# Chapter 1
# The Economy and Economic Policy

- The Israeli economy grew at a rapid pace in 2011 relative to other developed countries. The growth rate of per capita GDP was higher than the average over recent decades and the unemployment rate was the lowest since 1983.
- The rapid growth that began in the second quarter of 2009 continued during the first part of the year, as the economy approached full employment. However, growth, particularly of exports and private consumption, decelerated later on in the year as a result of the global slowdown.
- The deceleration of growth was accompanied by a decline in inflation from above the upper bound of the target range to near its center, and by a decline in inflation expectations.
- The global slowdown also affected the profitability of local financial institutions; stock prices fell during the second half of the year and the spreads on corporate bonds rose.
- Monetary policy reacted to the economic developments: up until mid-year, the interest rate was raised in response to the high rate of inflation and accelerated economic activity; during the second half of the year, the Bank of Israel lowered its interest rate in reaction to the global deceleration of growth and the fears that it would worsen.
- In order to reduce the moderating effect of an interest rate increase on the tradable sector, and the risk to stability from short-term foreign capital inflows, a number of macroprudential measures were taken in the beginning of the year. In addition, the Bank of Israel purchased foreign currency, though it stopped in August, against the background of the depreciation of the shekel.
- To reduce the risk to stability originating from the housing market, the variable-interest rate component of new mortgages was limited to one-third beginning in May.
- The government budget deficit was only slightly above its target. Nevertheless, its current level does not facilitate further significant reduction in the debt to GDP ratio. The trajectory of expenditure and taxes is not consistent with a reduction in the deficit in coming years, certainly not to the levels specified by law.
- In the summer of 2011, a social protest developed which included broad sections of the public. The government reacted to the protest by instituting changes in its tax policy and by increasing support, particularly for young working families, based on the recommendations of the Committee for Economic and Social Change.
- The policy measures which the government approved following the Committee's recommendations widened the gaps between the cost of government programs in coming years and the legal ceiling on expenditure. Dealing with these gaps will require some significant decisions.
- The expected deceleration of growth of the working age population during the coming decade and the change in its composition require rapid adoption of a long-term plan to increase labor force participation and to raise total factor productivity, in order to maintain the growth rate of per capita GDP that has characterized recent decades.
- An "excess profit tax" was approved this year on the production of natural gas, which was discovered off the coast of Israel. To optimize the effect of the discovery on the Israeli economy, the government has decided to deposit the revenues from this tax into an intergenerational fund, which will invest the proceeds abroad and will allocate to the State budget each year a sum derived from its profits.

## 1. MAIN DEVELOPMENTS

The Israeli economy grew rapidly in 2011.

In 2011, the Israeli economy grew at a rapid rate, relative to other developed countries, although the growth rate slowed over the course of the year, against the background of the global slowdown. Looking at the full year, per capita GDP grew faster than the average for recent decades; the unemployment rate reached its lowest level in three decades; and the inflation rate at the end of the year was close to the center of the target range. The deterioration in the debt crisis in Europe, which led to a slowdown in global growth, was also expressed in a significant downward revision of expected growth rates for 2012, both in Israel and worldwide.

Economic policy this year faced significant challenges, including the social protest, political changes in the region, and the rise in housing prices.

Against a background of positive macroeconomic conditions, economic policy this year faced significant challenges, some of which were byproducts of past policies and some the result of long-term processes in the economy and in Israeli society. These challenges included the social protest movement and its root causes, the political changes in the region and the high level of housing prices—following their sharp increase during the last three years—with the accompanying financial risks. Dealing with the social and geopolitical challenges is complicated by the large structural fiscal deficit and the potential effect of demographic developments on the economy's future growth. Important policy measures were enacted during the year to deal with some of the aforementioned structural issues; however, it appears that these problems will continue to occupy policymakers in coming years.

The negative impact of the global financial crisis on the Israeli economy was less than on many other developed economies.

The global financial crisis, which reached its peak at the end of 2008 and in 2009, affected the Israeli economy less than many other developed economies. During the two years since then, the Israeli economy has grown faster than almost all of the other OECD economies, with a rapid decline in unemployment of 2 percentage points (Figures 1.1 and 1.2). As a result of the rapid growth in economic activity, the current account surplus has shrunk more than in other OECD countries and inflation has been higher.

The high rate of growth expressed a rapid increase in investment and was accompanied by a decline in unemployment. Over the course of the year, growth of private consumption and of exports slowed.

The high rate of growth this year (4.7 percent, or 2.8 percent in per capita terms) was supported by even faster growth in aggregate demand (uses excluding the change in inventories), which grew by 5.5 percent in real terms and was partly met by a real increase of about 11 percent in imports. There was particularly rapid growth in investment, both in the business sector and in residential construction. The other components of aggregate demand also grew rapidly, although during the course of the year the growth in private consumption slowed, to a large extent as a result of global economic developments and the decreased expectations of world growth in 2012. The slowdown in the expansion of global economic activity, which led to a drop in global demand, was manifested in a decline in exports during the second half of the year, against the background of the shekel's appreciation trend in recent years.

The rapid growth has also been manifested in the labor market: the demand for labor increased this year and the unemployment rate dropped to 5.6 percent, its lowest level since 1983. The decline in unemployment was accompanied by a minimal rise in the labor force participation rate from 57.3 to 57.4 percent and an increase of 4 percent

**Table 1.1**
**Main Developments in Israel and Around the World, 2008-11**

| | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| **Israel** | | | | |
| GDP[a] | 4.0 | 0.8 | 4.8 | 4.7 |
| Exports[a] | 6.6 | -12.6 | 13.4 | 4.9 |
| Private consumption[a] | 2.8 | 1.4 | 5.3 | 3.6 |
| Unemployment rate[b] | 6.0 | 7.5 | 6.7 | 5.6 |
| Inflation[c] | 3.8 | 3.9 | 2.7 | 2.2 |
| 1-year real interest rate[b] | 1.9 | -0.4 | -0.7 | 0.3 |
| Current account of the balance of payments ($ billion) | 1.8 | 7.0 | 6.3 | 0.2 |
| Public debt/GDP ratio[d] | 77.1 | 79.5 | 76.1 | 74.2 |
| Real effective exchange rate[e] | -10.7 | 1.8 | -5.1 | -1.4 |
| Nominal effective exchange rate[e] | -10.1 | 4.3 | -4.8 | -1.0 |
| Tel Aviv 100 Index[f] | -49.5 | 79.4 | 15.1 | -17.8 |
| **Around the world** | | | | |
| GDP of advanced economies[a] | 0.2 | -3.4 | 3.2 | 1.6 |
| GDP of developing countries[a] | 6.0 | 2.6 | 7.3 | 6.2 |
| World trade[a] | 2.9 | -10.7 | 12.7 | 6.9 |
| Commodities Price Index (Merrill Lynch)[f] | -40.4 | 52.9 | 23.4 | 3.0 |
| MSCI share index of advanced economies[f] | -44.3 | 30.9 | 8.4 | -7.0 |
| MSCI share index of emerging markets[f] | -55.7 | 76.8 | 15.6 | -17.6 |

[a] Real rate of change, percent.
[b] Annual average, percent.
[c] During the year, percent.
[d] End of year, percent.
[e] Rate of change, annual average compared with previous year's average. A negative figure indicates appreciation.
[f] Nominal change during the year: December average compared with December average in previous year.
SOURCE: Data on Israel—Bank of Israel, except for the real effective exchange rate (from IFS database) and share price indices ( from the Tel Aviv Stock Exchange). International data—World Economic Outlook Update January 2012 and MSCI Barra.

in the nominal wage per employee post. However, the rapid growth in the nominal wage resulted in only a small increase in the real wage, in terms of the CPI, because the latter increased by 3.5 percent in annual average terms.

The deceleration of economic growth during the year was accompanied by a moderation in inflation.

The deceleration of economic growth during the year was accompanied by a drop in inflation (over the preceding 12 months) from an annual rate of over 4 percent at the beginning of the year to 2.2 percent at the end of the year (and even less during the second half of the year). This was accompanied by a decrease in the expected 12-month inflation rate from about 3.7 percent at the beginning of the year to about 2 percent at the end. The rise in prices this year included an increase of 5.1 percent in rents, which slowed during the second half of the year, and a rise in energy prices of about 9.2 percent, which included a hike in electricity rates due to disruptions in the supply of natural gas.

Increased risk on financial markets worldwide affected Israel's capital market.

In addition to the real channel Israel's economy was affected by global developments through the financial channel as well. Israel's capital market was affected by the increase in risk in global financial markets, a result of its integration with global markets. Thus, following two years of positive trends in the local financial system, the profitability of financial institutions declined during the second half of 2011, against the background of negative developments in the global environment. Share prices fell by 18 percent from their peak at the end of 2010 and the yield gap widened between government and corporate bonds, particularly unrated bonds and bonds of real estate companies. This phenomenon implies a higher perceived risk that companies will not be able to redeem their debt and makes it more difficult to issue new debt on the market. The profitability of the financial institutions (banks and insurance companies) was also adversely affected. The growth rate of total credit fell somewhat this year; reflecting a moderate increase in credit to the business sector and the continuing rapid expansion of credit to households, particularly in the form of mortgages. The moderate growth in total credit to the business sector in parallel to an increase in its price (relative to the interest rate on deposits) reflects to a certain extent a decrease in the supply of credit from the banks, against the background of an increased level of risk. Meanwhile, the continuing rapid growth of fixed capital formation in the economy may indicate the existence of sources of self-financing and the relatively modest need for credit financing.

The deceleration of growth, together with fears of a continuation of the global crisis and decline in the long-term growth rate, were reflected in a downward trend in real long-term yields on indexed government bonds, from about 4 percent prior to the crisis (2004–07) to around 2 percent. Nominal long-term yields, which have risen since mid-2010, started to fall again in April at a moderate rate. This trend characterized many other developed countries although in most of them the decline was larger than in Israel, widening the interest rate gap between those countries and Israel.[1]

Monetary policy responded to changes in inflation and economic activity.

Monetary policy during the year responded to the changes in economic activity and inflation. At the beginning of the year, the interest rate was raised steadily to a level of 3.25 percent. This was in response to the rise in prices and in short- and medium-term inflationary expectations, alongside the economy's proximity to full employment and the continuing increase in home prices. Even after the interest rate hikes, the short-term real interest rate remained very low, similar to the level of other advanced economies—less than one percent—a level supporting expansion of economic activity. With the intensifying fear of the crisis in Europe and the moderation of inflation and inflationary expectations, together with signs of decelerating growth in economic

[1] Apart from countries at the heart of the crisis, in which the rise in the risk premium has led to an increase in yields on government bonds.

activity, the Bank of Israel stopped raising the interest rate, and in October began lowering it, reaching a level of 2.5 percent in February 2012.

The Bank of Israel also implemented macroprudential measures in the foreign exchange and mortgage markets.

Apart from the interest rate, which is the main monetary policy tool, the Bank of Israel also implemented macroprudential measures in the mortgage market. Its goal was to reduce the risk to the stability of the financial system, in view of the continuing rapid rise in housing prices at the beginning of the year and the increase in total mortgages, particularly the variable-rate type. The main step taken in May 2011 was the limiting of the variable-rate component of a mortgage to one-third of the total housing loan, with the goal of reducing the risk to borrowers and to financial institutions that will result from a significant (unexpected) increase in the burden of debt servicing on borrowers in the future, when the interest rate returns to higher levels.

The purchase of foreign currency by the Bank of Israel, which was one of the main policy tools used in 2010 to limit the appreciation of the exchange rate to that reflecting the economy's fundamentals, was cut back in 2011 and took place primarily at the beginning of the year. From August onward, the Bank of Israel did not intervene in the foreign exchange market. Intervention became less necessary as a result of the decline in the total holding of government bonds and makam by foreign investors and the increase in the net outflow of capital among institutional investors, which was manifested in the halt of the exchange rate's appreciation. These developments were the result of regulatory measures adopted in the beginning of the year, which included the imposition of a liquidity requirement on deposits of foreign residents and requirements to report certain transactions,[2] as well as the change in the risk assessment of foreign residents regarding investment in foreign economies, including Israel.

At the beginning of the year economic activity was near full-employment level.

A key question in determining the formation of monetary policy this year was whether the Israeli economy is at full employment. In such a situation, the economy's factors of production are being almost fully utilized, such that any additional increase in demand can only partially be met by an increase in production and is therefore manifested primarily in price increases and a reduction in the surplus of the goods and services account. The assessment that the economy was indeed close to full employment at the beginning of the year was supported by a number of indicators: a low unemployment rate, an increasing ratio of offered jobs to the number of unemployed, a rapid rise in capital formation and imports, a high rate of inflation and an accelerating rise in nominal wages. In view of this assessment, the hikes in the interest rate at the beginning of 2011 reflected the need to constrain aggregate demand and thus reduce inflationary pressures. However, later in the year, demand growth slowed by more than the effect of the rise in the interest rate, primarily due to global economic developments, which adversely affected exports and private consumption, and led to a decline in imports and a moderation in inflation.

