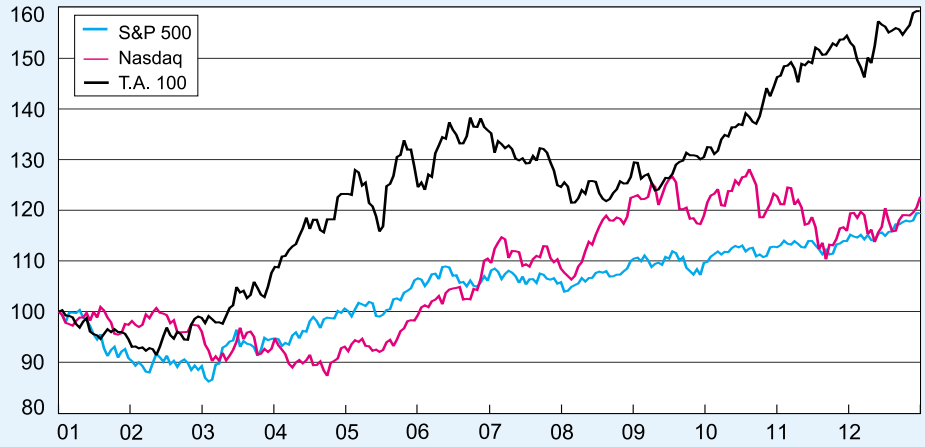


c. Future 5-9-Year Yields (derived from yields on CPI-indexed bonds)



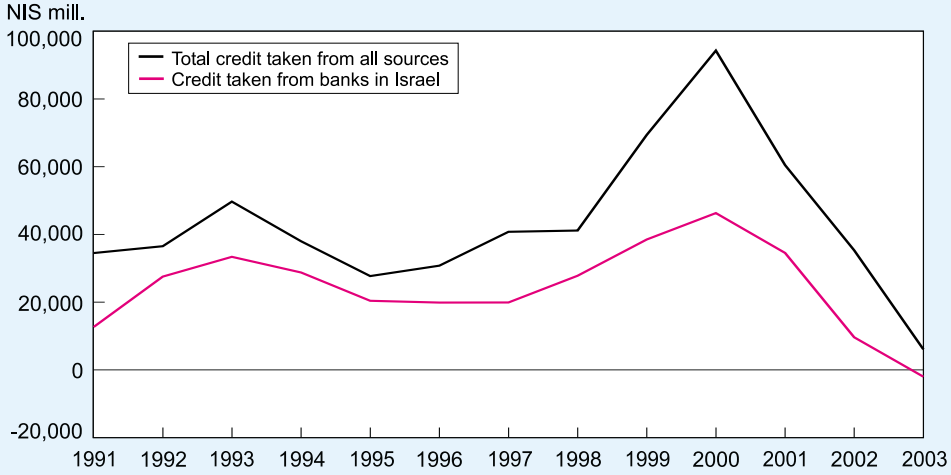
SOURCE: Bank of Israel.

Figure 7
Development of Share Indices in US and Israel, 2003



SOURCE: Bank of Israel.

Figure 8
Total Capital Raised by Private Sector from all Sources: Banks in Israel,[a] Banks Abroad,[b] Stock Markets in Israel and Abroad, and Venture Capital Funds, 1991–2003 (end-2002 prices)



[a] Credit from banks in Israel: change in outstanding credit, excluding mortgage credit.
[b] Credit from banks abroad: $ change in outstanding credit in NIS terms.

SOURCE: Bank of Israel and Association of Venture Capital Funds in Israel.