[2] See the press releases of the Bank of Israel on the 19th and 20th of January 2011.

Various factors explain the moderate increase of real wages in recent years.

In view of the low rates of unemployment and the stable participation rates, the question arises as to why the real wage has risen only moderately in the last two years, particularly in view of the sharp drop in the share of wages in GDP at the beginning of the crisis. One possible explanation for this phenomenon is the limited ability of some employers to raise wages—due to the rising prices of raw materials, which has hurt their profitability, alongside the limited ability to raise prices due to the slowdown in export markets and the growing competition from imported goods as a result of the exchange rate appreciation. The business sector's product deflator, which reflects producers' ability to raise wages while maintaining the same level of profitability, rose less than the CPI[3] and therefore wages in terms of the business sector's GDP deflator rose more than the real wage in terms of the CPI (see Figure 5.5). An additional reason for the moderate increase in real wages is that actual inflation has been higher than expectations and therefore ex post real wages were lower than planned at the time of the signing of wage contracts (which led in 2011 to a large nominal rise in the wage per salaried position relative to previous years). In addition, the reductions in tax rates that took place prior to 2009 raised the net wages for workers in the upper half of the wage distribution.

## 2. THE GLOBAL ENVIRONMENT

The recovery of the global economy from the crisis stalled to some extent this year, and the uncertainty surrounding its persistence increased.

The recovery of the global economy from the crisis stalled to some extent in 2011 and the uncertainty surrounding its persistence increased. The developed economies grew at slower rates than in 2010, while the developing countries, which were much less affected by the global crisis, continued to grow rapidly in 2011, though at somewhat slower rates than the previous year. The deceleration of growth was also reflected in the slower expansion of global trade (Table 1.1).

At the same time, inflation in the developed countries was higher than in 2010 due to the continuing rise in the price of oil and other commodities. Share prices fell in many countries while their volatility increased. Significant gaps appeared in bond yields between countries that are perceived as risky, particularly in Europe, and the "anchor markets", i.e. Germany, Switzerland and the United States, where long-term interest rates are at historic lows. In the "anchor markets", rates fell by a percentage point or more, primarily during the second half of the year,[4] due to, inter alia, the effect of central bank activity and despite the lowering of credit ratings for the US and Japan and the credit rating warning issued for Germany.

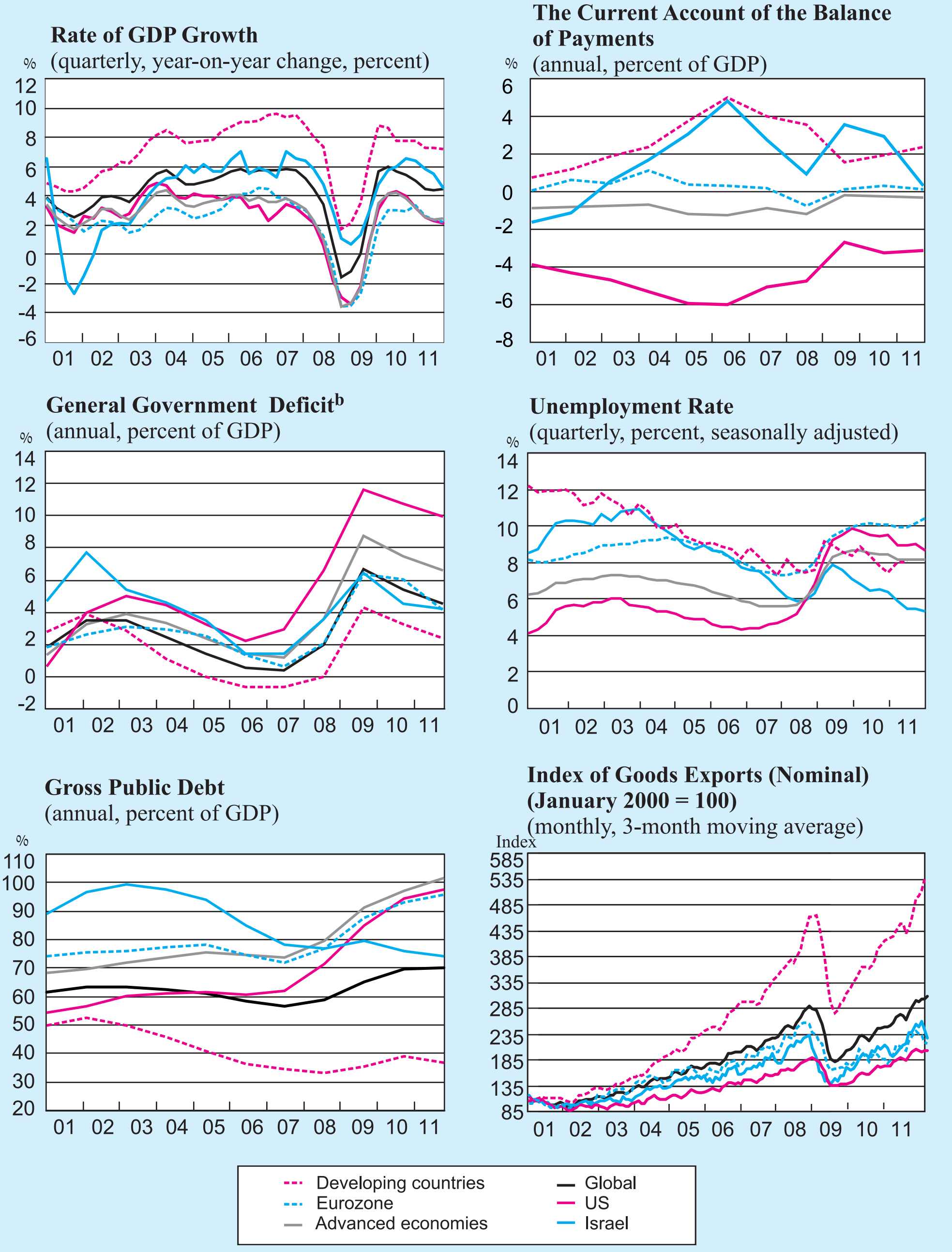
During the first quarter, the global recovery from the crisis continued and some central banks increased interest rates.

During the first quarter of 2011, the recovery from the global crisis continued (Figure 1.1). In Europe, growth even accelerated relative to the second half of 2010 and the

[3] A large part of the increase in the CPI reflects the increase in housing prices. About 70 percent of households own the home they live in, so an increase in rent does not in fact increase their expenditures.

[4] The level of the interest rate varied over a large range: from a low level of one percent in Japan to about 4 percent in Australia, Korea, New Zealand and others. Such a wide variation in interest rates has been characteristic of the past decade.

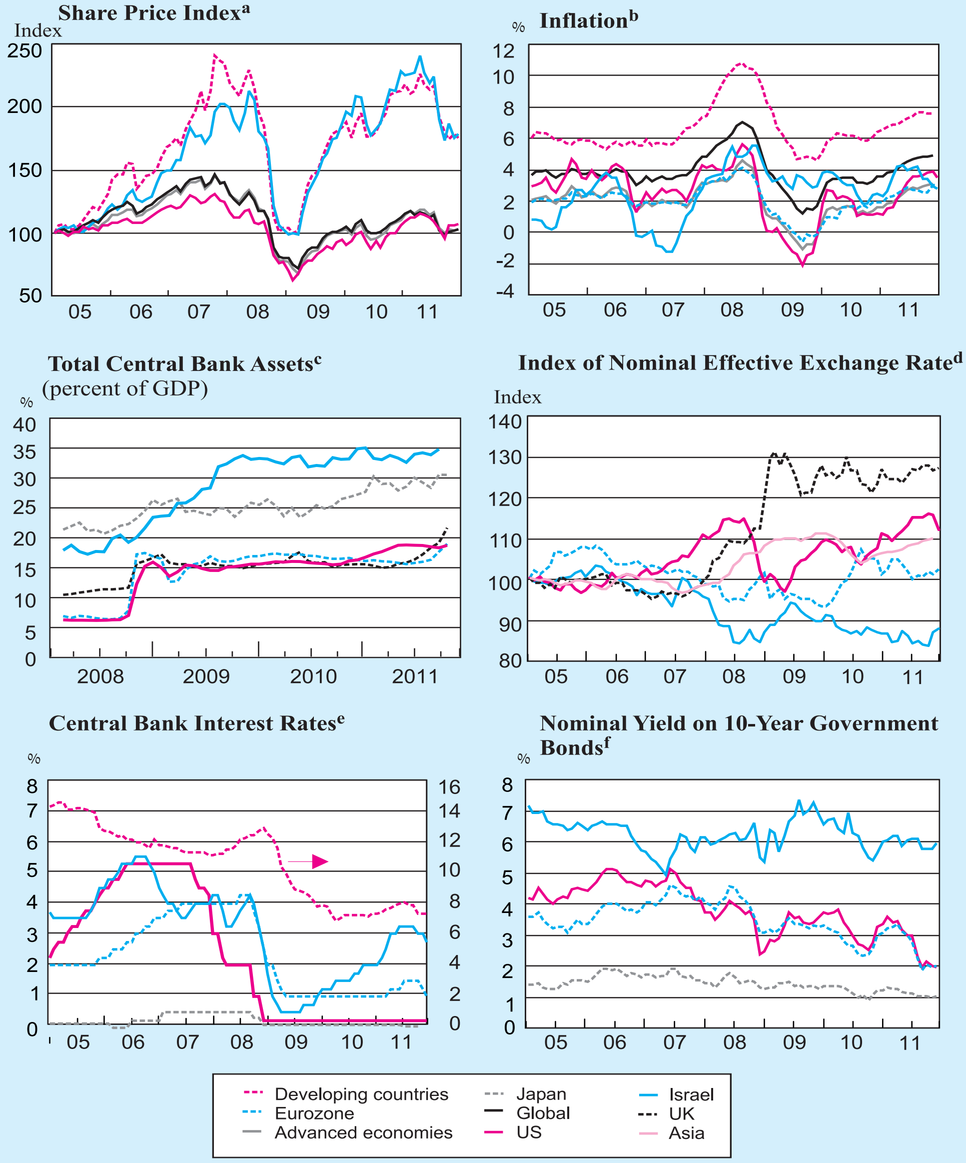
**Figure 1.1**
**Indicators of Economic Activity in Israel and around the World,[a] 2001-11**




[a] The aggregates in all graphs are taken from the IMF World Economic Outlook, except for unemployment, for which the figure for the advanced economies is taken from the OECD database, and the figure for developing countries is calculated from the weighted average (the weights relate to size of GDP in 2008 in PPP terms) of Argentina, Brazil, Bulgaria, Colombia, Latvia, Lithuania, Malaysia, Peru, the Philippines, Russia, South Africa and Thailand.
[b] The figure for Israel is adjusted to conform with the international definition to enable the international comparison to be made. A positive sign denotes a deficit.

SOURCE: For Israel-the Bank of Israel; international data-IMF World Economic Outlook 2011 and 2012, IFS database and OECD database.

**Figure 1.2**
**Monetary Indicators, Israel and Abroad, 2005-11**




[a] Based on monthly average, in dollar terms, of groups of shares. Advanced economies include the following 23 countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the UK, and the US. The developing countries include the following 21 countries: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.
For Israel-the Tel Aviv 100; for the US-S&P 500.
SOURCE: MSCI Barra and Yahoo Finance.
[b] Inflation over the previous twelve months. The groups of countries are as per the IMF definition.
SOURCE: IFS database.
[c] Monthly average of each central bank's assets, divided by quarterly GDP of the country (or region). Annual terms, seasonally adjusted.
SOURCE: Central banks of eurozone, Japan, UK and US, Bank of Israel, OECD Economic Outlook..
[d] SOURCE: For data on Israel, the UK and the US-IFS; for Asia-IMF World Economic Outlook. Increase indicates depreciation.
[e] SOURCE: For Israel-the Bank of Israel; for the ECB, Japan and the US-Bloomberg; for the developing countries-the weighted average (the weights relate to size of GDP in 2008 in PPP terms) of the interest rates in Argentina, Brazil, Chile, Colombia, Latvia, Lithuania, Malaysia, Peru, the Philippines, Russia, South Africa, Thailand and Turkey.
[f] SOURCE: The Federal Reserve, Bloomberg, and the Bank of Israel.

ECB raised its interest rate (Figure 1.2). During the second quarter of the year, global growth slowed, due to, among other things, the tsunami in Japan which disrupted the global supply chain, and remained weak later in the year, particularly in the case of Europe. In contrast, there were some signs of economic improvement in the US. The slowdown in global growth was exacerbated by the increase in interest rates in some of the emerging markets, where fears of overheating and inflationary pressures developed. Several countries in Eastern Europe (as well as Norway, Denmark and Sweden) also raised their interest rates during the first half of the year, in view of the relatively strong growth, which was accompanied by increased inflation.

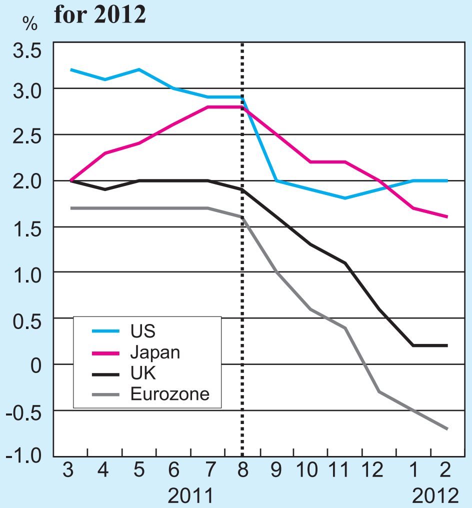
During the second half of the year, the financial crisis in Europe worsened due to fears that some countries would not be able to service their debt and concerns of the impact on the financial sector, particularly in light of the potentially limited ability of some governments to support the financial institutions in their countries. The close interrelationships between financial institutions in Europe and worldwide increased the fear that a debt crisis in one of the European countries would seriously harm the financial sector on the whole continent. This concern weighed on the chances of recovery in Europe and was reflected in the large and continuous downward revisions in the growth forecasts for Europe, which began in August. Current forecasts expect a decline in GDP in 2012 (Figure 1.3). The fears regarding the European economy also led to the downward revision of growth forecasts in the rest of the world, though to a lesser extent. Most countries that raised their interest rate during the first half of the year left it unchanged or lowered it during the second half.

During the second half of the year, the financial crisis in Europe worsened, and growth forecasts were revised downward.

Beyond the concerns regarding growth in 2012, global economic developments are also worrying with respect to the duration of the crisis and the ability of the global economy to rapidly return to growth rates that will close the output gap which emerged during the crisis. Interest rates in most developed countries—primarily the larger ones—are close to zero and in some of them the central banks (including the Fed and the ECB) are using additional expansionary monetary tools and are providing banks with medium- and long-term financing. The difficulty in increasing the public debt, in view of the potential threat to confidence and the difficulty of servicing the debt, has limited the ability of most European countries to adopt expansionary fiscal policies. Some of them, including larger countries such as the UK, France, Italy and Spain, were even forced to raise tax rates and reduce government

There is concern over the duration of the crisis and the pace of closing output gaps that opened.

**Figure 1.3**
**Development of Growth Forecasts for 2012**




SOURCE: Based on The Economist.

expenditure in order to cut the deficit, despite the high unemployment rates in those countries. In the US, where expansionary fiscal policy is still being used to stimulate economic activity, there is increasing pressure to reduce the deficit. Moreover, since attempts to boost growth, primarily in the US, are based predominantly, at this point, on encouraging private consumption and the real estate sector and to a lesser extent on reducing trade deficits, there is concern of renewed expansion of the imbalance which existed in the global economy prior to the crisis, and was reflected in large current account deficits in advanced economies. Correction of this imbalance may constrain global growth during the rest of the decade as well. These concerns are also reflected in low long-term interest rates, except in those countries in which risk premiums have risen.

Commodity prices increased through the beginning of 2011 and declined over the remainder of the year.

Commodity prices, and in particular food prices, which were characterized by a steep uptrend until the beginning of 2011, fell during the course of the year, though they remained high relative to recent years. The rise in commodity prices contributed to the pressure on prices during most of the year in the developed countries, despite the slowdown in economic activity, and particularly in the developing countries, where the share of food in private consumption is large. Oil prices increased rapidly until April, partly against the background of political developments in the Middle East; however, the trend leveled off and prices remained stable during the rest of the year, with even a slight downward trend. The exchange rate of the euro, which strengthened against the dollar during the first half of the year, remained stable in the following months and weakened at the end of the year, as a result of the worsening situation in the eurozone relative to the improvement in activity in the US.

## 3. THE ISRAELI ECONOMY

### a. Real activity

Economic activity expanded markedly in 2011, due to the rapid increase in domestic demand and growth in exports.

Economic activity expanded markedly in 2011, due to the rapid increase in domestic demand and growth in exports. GDP grew by 4.7 percent, more than any other OECD country (except Turkey) and per capita GDP grew by 2.8 percent, reaching a high level that exceeds its long-term growth trend. The rapid pace of growth was also reflected in rapid growth of employment, which led to a drop in the unemployment rate to its lowest level in three decades. After reaching the vicinity of full employment according to various indicators in the beginning of the year, growth then slowed, primarily due to a change in the trend of the global economy and concerns of a continued slowdown worldwide.

The increase in GDP was based on notable growth in labor and capital inputs, alongside slower growth in total productivity.

The increase in GDP was based this year on the high level of growth in labor and capital inputs, alongside slower growth in total productivity, a phenomenon that is characteristic of an economy near full employment. The growth in labor input was based on the rapid increase in the number of persons employed, while the number of hours worked per employee remained stable. The growth in the business sector's capital stock also accelerated and the notable expansion in investment this year will be reflected in an even more rapid increase in the capital stock available to the economy in 2012 (see Chapter 2).

All of the main demand aggregates grew at high rates during the year, in particular fixed capital formation, which increased by 16.2 percent, following an increase of 13.6 percent in 2010. The rapid increase in investment encompassed both investment in the various industries of the economy as well as investment in residential construction, which reacted to the sharp rise in home prices in recent years and to the policy measures adopted to increase the availability of land for construction. Private consumption expenditure grew by 3.6 percent, public consumption grew by 3.7 percent, and exports grew by 4.9 percent. The composition of the increase in demand—which was led by investment and consumption of durable goods (which are import-intensive)—was reflected in the large increase in imports (11 percent).

The goods and services account of the balance of payments went into deficit this year, after two years of significant surplus

The goods and services account of the balance of payments went into deficit this year. This followed two years of large surpluses and was similar to the increase in the deficit in 2007 and 2008, during the peak of the previous business cycle. The shift to a deficit this year reflected the rapid quantitative increase in imports, alongside the more moderate growth in exports and the significant deterioration in the terms of trade, which was primarily the result of higher prices for raw materials in the global market (see Chapter 7). In parallel with the increase in import prices, inventories declined significantly over the past two years; this is liable to intensify the effect of the increase in the prices of raw materials—if it continues—on economic activity. The shift to a deficit also reflected the cumulative real appreciation of the shekel during the last three years (see Chapter 7, section 2). The appreciation, which was primarily due to the Israeli economy's growth rate outpacing those of its main trading partners, reduced over time the improvement in the tradable goods sector's ability to compete, an improvement attained by the recession's moderate negative impact on the utilization of production factors in Israel, relative to its trading partners. While the cumulative growth in exports since 2007 has been similar to that in global trade, despite the cumulative appreciation of 12 percent, the rate of growth in exports this year was somewhat lower than that of global trade.

The savings rate continued to decline, while the share of investment increased.

An analysis of the decrease in the current account surplus according to changes in saving and investment in the economy indicates that these two forces worked in tandem to expand the deficit. Thus, the savings rate continued to fall this year, after it rose in 2009 during the crisis, while the share of investment in GDP rose from its low level, relative to the advanced economies, of the second half of the previous decade. The rate of saving during the last two years was significantly lower than in the years prior to the crisis of 2009. This is to a large extent due to the return of the public sector to negative saving, after public saving became positive in mid-decade as a result of the consolidation plan of 2003.

Growth rates of GDP and demand moderated gradually during the year.

Private consumption grew this year by 3.6 percent, with an increase of more than 7 percent in the consumption of durables goods, whose movements are pro-cyclical.

This increase was partly the result of the low real interest rate relative to the past. Current consumption grew by 3.2 percent, which translates into 1.3 percent per capita, somewhat lower than the long run growth in per capita income. The growth in private consumption was supported by the low rate of unemployment.

The growth rates of GDP and demand moderated gradually during the course of the year. During the first quarter, GDP grew by an annual rate of 4.7 percent, compared to 5.5 percent during each half of 2010. During the second and third quarters, the rate of growth slowed to about 3.5 percent, and in the fourth quarter it fell to 3.2 percent. The moderation of growth in demand was led by a marked slowdown in private consumption, primarily in the consumption of durable goods, starting from the second quarter of the year. This occurred in parallel to the price declines in the capital

Table 1.2
Developments in 2010–11

| | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II | III | IV |
| GDP[a] | 5.5 | 5.9 | 4.8 | 7.6 | 4.7 | 3.7 | 3.4 | 3.2 |
| Business sector product[a] | 7.6 | 7.2 | 4.9 | 8.9 | 5.7 | 3.0 | 4.4 | 3.5 |
| Unemployment | 6.9 | 6.6 | 6.6 | 6.4 | 6.0 | 5.6 | 5.6 | 5.4 |
| Exports excluding diamonds[a] | 3.4 | 16.5 | 1.6 | 4.8 | 7.2 | 4.3 | -2.8 | -10.9 |
| Private consumption[a] | 0.6 | 7.8 | 0.9 | 10.9 | 5.5 | -0.2 | 0.8 | -0.8 |
| Civilian imports (excluding ships, aircraft and diamonds)[a] | 19.1 | 3.6 | 6.8 | 13.2 | 32.4 | 10.2 | -8.5 | -9.9 |
| Fixed investment[a] | 15.2 | 29.6 | 15.4 | 26.4 | 19.1 | 13.6 | 13.4 | 4.7 |
| Current account of the balance of payments[b] | 1.9 | 2.1 | 1.9 | 0.7 | 0.4 | -0.1 | 0.2 | -0.7 |
| Real effective exchange rate[c] | -2.0 | -2.5 | 0.5 | -1.7 | 0.0 | -1.6 | 2.0 | 1.9 |
| Nominal effective exchange rate[c] | -3.4 | -2.2 | 1.7 | -1.6 | -0.1 | -1.8 | 2.2 | 1.4 |
| Bank of Israel foreign currency purchases[d] | 2.3 | 3.2 | 1.3 | 5.2 | 2.3 | 2.1 | 0.2 | 0.0 |
| Inflation[e] | -0.9 | 1.5 | 1.2 | 0.7 | 0.7 | 1.5 | 0.0 | 0.0 |
| One-year forward inflation expectations[f] | 2.8 | 2.8 | 2.8 | 3.1 | 3.6 | 3.1 | 2.3 | 1.8 |
| Bank of Israel interest rate[g] | 1.25 | 1.50 | 1.75 | 2.00 | 2.50 | 3.25 | 3.25 | 2.75 |
| Interest on overdrafts[h] | 8.8 | 9.1 | 9.3 | 9.7 | 10.2 | 10.4 | 10.6 | 10.7 |
| Tel Aviv 100 index[i] | 9.7 | -10.8 | 7.8 | 9.2 | -2.4 | -5.6 | -14.0 | 3.8 |

[a] Real rate of change in annual terms, percent, seasonally adjusted.
[b] Seasonally adjusted, $ billion.
[c] Rate of change during the quarter, in percent. A negative sign denotes appreciation.
[d] Total purchases, $ billion.
[e] During the quarter.
[f] Quarterly average.
[g] Published rate, last month in quarter.
[h] Quarterly average, nominal, in annual terms.
[i] Change during quarter, percent.
SOURCE: Based on Central Bureau of Statistics and Tel Aviv Stock Exchange data.

market, which reduced the public's financial wealth, and indicated an expected future decline in the growth of income. During the second quarter of the year, the slower growth was accompanied by a drop in exports as well, although the effect of slower growth was partially offset by the decline in imports. In the fourth quarter, the growth in fixed capital formation also slowed. Despite the deceleration in growth, GDP per worker grew at a rate slightly exceeding its long-run average during the second half of the year.

The assessment that at the beginning of the year that the economy was approaching the peak of the business cycle and the limits of its production capacity was supported by several economic developments: the rapid increase in the CPI at the beginning of the year, the return of the economy to a deficit in the goods and services account, the low rates of unemployment and the growth in hours worked per employee and in investment. Nonetheless, it appears that later on in the year the moderation in growth was in fact brought about mainly by pessimism regarding the global economy, which became an actual slowdown of global economic activity. Private consumption, in line with capital market developments, responded first, reflecting the expectations of an approaching slowdown in global demand; later, an actual moderation in global demand led to a decline in exports. Investments in the business sector, which are based on decisions made in previous periods, reacted to the change in the global environment only in the fourth quarter while public consumption, which is anchored in the biennial budget, and investment in residential construction, which is dependent on long-term processes, continued to grow rapidly. The slower rise in prices that began in the second quarter of the year and the decline in imports during the second half are consistent with the assessment that a decline from the peak of the business cycle has in fact begun.

At the beginning of the year the economy approached the peak of the business cycle and the limits of its production capacity.

**b. Price developments**

The rate of increase in prices slowed during 2011, and annual inflation, which was in the vicinity of 4 percent during the first half of the year, dropped to 2.2 percent by the end of the year, close to the center of the price stability target range (1–3 percent). The trend in the CPI after adjustment for the volatile components of energy, food, and fruit and vegetables was similar. The seasonally adjusted rates of change in the CPI slowed considerably, from about 0.5 percent per month during the second half of 2010 and the beginning of 2011 to about 0.1 percent per month on average starting from March, which indicates an inflationary environment that is below the center of the target range. This was accompanied by a moderation in inflation expectations for the coming year.

During the year, the annual rate of inflation declined from 4 percent to 2.2 percent.

The rate of inflation in 2011 was similar to that which has characterized the Israeli economy in recent years, i.e. between 2 and 4 percent, which is in the upper part, and above, of the inflation target range. During these years, the relative price of housing services has increased. Since the beginning of 2008, the housing component of the

The moderation of the rate of inflation is consistent with the weakness in demand and the drop in commodity prices.

CPI rose by a cumulative 30 percent, in contrast to an increase of only 8.6 percent in the CPI excluding housing.[5]

The moderation of the rate of inflation during the course of the year is consistent with the weakness that characterized demand and real activity, against the background of global developments and the drop in commodity prices. This is in addition to the moderating effect of the hikes in the interest rate during the first half of the year.[6]

On the supply side, the increase in the wage per hour of work at a pace faster than the pace of growth in productivity during 2010 and early 2011, which was reflected in increased unit labor cost, supported the increase in inflation during the first half of the year. The decrease in the unit labor cost during the remainder of the year weakened these forces.

Nonetheless, the development of relative prices throughout the year does not support the assessment that domestic costs were the main source of price increases, since the rate of increase in business product prices was lower than the increase in import and export prices throughout the year. Thus, despite the increase in import prices of 4.5 percent in 2011 and the increase of 2.0 percent in export prices, business output prices rose by only 1.5 percent relative to their average level in the previous year. In addition, if we measure relative prices according to the real effective exchange rate, then during 2011 there was a moderate real depreciation of about 2 percent.

The housing component of the CPI increased during 2011 by about 5.1 percent, with some deceleration at the end of the year.

The housing (services) component of the CPI increased during 2011 by about 5.1 percent, similar to its increase in each of the previous three years, although there was some slowdown in the increase in the final months of the year.[7] The annual rate of change in the CPI without housing was 1.3 percent.

The changes in the CPI during the course of the year were influenced by a number of unique factors. Thus, the price of food (excluding fruit and vegetables) fell during the summer months by 2.1 percent, which to some extent reflects the influence of the social protest that led primarily to the lowering of prices on dairy products. However, the price decreases were also the result of the much slower rate of increase this year in the prices of agricultural commodities worldwide. For the year as a whole, food prices rose by 2.3 percent, which is similar to the increase in the overall CPI and is higher than the increase in each of the preceding two years. The prices of fruits and vegetables fell sharply (by about 15 percent) from their high level in 2010, and contributed significantly to the slower rate of increase in the overall CPI, even though their weight in the index is only about 3 percent.

[5] The average rate of inflation during the period 2008–11 was 3.1 percent, while the rate of annual change in the CPI without housing was only 2.1 percent during those years.

[6] According to the estimates of the Bank of Israel Research Department, an increase in the interest rate by one percentage point is expected to lower inflation during the subsequent 12 months by about 0.5 percentage points (see Chapter 3 of this report).

[7] From the perspective of new and renewed rental contracts during the last six months of the year, there was a seasonally-adjusted decrease from 10 percent in annual terms in mid-year to only 1–2 percent at the end of the year.

The prices of energy in the CPI, which are affected by changes in global prices and the exchange rate, increased at the high rate of 9.2 percent. Electricity rates rose by about 13 percent during the year. This was primarily due to the disruptions in the supply of gas from Egypt which required a shift to significantly more expensive diesel fuel and the purchase of local natural gas through short-term contracts. The rise in the electricity rates contributed about 0.3 percent to total CPI.

The prices of energy in the CPI increased at a high rate of 9.2 percent.

The slowing of the rate of inflation occurred despite the depreciation of about 6 percent in the effective exchange rate during the summer months, following a prolonged appreciation of a similar size that began in February. The effect of the exchange rate on prices has weakened to a large extent in recent years, primarily because housing prices (rent and sale prices) are no longer denominated in dollars, though it has also been the result of the weakening of the transmission mechanism to the rest of the CPI components. As a result, short term changes in the exchange rate have only a minor effect on prices.[8]

The social protest which began in the summer of 2011 placed the issue of the cost of living on the public agenda—in particular the high prices faced by home buyers and renters, alongside the high prices of other consumer goods. A comparison of the level of consumer prices in Israel to other developed countries shows that the prices of certain groups of products (such as dairy products, soft drinks, eggs and automobiles) are relatively high in Israel, under current exchange rates and taking into account the level of GDP in Israel. The markets for these products are characterized by, among other things, import barriers, high taxes and a low level of competition (see the discussion of the social protest in Section 5 of this chapter).[9]

The social protest which began in the summer of 2011 placed the issue of the cost of living on the public agenda—in particular the high housing prices.

**c. The financial markets**

The developments in Israel's financial markets in 2011 reflected the changes that occurred in the global and local environments during the course of the year. Following two years of rapid recovery from the global crisis in 2008, the situation of the local financial system worsened in 2011, particularly during the second half. This was reflected in sharp declines in share prices, a notable decline in bond issues by the business sector, accompanied by a rise in the risk premiums of corporate bonds, and lower profitability of the banks and insurance companies.[10]

After two years of rapid recovery of the financial system from the global crisis, the situation worsened in 2011.

The Tel Aviv 100 Index fell by about 20 percent in 2011 from the record levels reached at the beginning of the year and remained at its low level in the latter part of the year. The trend in share prices in Israel was to a large extent similar to that in developing countries, in contrast to the moderate declines in the developed markets,

[8] Various studies have shown that transmission from the exchange rate to the CPI in the short term, i.e., the change in the CPI relative to a change of one percent in the exchange rate, has declined in recent years to about 0.1 percent, as compared to between 0.2 and 0.3 percent in previous years.

[9] See "Price gaps between Israel and developed countries", Recent Economic Developments 132, February 2012.

[10] For a detailed analysis of the financial markets, see Chapter 4 of this report.

where share prices had also not risen as sharply in previous years (Figure 1.2). As in the rest of the world, the fall in share prices was accompanied by increased volatility.

The change in operating environment was particularly evident in the corporate bond market.

The change in the financial system's operating environment was particularly evident in the corporate bond market. Starting from the second quarter of the year, the spreads of corporate bonds of all ratings, relative to government bonds, increased. Particularly noticeable were the increased spreads in the real estate industry and the investment and holding industries (which includes the business groups), as well as the unrated companies, against the background of a relatively large volume of debt that matures in the coming year. At the same time, spreads are significantly lower than those at the peak of the crisis at the end of 2008. In parallel, the number of companies that required a debt restructuring arrangement rose again, and the value of debt involved was double or more than that in 2010 (see Box 3 in Chapter 4). With the increase in spreads, there was also a steep decline in the volume of issues and a total halt by the end of the year.

The increase in spreads reflects the higher level of risk, which was amplified by the rapid expansion of the corporate bond market in recent years.

The significant increase in spreads reflects the higher level of risk, which is related to the global crisis, though it was amplified by the rapid expansion of the corporate bond market in recent years. Particularly noticeable is the large weight (about 23 percent) of bonds issued by the real estate industry, which is exceptional relative to markets abroad where the main source of financing for this industry is the banks. About 50 percent of these bonds are traded at yields of above 10 percent. Their weight in total corporate bonds that are traded at high yields was about one-quarter at the end of 2011, compared with 6 percent at the end of 2010. However, this is much lower than the level of 53 percent which it reached during the peak of the crisis at the end of 2008. In 2012, the value of redemptions is expected to be NIS 40 billion (including interest), out of a total stock of NIS 280 billion. Fourteen percent of the maturities (about NIS 5.5 billion) involve bonds traded at relatively high yields (greater than 12 percent), which represents a significant risk to repayment ability.

Despite the market failures that have appeared in the non-bank credit market in recent years, the existence of this market alongside the bank credit market is important. Therefore, it is essential to ensure the scope and quality of supervision in this market, particularly with respect to the activity of institutional participants and debt issuers. The recommendations of the Hodek Committee are a step in this direction, but only for new issues.

The main recommendations of the Committee on Increasing Competitiveness deal with the control or holding of a major financial institution by a major real corporation, and with corporate governance.

In view of the significant proportion of large business groups within publicly-traded companies, their control of financial and real areas of activity[11] and its impact on risks to financial stability and the level of competition and efficiency of allocation of resources in the economy, the Committee on Increasing Competitiveness in the Economy was established in October 2010. The Committee focused on the control of financial companies by real companies, the pyramidal holding structure of publicly-traded companies and the quality of corporate governance in these companies. The Committee's main recommendations (which were submitted in February 2012) are

[11] See Box 4.2 in the Bank of Israel Annual Report for 2009.

to gradually prohibit the control or holding of a major financial institution by a major real corporation and limit the pyramidal structures of companies as well as the volume of loans provided by institutional investors to large borrowers and business groups. The Committee also recommended that the powers of the Israel Antitrust Authority be increased in order to encourage competition and create a process in which considerations of competition within an industry and dissipation of control be taken into account in decisions to privatize essential infrastructures or in tenders to operate them.

Credit to the business sector increased moderately.

Total credit to the non-financial private sector—households and businesses—increased by 4.1 percent in 2011. Credit to the business sector grew by 2.4 percent,[12] the result of a moderate increase in bank credit and a more rapid increase in local non-bank credit and credit from abroad. The moderate rate of growth in credit to the business sector since the crisis in 2008 is reflected in the decline of the ratio of credit to business output, from a high level of about 140 percent in 2007 to 126 percent at the end of 2011. Against the background of the continuing growth in economic activity and the rapid expansion of investment in the economy, it can be assumed that some firms were able to finance their activity from internal sources, without turning to external sources of credit. This can also be seen in the data on the returns on capital in the business sector (Table 2.5). Nonetheless, there are also indications that some firms are finding it increasingly difficult to finance their activity through bank and non-bank credit. Thus, the increase in yields on corporate bonds, the increased gap between bank interest rates on deposits and the interest rate on credit during the year and the increase in allowance for credit losses point to the greater level of risk that banks are attributing to borrowers.

Credit to households, mostly mortgages, increased 7.4 percent. The share of variable rate mortgages declined.

Credit to households, of which about 70 percent is composed of mortgages, increased by 7.4 percent during 2011. The rate of growth in mortgages slowed somewhat this year and the proportion of variable-rate mortgages fell significantly, due to the regulatory measures adopted during this year and the previous one and the slowdown in activity in the housing market. Despite the rapid rise in the volume of mortgages in recent years, the ratio of household debt to income is low relative to other countries in the world, which contributes to the lowered risk of a crisis in this market.

Bank profits declined notably in the third quarter of 2011.

The profitability of the banks, which was relatively high during the first two quarters of 2011, fell significantly in the third quarter, which was partly due to a large increase in expenses due to credit losses, particularly on credit to the construction industry. The preparations of the banks for the adoption of new definitions of core capital in accordance with the instructions of Basel III were reflected in the slower rate of growth in credit offered by the banks, accompanied by an increase in total

[12] A new directive, from January 2011, regarding the treatment of impaired loans, reduced the debt balance beginning in January. Thus, these figures refer to rates of change compared with January 2011. See Table 4.2 as well.

cash and deposits with the Bank of Israel and a reduction in the size of their securities portfolio[13].

Nonresidents reduced their activity in the shekel market against the background of macroprudential measures and regional political developments.

Nonresidents reduced their activity in the shekel market during 2011, after their holdings of makam in 2010 increased significantly to 36 percent of the total stock. The change in the behavior pattern of nonresident investors is explained by the macroprudential measures adopted at the beginning of the year: the reporting requirement and the imposition of a liquidity requirement on foreign currency derivative transactions, and the cancelation of the tax exemption for nonresident investors on their profits from makam. Since for government bonds issued in the past and whose term to maturity has shortened the exemption remained unchanged, there was a major shift by foreigners from makam to government bonds close to maturity, while the total holdings of the two assets fell. In addition to the regulatory changes, it appears that the behavior of foreigners was also influenced by the political developments in the region.

The reduction in holdings of makam by foreigners was reflected in a decline of their (net) holdings of unindexed assets to a level of about $7.5 billion in December 2011, compared to only $3 billion at the end of 2009. In contrast, local residents and in particular institutional investors increased their demand for foreign currency, since in addition to their continuing investment abroad they stopped hedging these investments against exchange rate risk during the year. The increase in demand, together with the transition to a deficit in the current account reduced the need for the Bank of Israel to intervene in the foreign currency market in order to prevent excessive appreciation.

The public's portfolio of financial assets shrunk in nominal terms by about one percent.

The public's portfolio of financial assets shrunk in nominal terms during 2011 by about one percent, following a rapid increase during the previous two years. The reduction in the value of the portfolio resulted from the sharp decline of about 30 percent in the value of shares held by the public and an increase of about 13 percent in cash and deposits. As a result of the continued increase in the interest rate during the first half of 2011, there was a sizable shift from demand deposits to fixed term interest-bearing assets.

### d. The housing market

During the year, the rate of increase in home prices slowed considerably.

The construction industry and the housing market are central to the Israeli economy, both because of their importance in real activity and because of their influence on prices, household expenditure and credit, and on the stability of the financial system. The rapid increase in prices in recent years led to the adoption of fiscal and monetary policy measures that influenced the developments in this market in 2011.

During 2011, the rate of increase in home prices (looking over the previous 12 months) slowed considerably to about 4.5 percent, as compared to the record rate of

[13] In March 2012 the Supervisor of Banks published a draft directive for increasing banks' core capital, and assessments are that the rate of increase of credit, pursuant to the directive, will be in line with the economy's requirements.

increase of 20 percent at the beginning of 2010. From August until October, home prices even fell somewhat, for the first time[14] since the beginning of their uptrend at the end of 2007 (since then they have risen by about 60 percent). The ratio of home prices to rents also fell somewhat starting from August, though it remained high relative to the past decade. The level of prices relative to the average wage remained around the high levels that prevailed in the mid-1990s, i.e., about 11 years of wages for an average apartment.

Contributing to the change in trend of prices was acceleration in the pace of housing starts, alongside a decline in demand, which was affected by policy steps.

The background to the deceleration of the increase in home prices was the high level of prices, which reduced the number of potential house buyers. Also contributing to the change in trend of prices was the increase in supply, as a result of the acceleration in the pace of housing starts, alongside a decline in demand, which was partly the result of the increase in interest rates and the restriction placed by the Supervisor of Banks on the composition of mortgages. Among the factors that led to the drop in demand and the growth in supply are the policy measures adopted by the government at the end of 2010 and beginning of 2011. These included a discount on the land betterment tax for sellers of land available for construction and an increase in the purchase tax for buyers of apartments as an investment. Additionally, an exemption from the land betterment tax was granted for the sale of investment apartments and the exemption from VAT for purchase groups was cancelled.[15] Beyond that, it appears that the drop in demand partly reflects a short-run postponement of purchases, in the expectation of a future decline in prices.[16]

The change in the trend of prices following a long upward trend is a welcome move toward the adjustment of home prices to a sustainable level. Nonetheless, it is important that policy supports a gradual adjustment of prices. This is in order to reduce the risk to the stability of contractors who purchased land at high prices and other players active in the homes market, and thus the risk to the stability of financial institutions that have provided them with credit.

Starting from August there was a notable decline in the number and total value of new mortgages granted.

The rapid increase in housing starts continued in 2011 and they reached a level of 44 thousand housing units as compared to between 30 and 35 thousand units in previous years. During this and the previous year, land was made available by the Israel Land Administration at a more rapid pace than in the past, which was the result of the government's policy to increase the supply of land available for construction. Construction output grew by 9 percent in 2011, which was accompanied by an increase in the number of Israeli employees in the industry and an increase in production and labor productivity.

Starting from August, in addition to other signs of weakness in the homes market, there was a notable decline in the number and total value of new mortgages. The cost of new CPI-indexed or fixed rate mortgages remained relatively unchanged, in

[14] Apart from the cumulative drop in prices of 0.4 percent in October and November 2008.

[15] The government also approved a program for providing subsidies to young couples who purchase a home in the periphery, which may shift some demand away from the center of the country.

[16] For a more extensive discussion of the policy measures, see the section on construction in Chapter 2 of this report.

accordance with the trend in long term yields, while the cost of unindexed variable rate mortgages went up significantly in the first half of the year and later declined, consistent with the path of the Bank of Israel interest rate during the period. However, since the proportion of this type of mortgage in total new mortgages fell considerably, as a result of the directives issued by the Supervisor of Banks, the average interest rate on new mortgages remained essentially unchanged in the second half of the year. The slowdown in the housing market was also evident in the reduced number and total value of mortgages provided in order to purchase investment apartments.[17]

For mortgages granted in 2011 (figures beginning in April), the share of the average repayment out of a borrower's income was about 35 percent, and for half the mortgage volume granted in that time, the share was up to 30 percent. About 60 percent of mortgages taken out during the year had up to a 60 percent loan to value ratio (LTV) and only three percent of the mortgages represented an LTV of 90 percent or more. The average share of financing and the average share of repayment out of a borrower's income are lower than generally found in other Western countries. Nonetheless, the rapid increase in the portfolio of mortgages in recent years, particularly for investment apartments, involves increased risk.

## 4. ECONOMIC POLICY

Economic policy this year was affected by the deterioration of the debt crisis in Europe, the social protest movement, and the political changes in the region.

Economic policy in 2011 was influenced by three significant events, which were unexpected at the beginning of the year: the deterioration of the debt crisis in Europe in mid-year, the social protest, and the political shocks in various Middle East countries. Against the background of the worsening crisis in Europe, the direction of monetary policy was changed in mid-year, from an upward trend in interest rates during the first half of the year, in response to the relatively rapid rise in prices in a vicinity of full employment, to a downward trend later in the year, in response to the decline in inflation and the deceleration in activity. Fiscal policy was characterized by a slightly larger than planned deficit, due to revenues that were somewhat less than expected, and only a moderate decline in the debt to GDP ratio, despite the high rate of growth. The social protests led to a major change in the trajectory of fiscal policy in coming years, as a result of the adoption of recommendations of the Committee for Economic and Social Change (the Trajtenberg Committee), which the government established in response to the social protest movement. In view of the security risks, the government decided to increase defense expenditures, simultaneous with the increase in social welfare expenditure.

The path of monetary policy during the year reacted to change in the economic environment: the interest rate was increased at the beginning of the year and was reduced at the end.

### a. Monetary policy

The path of monetary policy changed over the course of 2011 in a response to change in the local and global economic environments. At the beginning of the year, monetary

[17] See Box 2.3 on "The purchase of investment apartments", in this report.

policy was focused on the inflation rate which had exceeded the target, and the rapid increase in home prices, against the background of the expansion in real economic activity. Later in the year, policy was adjusted in response to the fears of a slowdown in economic activity and the moderation of the pace of price increases, and was aimed at maintaining inflation within the target range while maintaining financial stability. The real rate of interest was very low throughout the year relative to the 15 years that preceded the crisis, similar to the interest rate in many developed countries. The extent to which policy was expansionary changed over the course of the year, in response to changes in economic conditions in Israel and world wide.

Since the full onset of the crisis in 2008, monetary policy in Israel, as in other countries, has utilized a combination of tools to deal with the effects of the crisis. In addition to the use of the interest rate, which is a central bank's main monetary instrument, the Bank of Israel has also purchased foreign currency in order to moderate the appreciation of the shekel beyond the level consistent with the economy's fundamental conditions, and thus facilitate the activity of the tradable goods sector.[18] Apart from these tools, the Bank has utilized macroprudential tools in the foreign currency market, in order to maintain financial stability, and in its capacity as supervisor of banks it acted in the mortgage market, with the goal of directly influencing these markets and reducing the risks in them.

The Bank of Israel raised the interest rate until April, to 3 percent.

In the first half of the year, the Bank of Israel acted to restrain the rise in prices by continuing to raise the rate of interest and thus return it to a range that is consistent with long-term growth and inflation rates. This process, which began in September 2009 when the interest rate was raised from its record low level of 0.5 percent, continued during the first quarter of 2011 at a relatively fast pace. Thus, the interest rate was raised from 2 percent in January to 3 percent in April (Figure 1.4). One of the main justifications for the interest rate hikes was the increase of inflation to above the upper bound of the target range, together with an increase in inflation expectations, according to the various indicators, to more than 3 percent. It is possible that this level of expectations reflected, among other things, the belief that in view of the intensity of the global crisis the weight attributed by the Bank of Israel to a deviation of inflation from the target range is less than it has been in the past.[19] The interest rate increases, which were meant to return inflation to within the target range, were therefore also intended to strengthen confidence in the inflation target regime. The expansion of economic activity, which was led by domestic demand, in an environment that is not far from full employment also provided support for the decision to raise the interest rate. An additional and important motive was the continuing rise in home prices.

From the second quarter, inflation expectations moderated and the pace of increase of the interest rate was slowed.

Starting in the second quarter and in response to the interest rate hike in April, inflationary expectations moderated, even though actual inflation (over the preceding 12 months) still remained above the target range. The exchange rate reflected shekel

[18] For several months at the time of the crisis in 2009, the Bank of Israel also intervened in the government bond market in order to reduce longer-term interest rates as well.

[19] From the beginning of 2008 until March 2011, the CPI increased by an average annual rate of 3.4 percent.

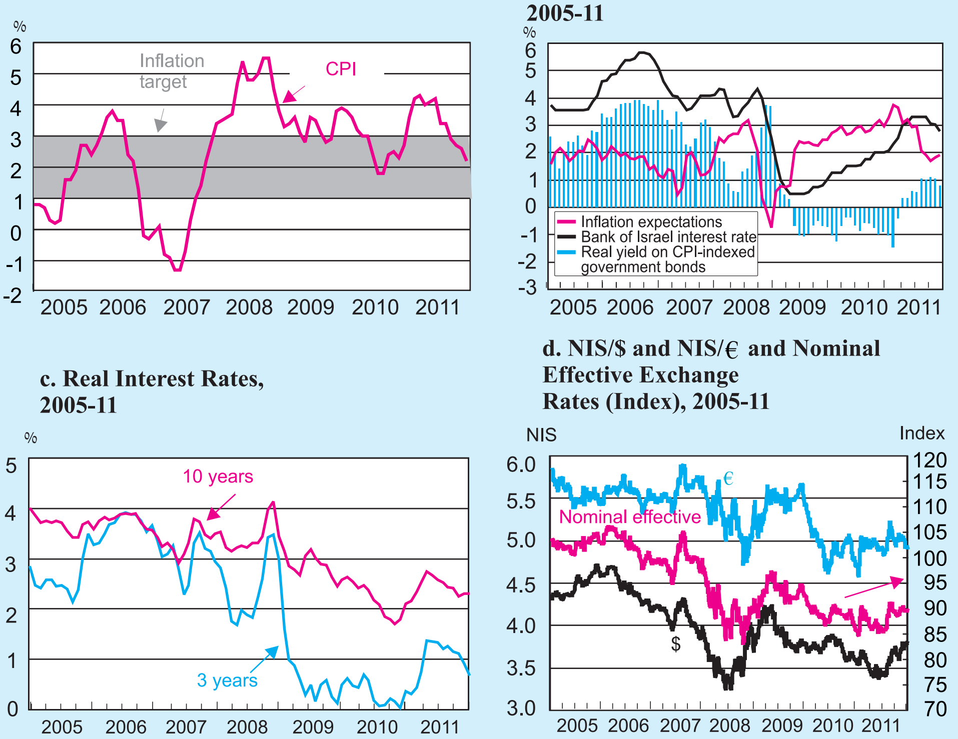
**Figure 1.4**

**a. Rates of Change of Selected Price Indices in the Preceding 12 Months, 2005-11**

**b. Bank of Israel Interest Rate, 1-Year Inflation Expectations, and Real 1-Year Yield on CPI-Indexed Government Bonds, 2005-11**

**c. Real Interest Rates, 2005-11**

**d. NIS/$ and NIS/€ and Nominal Effective Exchange Rates (Index), 2005-11**




SOURCE: Based on Central Bureau of Statistics data.

appreciation during this period, as an interest rate gap developed relative to other countries. Accordingly, the increase of the interest rate was slowed and it reached a level of 3.25 percent in June. However, the path of the interest rate expected over the next 12 months was still upwardly sloping, according to the assessment of market participants and according to the forecast of the Research Department at the Bank of Israel. This was based on the view that the interest rate was expected to return to a level that is consistent with the economy's long-term level of activity.

In light of the deteriorating situation in Europe and moderation of inflation expectations and domestic activity, the interest rate was reduced, reaching 2.5 percent in February 2012.

The worsening of the economic situation in Europe and the fear of a significant financial crisis there increased uncertainty with respect to the expected developments in local economic activity, and according to various indicators the increase in uncertainty did indeed slow. These factors, together with lower inflation and a further decline in inflation expectations led the Bank of Israel to change the direction of its interest rate adjustments. Thus, the rate of interest was lowered to a level of 2.5 percent by February 2012. Along with the change in the trend in the interest rate towards the end of the year, there was also a change in the expected path of the interest rate, which indicated an expected continuation of moderate interest rate cuts in 2012 as well.

The short term real interest rate (on one year CPI-indexed bonds), which has been negative since mid-2009, returned to being positive in the second quarter of the year, primarily as a result of the increase in the monetary interest rate. In spite of the reduction in the interest rate during the second half of the year, the even larger reduction in inflation expectations was reflected in the continuing rise in the short-term real interest rate to about one percent. This is still lower than the level that is considered "normal", i.e., consistent with a situation of growth in line with the economy's potential and where the inflation rate is at the center of the target range,[20]. It also at its lowest level since the beginning of the 1990s, similar to the situation in other advanced economies.

The path of the interest rate in Israel during 2011 was similar to that observed in other developed countries, although the interest rate was raised to a greater extent in Israel. Central banks in many countries, including the ECB, raised their interest rates during the first half of the year and left them unchanged during the second half or lowered them moderately. The interest rate in Israel was higher than those in some of the OECD countries, particularly the larger ones, while the levels in other countries were similar to Israel (Korea, Norway and New Zealand) or higher (Australia, Chile, Poland and Mexico). The average interest rate in developing countries was much higher during the course of the year, although in those countries as well interest rates were lowered during the second half of the year (Figure 1.2).

The Bank of Israel's monetary policy also takes into account financial stability, and thus it acted in the foreign exchange and mortgage markets.

As a result of the crisis which began in 2008, the Bank of Israel's monetary policy—like that of other central banks worldwide—also took into account considerations of financial stability and was active in the foreign currency market and the mortgage market by means of macroprudential measures. In the foreign currency market, the Bank acted to moderate the flows of short-term capital which created pressure for appreciation beyond that justified by the fundamentals of the economy and threatened the activity of the tradable goods sector. Thus, the Bank also helped reduce the risk of instability arising from large short-term capital flows. At the beginning of the year, a number of measures were adopted in order to reduce the effective yield for foreign investors. Thus, a reporting requirement was introduced for shekel-foreign currency swap transactions and on transactions by foreigners in makam and short-term government bonds, and from the beginning of February a liquidity requirement of 10 percent was imposed on the transactions of foreign residents in foreign exchange derivatives (swap transactions and futures transactions). These steps, which were accompanied by a change in foreigners' risk assessment of investment in the Israeli economy as a result of regional developments, led to a sizable reduction in the import of foreign capital for investment in financial assets during the second quarter of the year. This occurred in spite of the widening of the interest rate gap between Israel and abroad. Later in the year, the government cancelled the tax exemption for nonresident investors on the profits from investment in makam and short-term government bonds

[20] A more extensive discussion of the "normal rate of interest" can be found in Section 1(b) of Chapter 3 of the Bank of Israel Annual Report for 2010.

which had been among the main assets in their securities portfolios. During the third quarter, the capital inflow from foreign residents became a capital outflow.

The Bank of Israel's foreign exchange purchases were reduced, among other reasons due to a decrease in capital inflows of nonresidents.

The change in the capital flows of foreign residents was accompanied by a large drop in the volume of foreign exchange purchases by the Bank of Israel in 2011, from about $12 billion in 2010 to $4.6 billion in 2011. The intervention took place mainly in January (about $2 billion) and in April ($1.5 billion), following a continuous appreciation of the shekel during the previous two months and a hike in the interest rate of 0.5 percent at the beginning of April. The Bank of Israeli did not intervene in the foreign currency market from August until the end of the year, in view of the depreciation in the effective exchange rate. The deficit, following several years of surplus, in the current account of the balance of payments, against the background of price increases for imported commodities, also contributed to the depreciation.

The Supervisor of Banks limited the floating rate component of a mortgage to one third of the housing loan.

The Bank of Israel also made use of macroprudential tools in the housing market. The rapid rise in home prices during the last three years, against the background of the low interest rate, led to historically high ratios of home prices to average wages and of home prices to rent. This rise and the rapid increase in the volume of mortgages focused the attention of the Bank of Israel, and in particular the Banking Supervision Department, on the problems that are liable to develop in this market and which may affect the stability of the banking system and the financial system in general. The increases in the interest rate during the first half of the year therefore also reflected concern regarding the continuing rapid rise in home prices, apart from the considerations related to inflation and real activity taken into account by the Bank. One of the main steps taken by the Supervisor of Banks, in May 2011, was to publish directives limiting the variable-rate component of a mortgage to one-third of the total housing loan.[21]

Use of macroprudential tools allows the Bank to influence certain markets in specific ways.

The use of a number of tools to implement monetary policy, and in particular the use of macroprudential tools in addition to the interest rate, allows the Bank of Israel to act via the interest rate in response to domestic macro conditions and to also influence certain specific markets. Thus, the limitations on foreigners' short-term capital flows reduce the import of capital that is the result of a hike in the interest rate and which can lead to excess appreciation of the exchange rate and thus threaten the tradable goods sector. The limitations reduce the influence of raising the interest rate on the activity of the tradable goods sector and the need for the Bank of Israel to purchase foreign currency in order to prevent a major deviation of the exchange rate from the level consistent with real activity. The restrictions also reduce the risk of an accumulation of short-term foreign capital which may flow out of the economy rapidly during a period characterized by reductions in the interest rate or other shocks, and lead to a rapid depreciation. With that, the more limited effect of interest rate changes on the exchange rate and on the activity of the traded goods sector weakens

[21] The directives apply to CPI-indexed and unindexed mortgages, whose interest rates change within five years or less. In addition, the Supervisor of Banks published instructions regarding disclosure to customers who have taken out housing loans in the past.

one of the transmission mechanisms of monetary policy, and as such may mean that larger changes in the interest rate will be needed to affect demand in the economy and the rate of inflation.

A low interest rate maintained over time increases the incentive to invest in higher-yield assets, which are also riskier, and this is likely to result in greater instability in these markets when changes occur in the economic environment. The use of restrictions in the mortgage market made it possible to effectively increase the interest rate on mortgages in order to reduce the demand for housing without changing the interest rate faced by other sectors of the economy. With that, when the interest rate is increased, the restriction imposed on the variable-rate component of a mortgage reduces the effect of such an increase on the cost of new mortgages and on the demand for homes.

The interest rate decision for November, which was made at the end of October, was the first one made by the Monetary Committee, which was appointed in accordance with the new Bank of Israel Law approved in March 2010. There are six members of the Committee: three from the Bank of Israel (the Governor, the Deputy Governor, and an additional Bank employee) and three members from among the public. The decision of the Committee requires a majority of votes and in the case of a tie, the Governor has an additional, deciding, vote.

The interest rate decision for November was the first one made by the Monetary Committee, in accordance with the new Bank of Israel Law.

### b. Fiscal policy

The government deficit this year was somewhat higher than the original target, i.e., 3.3 percent, compared to the target of 3.0 percent. The deviation can be explained by cyclical developments in the real and financial sectors—the fall in prices in the capital market and the slowdown in new home sales—which reduced tax revenues relative to the original forecast. This is in addition to the cancelation of the increase in the excise tax on gasoline and coal, which reduced tax revenues by about NIS 1 billion. Non-tax revenues (dividends and royalties) were also lower than the original forecast (by about NIS 2 billion), but government expenditures being lower than the original budget by about one percent (about NIS 3 billion) has offset some of the shortfall in revenue. Overall, the budget aggregates were similar to the original forecast. The debt to GDP ratio continued to decline this year and reached about 74 percent, although this was the result of financing the deficit through the redemption of government credit provided to the public in the past, revenues from privatization and the sale of land and reduction of government balances held with the Bank of Israel (see Table 6.9). In a year in which growth was high and the rate of unemployment was at a historic low, the result shows that a significant reduction of the debt to GDP ratio in the coming years will require significantly sized policy measures.

The budget deficit this year was slightly above the original target. This deviation can be explained by the fall in prices in the capital market and the slowdown in new home sales.

From a longer-term perspective, it appears that due to the reduction in tax rates, the general government deficit has moved to a higher level since 2008, after being

Due to tax reductions, the cyclically-adjusted deficit rose from about 1 percent of GDP in 2005–07 to around 3 percent in 2008–11.

balanced in 2007. The cyclically-adjusted deficit[22] rose to a level of about 3 percent of GDP,[23] after reaching a level of slightly more than one percent of GDP during the years 2005–07 (see Table 6.3). If growth rates are not particularly high in coming years and if expenditure grows according to the existing expenditure ceiling and the tax rates specified by law are maintained, then the deficit is not expected to shrink significantly and the debt to GDP ratio essentially will not be reduced. The magnitude of the gaps between the expected deficit and the deficit target set by law will require the government to carry out significant policy adjustments in order to reduce them. Moreover, the cost of multi-year programs which the government has adopted is considerably higher than the expenditure ceiling for coming years. This will require the government to make significant decisions with respect to its order of priorities in order not to exceed the ceiling. The determination of the order of priorities will also require more rationalized management of the defense budget, which in recent years has been budgeted repeatedly at levels below what is eventually approved, a situation that leads to the distorted presentation of priorities. This is in spite of the fact that the government has adopted a long-term framework for the defense budget starting from 2008, on the basis of the Brodet Committee's report, and actual defense expenditure, including additions to the budget, has not significantly deviated from it.

The gaps between the expected deficit and the deficit targets set by law for the coming years will require the government to carry out significant policy adjustments in order to reduce them.

Following the recommendations of the Committee for Economic and Social Change, the government and the Knesset decided at the end of 2011 to cancel the plan for reducing tax rates in 2012–16, which was expected to increase the deficit even further in coming years. The cancelation of the plan was a significant decision, which will help achieve the government's objective to gradually reduce the public debt to GDP ratio. Nonetheless, the move negatively affects those individuals and companies who based their plans on the tax reductions that were specified in the abolished law.

The cancelation of the tax reduction plan was an important decision, which will help achieve the government's objective to gradually reduce the public debt to GDP ratio.

## 5. THE SOCIAL PROTEST: BACKGROUND AND POLICY RESPONSE

The claims of the protestors emphasized that the distribution of income in the economy is important and not only economic growth.

One of the main developments this year was the social protest, which began in the spring and included a consumer boycott of a number of products, the establishment of protest tents throughout the country and mass demonstrations, which continued until the end of the autumn. The protesters voiced claims that touched on numerous aspects of Israel's economy and society. One of the points emphasized in the protest was that the distribution of income in the economy is also important, and not only economic growth. Although the claims were summarized in the call for "social justice", the interpretation of this slogan and the identification of the "lack of social

[22] The cyclically-adjusted deficit is an estimate of the deficit that would be achieved in a particular year if GDP was at a level which reflects the exploitation of productive capacity in accordance with its long-run average.

[23] The increase in the cyclically-adjusted deficit in 2009 to a higher level was the result of the excessive elasticity of tax revenues with respect to the global economic crisis—which was similar to what was observed in other developed countries—rather than government policy measures and similarly with regard to the return of the deficit to a level of 3 percent in 2010.

justice" that led to the protest, and offering a solution to it, represented a non-trivial challenge to the government, particularly in light of the constraints on fiscal policy described above. To meet this challenge, the government established the Committee for Economic and Social Change (the Trajtenberg Committee) and later on adopted a significant proportion of its recommendations. In contrast to other countries in our region and in Europe, the protest in Israel did not involve violence or the disruption of social order or economic activity.

Although it is premature to provide a full explanation of the forces that led to the protest, there appear to be a number of developments in recent years—in government policy and in the management of a number of economic entities in the Israeli and in the global economy—that can explain why broad segments of the Israeli public felt dissatisfied with the economic and social situation. It is possible that each of these developments separately would not have led to such a large scale protest movement but their combined effect was sufficient to do so, and also led to the expansion of the protest to additional issues that are relevant to large segments of the population.

One of the main issues raised by the social protest was the marked increase in rents and home prices.

One of the main issues raised by the social protest was the high level of rents and home prices. The increase in rent in recent years has created a heavy burden on renters, who constitute about 30 percent of households—mostly the weaker households. For an average renter, the increase in rents during 2008–11 was equivalent to about 4 percent of the household's expenditure, which is well beyond the growth in private expenditures on health and education during the last decade. For potential buyers of a first home, who number 25,000–30,000 young couples per year, the increase in home prices led to a dramatic increase of more than 10 percent of the family expenditure on monthly mortgage payments for a typical home buyer, even taking into account the decline in the interest rate. The increase in home prices was affected by, among other things, the low interest rates in the economy, which were lowered sharply to deal with the effects of the global crisis. These factors encouraged the purchase of homes for investment purposes and the moving forward of purchases, which increased demand and accelerated the rise in prices. The effect of higher rents and home prices was amplified by the lack of affordable housing solutions in Israel and the weakness of the public transportation system that connects the peripheries of the metropolitan areas to the city centers (see section 2.3 on transportation in Chapter 2). The protest was directed toward the government in view of its pivotal role in the housing market, both as owner of much of the land in areas of high housing demand and due to its control of the planning processes. Furthermore, the main factor in the rise in prices in areas of high demand was the government policy of reducing the scope of building in the center of the country in order to encourage a shift of population to peripheral areas. Although the government had decided, even before the protest began, to respond to the rise in prices by increasing the supply of land, accelerating the planning process, and other steps (as described in the section on construction in Chapter 2), it takes time until they lead to the provision of actual housing solutions.

The global economy contributed to the development of the protest movement through the worldwide increase in commodity prices.

The global economy contributed to the development of the protest movement through the worldwide increase in the price of commodities. This increase was a major component in the rise of consumption prices in Israel in recent years, both directly and through the higher cost of imported raw materials used in the production of local goods. Prominent among the issues raised by the protest movement was the increase in the price of gasoline, which was mainly the result of the increase in the global price of oil. An increase in the tax on fuel and coal (used to produce electricity), which was meant to finance the reduction in the income tax and the corporate tax, occurred simultaneously with a substantial increase in the world price of oil and disruptions in the supply of natural gas from Egypt. Since the prices of gasoline and electricity are set by the government,[24] the public attributed the rise in prices to government policy, although it was responsible for only a small portion of the increase.[25] In addition, the increase in the price of grains contributed to the higher price of local and imported food products. Nonetheless, at least part of the price increase and the high level of prices in Israel relative to the developed countries can be attributed to the overpricing of goods and services in non-competitive markets in Israel.

The fiscal consolidation which began in 2003 contributed much to the creation of conditions that supported the exit of the economy from the crises of the last decade. With that, some of the steps taken as part of that policy contributed to widening inequality in the economy.

Israel's economy and society have also been influenced by the process of fiscal consolidation in the last decade. This process, which began in 2003, was consistent with the situation of the economy at that time, when the government deficit, the debt to GDP ratio, and the level of government expenditure were much higher than in the developed countries (Figure 6.1). The fiscal consolidation involved a significant reduction in government expenditure, the deficit and the debt to GDP ratio and contributed significantly to the creation of conditions that supported the exit of the economy from the crisis and put it on a path of rapid growth and low unemployment. The results of this process also made it easier to successfully cope with the global crisis at the end of the decade. Nonetheless, some of the steps taken as part of this policy also contributed to increased inequality in the economy, such as the reduction in National Insurance social welfare payments that primarily benefit weak sectors of the population, a significant slowing of growth in expenditure on public services and the reduction in the direct tax burden, which mainly benefited the top two deciles of the income distribution.[26] One of the most important components in the reduction of government social welfare payments was the cut in child allowances paid by the National Insurance Institute. This step significantly reduced government support for working age families that do not include workers, which was consistent with the

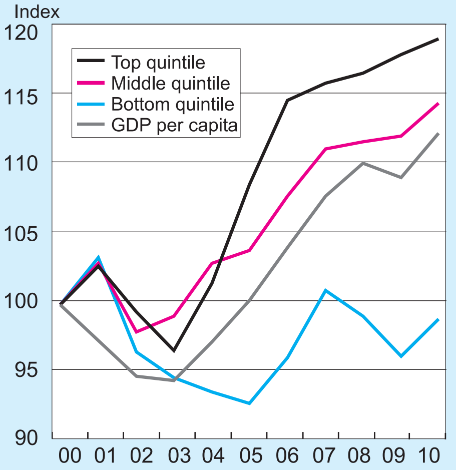
[24] Through the use of fixed formulas that convert world prices into the local price, apart from special circumstances or changes in tax rates.

[25] Between January 2009 and May 2011, the price to the consumer (for self-service) of 95 octane gasoline increased from NIS 4.77 to NIS 7.62. The increase in world oil prices contributed NIS 1.92 to the increase (adjusted for the exchange rate), the gasoline excise contributed NIS 0.50 and the increase in VAT another NIS 0.41 (of which NIS 0.08 is the extra VAT on the increase in the excise tax and the rest is due to the increase in the world price of oil).

[26] For a description of the declining effect of the government in reducing inequality during the decade, see Figure 8.4 in Chapter 8. For a survey of the slowdown in the growth in government expenditure on public services, see Table 6.9 and Section 6 in Chapter 6.

policy goal of encouraging employment, but it also reduced the incomes of working parents. This is because only towards the end of the decade did the government begin implementing (and only on a limited basis) the earned income tax credit program (the "negative income tax") that assists low-earning working parents. The program was restricted to a small geographic area and the credit was small in size compared with other countries; in addition, the payments were puzzlingly cut by two-thirds in 2011.[27] The very moderate growth in the net wage during the decade, particularly in the lower portion of the wage distribution, and the loss of income from child allowances led to a drop in income among a large number of low-earning households and a very moderate rise in the income of many others who were not able to benefit from the tax reductions (Figure 1.5).

**Figure 1.5**
**Standardized Net Income for Households in Which Earned Income Was Over NIS 1,500 Monthly, 2000-10**
(constant prices, index, 2000 = 100)




SOURCE: Based on Central Bureau of Statistics data.

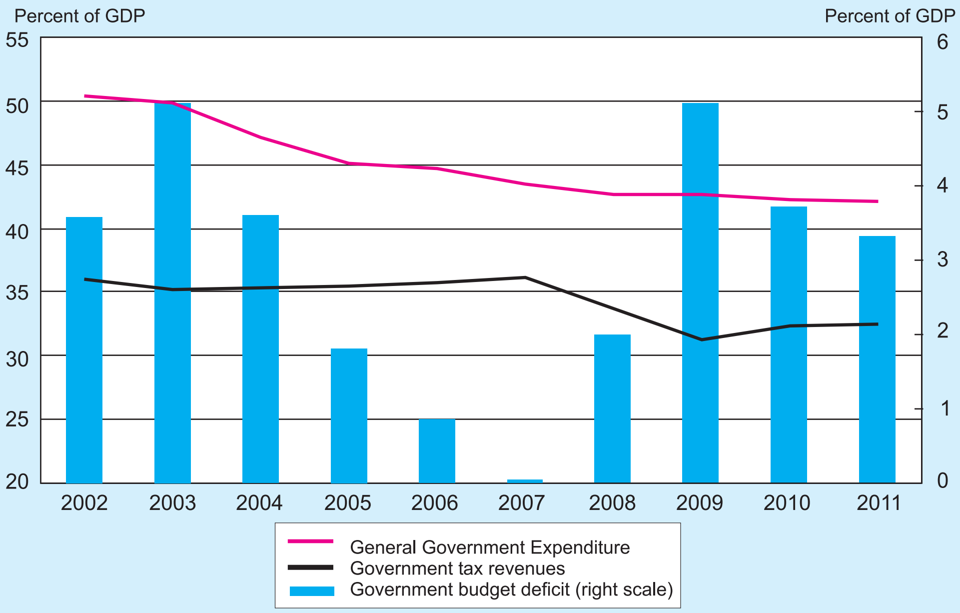
As the consolidation program progressed, public expenditure in Israel began to converge to levels similar to those in the developed countries and even below their average. In addition, the tax burden dropped to below the average of those countries, and the public sector deficit gradually declined and finally disappeared in 2007. This meant that dealing with the excess burden of defense expenditures and interest payments in Israel fell entirely on the primary expenditure side of the budget. As a result, primary civilian expenditure—the sources available to the government to provide civilian services and transfer payments—relative to GDP reached a level lower than in almost all other OECD countries.[28] This made it difficult for the government, among other things, to increase the amount of resources allocated to education, investment in infrastructure, and other expenses whose contribution to future growth of the economy and to welfare is important. Nonetheless, the government continued to restrain spending while aggressively reducing taxes, which led to a sizable increase

The excess burden of defense expenditures and interest payments in Israel fell entirely on the primary expenditure side of the budget.

[27] The earned income tax credit in 2011 (for income earned in 2010) was paid according to the law in areas where the Mehalev program operated. When the Mehalev program was discontinued at the end of April, it was decided that the earned income tax credit would not be paid, even though there is no direct connection between the programs and in spite of the adverse effect on those eligible for the credit and perhaps their confidence in the program as well.

[28] In 25 out of the 26 OECD countries for which it is possible to calculate this figure, the civilian expenditure excluding interest in 2010 was higher than in Israel. These countries include Australia, the US, Canada, Japan, and New Zealand, countries which are considered to have a small public sector.

**Figure 1.6**
**General Government Expenditure, Tax Burden, and Government Budget Deficit 2002-11**

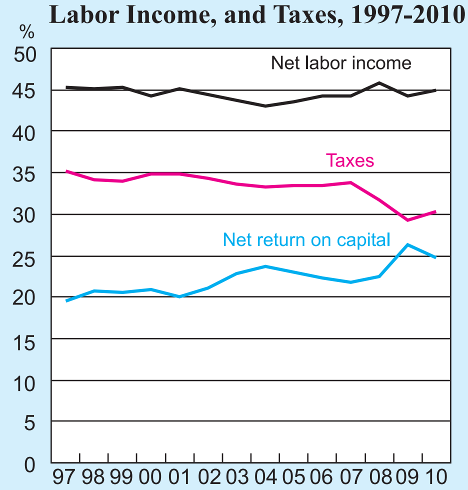



General government revenues, besides taxes, include receipts from assets (dividends, royalties, and interest), unilateral transfers from foreign governments and the public, accounting entries for undisbursed public pensions, and depreciation.
SOURCE: Based on Central Bureau of Statistics data.

Due to the tax cuts, the reduction in public expenditure during the decade led to a lower tax burden rather than to a structural reduction in the deficit.

in the deficit. Thus, the cut in public expenditure led at the end of the process to a smaller tax burden rather than a structural reduction in the deficit (Figure 1.6 and Table 6.3). Furthermore, legislation which the government initiated and which was in force during that time had specified a path for additional and significant reductions in the tax rates until 2016, which if it had been adhered to while staying within the legal deficit ceiling would have required a drastic cut in expenditure in coming years.

**Figure 1.7**
**GDP Breakdown into Capital, Labor Income, and Taxes, 1997-2010**




SOURCE: Bank of Israel.

Due to the high rates of unemployment in the middle of the last decade, the reduction in taxes was primarily manifested in an increased return on capital, rather than in the net return on labor.

The effect of government policy on the distribution of income is not just the result of the design of government measures themselves but also their interaction with the economic conditions and environment in which they are implemented. Thus, for example, due to the high rates of unemployment during the early years of the program's implementation the reduction in taxes was primarily manifested in a higher return on capital, rather than in the net return on labor (Figure 1.7) and therefore did not compensate large segments of the public for the reduction in social welfare payments and public services that were financed through those taxes. This is in spite of the fact that a large majority of the tax cuts were in fact on wages. [29]

The Committee for Economic and Social Change was created by the government to propose policy changes in response to the social protest. The Committee's letter of appointment stated that the "recommendations of the Committee will reflect the need to maintain fiscal responsibility with regard to the State Budget." The interpretation of "fiscal responsibility" was left to the Committee and it formally accepted the existing fiscal rules. By doing so, it significantly restricted the range of solutions that it could propose, though it supported the credibility of the government's fiscal framework. This meant that decisions to increase expenditure had to be matched by cuts of equal size in other expenditures and similarly with respect to tax reductions. Additionally, the Committee was confronted with a large gap between the expected deficit in coming years and the deficit ceiling set in law and therefore recommended that the tax reduction plan be cancelled after 2012. The tax-related recommendations of the Committee beyond the cancellation of the plan after 2012 were indeed balanced from a budgetary point of view but recommendations in the area of public expenditure were balanced only for 2012. The source of financing for additional increases in expenditure after 2012 was the "budget increase" according to the expenditure rule, even though previous decisions made by the government had already designated this increase to other objectives.[30]

The Committee for Economic and Social Change formally adopted the existing fiscal rules.

In actuality, the Committee's recommendations in the area of public expenditure were only balanced for 2012.

Considering the large number of issues raised during the social protest, the Trajtenberg Committee clearly could not offer a solution to all the demands made by the various groups, and the Committee emphasized that its recommendations should be viewed as only the first stage in dealing with the issues raised. In order to offer effective solutions to at least some of the problems, the Committee chose to focus on the expenditure side, and in the area of housing, on programs to assist working parents with young children. With respect to housing, it recommended expanding and accelerating government measures to increase the supply of available housing, while giving preference to this group. On the expenditure side, about 75 percent of the addition proposed by the Committee, and later approved by the government, was designated to the expansion of the education system for young age groups: free compulsory education for 3–4 year olds, afternoon care for children up to the age of 9 and increasing the supply of daycare centers. Although the extension of free compulsory education to 3–4 year olds is not restricted to the children of working

The Committee chose to focus on programs that will assist working parents with young children.

[29] However, it is possible that without the increase in the return on capital that was made possible by the reduction in taxes, the situation of workers would have worsened, as a result of slower economic activity and higher unemployment. Even after the increase in the return on capital, its share of GDP in Israel is low compared to most of the developed countries.

[30] See Bank of Israel, "Expected implementation of the State Budget in 2012 and in the medium term relative to the budget targets", December 7, 2011.

parents, in actuality significant portions of the non-working population already benefit from free education for their children of those ages and therefore the extension will predominantly benefit working families. The focus on working parents with young children is meant to assist them during a stage in life when their income is low and their expenses are high, with the understanding that the taxes they will pay in the future will help cover the costs of young parents in coming years (see Box 6.1).

The focus of the recommendations on working parents was based on the view of the Committee that an important source of the protest was the feeling of large segments of the public that government policy allows sizable groups in the population to violate the "social contract" of a welfare state, according to which each individual tries to provide for his own needs and when he is unsuccessful in doing so he receives assistance from the public purse.[31] Given the mechanisms for providing universal government assistance, which are financed through taxes paid by the public, the choice of certain segments of society not to work or to partially work places part of the burden on financing their subsistence on the rest of the public. One of the ways of dealing with this outcome is to condition government benefits on current or past employment, such that only someone who bears the burden of making a livelihood and supporting his family will be eligible for assistance from the public purse. This is in spite of the fact that such a policy, like any selective social welfare policy, can also create various types of distortions.

In the area of taxation, the Committee recommended, as mentioned, the cancelation of the tax reduction framework, which threatened the ability of the government to increase expenditure according to the new rule adopted in 2010.[32] In addition, it was recommended that the rate of direct taxation for the highest income bracket, the rate of corporate tax and the tax on interest, dividends and capital gains, be raised in order to increase the progressivity of the tax system. These additions will finance the cancelation of the increase in the fuel tax, the granting of tax credits to fathers of children up to the age of 3, and the reduction in excises and purchase taxes, with the goal of lowering the cost of living and encouraging competition in the economy.[33]

The social protest brought to the public agenda issues relating to the structure of activity in various markets and sectors of the Israeli economy.

The social protest raised some central issues relating to the structure of activity in various markets and sectors of the Israeli economy, a structure that affects the degree of competition within them and therefore the welfare of consumers. In industries where there is an advantage to having a small number of firms, the government can

[31] See the report of the Committee for Economic and Social Change, p. 27.

[32] Since the expenditure rule states that when the deficit is expected to exceed its ceiling expenditures are to increase at a lower rate than allowed by the ceiling or taxes are to be raised, the tax reduction plan limited the ability to increase expenditures according to the ceiling established by the rule.

[33] The implementation of the recommendations to reduce excises and cancel barriers to imports met tough resistance, as predicted by the Committee. This is because in some of the cases, the remaining protection in the Israeli economy mainly applies to vulnerable factories, whose exposure to competition will adversely affect either the employment or wages of low-earning workers, some of whom will find it difficult to find alternative employment. Therefore, the protection is being reviewed case by case, in order on the one hand to minimize the effect on the weakest groups of workers and on the other hand to cancel protection that is difficult to justify.

establish, by means of laws that it initiates and regulations that it sets, mechanisms that will prevent those firms from abusing their market power and thus reducing the welfare of consumers. Barriers to competition that are not economically justified, such as some of the barriers on imports or on the entry of additional firms into an industry, also harm the welfare of consumers and the efficiency of the allocation of resources in the economy. Therefore, the Committee for Economic and Social Change also recommended changes in regulation and the upgrading of enforcement mechanisms in order to increase competition in the economy.[34] Another important recommendation of the Committee is that the government attribute significant weight to competition in all of its activities, particularly in privatization and government tenders.

The recommendations of the Committee have been adopted in principle by the government; however, in the process of their approval a number of major changes were introduced. These changes affect the future course of the budget and therefore the probability of the recommendations indeed being implemented. This is particularly true given the large gaps between the cost of previous government decisions and the fiscal targets listed above (see also section 1 of Chapter 6). The tax recommendations proposed by the Committee have for the most part been approved by the Knesset; however this was accompanied by changes in legislation that reduced tax revenues by more than one billion shekels annually on a permanent basis. On the expenditure side, the government approved the expansion of public services that were recommended by the Committee, though it did not approve cuts of a similar magnitude.[35] This implies a significant increase in the budget and the need, already in 2012, to deal with large gaps between government expenditures that have been approved and the budget ceiling set by law. This problem will appear on a larger scale, in the discussion of the 2013 budget, in which the gaps between the cost of programs approved by the government and the expenditure ceiling will be even larger. There is no doubt that the government is facing difficult choices with regard to both the level of public expenditure and its composition, and the result of those choices will indicate to what extent the social protest was effective in influencing the structure of government spending and public services.

In the process of approving the Committee's recommendations a number of major changes were introduced, which affect the development of the budget and therefore the probability of the recommendations being implemented.

The government approved the expansion of public services that were recommended by the Committee, but it did not approve cuts of a similar magnitude.

## 6. STRUCTURAL ISSUES

The demands voiced by the public during the social protest to improve the level of public services and their scope and to expand the government's involvement in social issues and in the distribution of income—needs which were later given expression in the government's long-term spending plans—constitute a major challenge for the

[34] In June 2011, the government set up a committee to examine competitiveness in the food industry, and in August a committee to examine the automobile market. The Committee on Increasing Competitiveness in the Economy (the "Concentration Committee"), was created already in 2010 (See section 3C above).

[35] Bank of Israel, Recent Economic Developments 132, February 2012.

government: how these demands can be met while maintaining fiscal discipline and avoiding the shift of the burden to future generations due to an increase in public debt. This challenge becomes more serious when considering the possible effects of geopolitical developments in the region on defense and interest expenditures. One of the key ways to meet a multiplicity of needs is economic growth, which will increase both the government's sources of income and the income of the public and which will erode the existing public debt relative to GDP. In order to achieve high rates of growth, it is of course important that there exist appropriate geopolitical conditions and a positive global economic environment, though it is also dependent to a large extent on dealing correctly with structural issues, some of the most important of which are discussed below.

**a. The labor market and demographic developments**

During the past decade, the main working age population increased by an annual rate of about 2.3 percent. In the coming decade, it is expected to grow by only 1.2 percent per year.

One of the main components of long-run economic growth is the increase in the labor force. During the past decade, the main working age population (aged 25–64) increased by an annual rate of about 2.3 percent or about 0.4 percent above the growth rate of the population as a whole and GDP increased by an annual rate of 3.5 percent. The derived rate of growth of GDP per individual of working age is 1.2 percent per year, which is similar to its average rate since 1973; this rate has been fairly stable during recent decades. However, during the coming decade, it is expected that the rate of growth in the working age population (according to updated demographic forecasts published by the CBS) will drop to only 1.2 percent per year,[36] as compared to 1.6 percent per year for the population as a whole. This implies that the annual growth in potential employees in the economy is expected to slow by about one percentage point and the proportion of the population that is of working age is expected to shrink by two percentage points.

The non-ultra-Orthodox Jewish main working age population, which has the highest employment rates, is expected to grow during the coming decade by only 0.4 percent per year, compared to 1.8 percent during the previous decade.

In addition to the change in the age structure of the population, a major change is also expected in the composition of the working age population during the coming decade, which will primarily involve a rapid increase in the proportion of the ultra-Orthodox and Arab segments within the population. If each of these sectors maintains its current labor force participation rates, the change in their proportions within the population is expected to reduce the participation rate by one percentage point during the coming decade. Apart from this, the non-ultra-Orthodox Jewish population, which has the highest employment rates[37] and the highest number of working hours per employee, is expected to grow during this decade by only 0.4 percent, as compared to an annual increase of 1.8 percent during the previous decade.

[36] A. Paltiel, M. Spulker, A. Kornilenko and M. Maldorno (2011), "Long-run population forecasts for Israel: 2009–59", Central Bureau of Statistics. This involves an existing population, rather than an estimate that rests on forecasted birth rates. The estimate assumes stability in the level of immigration.

[37] The employment rate of non-ultra-Orthodox Jews aged 25–64 (both men and women) is 78 percent, as compared to 53 percent for the ultra-Orthodox and 49 percent for Arabs.

In view of these demographic processes, maintaining the growth rates of GDP and of per capita GDP that have characterized the Israeli economy during the last decade (and certainly if they are to be increased) will require an acceleration of the growth rate of labor productivity, as well as a major change in behavior that will increase the participation and employment rates to at more rapid paces than during the past decade,[38] especially among groups with low participation rates. To this end, the government has established ambitious employment targets for the coming decade (Table 5.5); however, even if they are attained, the increase in the rate of employment will only be similar to that during the previous decade and therefore it will not compensate for the slower growth in the working age population. These findings emphasize first and foremost the critical importance of implementing a detailed plan for achieving the employment targets, based on the proposals of the Eckstein Committee. In view of the central role that education plays in increasing employment rates, it is of critical importance to continue to increase the level of schooling among all population groups.[39] It is particularly important that what is taught in the schools, starting from the elementary school level, will provide the knowledge and skills needed to integrate into the modern labor market. In addition, a reexamination is needed of the mandatory pension arrangement, which reduces work incentives for low-earning workers.[40]

It is of critical importance to continue to increase the attainment of higher education among all population groups, and to include the core knowledge and skills needed to integrate into the modern labor market in education attained at every school, beginning with elementary school

One of the ways to deal with the slower growth of the workforce and the increase in the dependency ratio (the ratio of the non-working population to the working population) is to raise the age of retirement. In recent decades, life expectancy has risen considerably, while the retirement age has been raised only moderately. Consequently, the proportion of working years within a person's life has fallen on average and as a result the required amount of pension savings and old age pension payments from the National Insurance Institute has risen. Nonetheless, the Knesset this year decided to cancel a previous decision to raise the age of retirement for women from 62 to 64 in stages, even though this is lower than what is common in other countries with a similar life expectancy.[41] The raising of the retirement age starting from 2003 (from 60 to 62 for women and from 65 to 67 for men) was accompanied by a significant increase in employment at these ages, which indicates that it is an effective tool for raising the rates of employment (see Chapter 5 of the Bank of Israel Annual Report for 2010). Furthermore, the employment profile of working women above the age of 55 during the last decade indicates that their rates of retirement are not significantly different from those of men, that their wages continue to rise, and that the number

One of the ways to deal with a slowdown in the growth of the labor force is to raise the retirement age.

[38] During the past decade, the employment rate in the 25–64 age group rose by 5.5 percentage points and the participation rate by 4 percentage points.

[39] Nonetheless, the proportion of those in higher education increased considerably during the 1990s and has been stable at a high level since the middle of the previous decade. Therefore, the contribution of expanding higher education to employment and productivity is expected to be more moderate during the coming decade.

[40] See A. Brender (2011), "The first year of the mandatory pension arrangement: Compliance with the arrangement and its potential effects on labor supply", Bank of Israel, Discussion Paper 2011.05.

[41] See Chapter 6 of the Bank of Israel Annual Report for 2003 and the report of the Committee to Examine the Raising of the Retirement Age for Women (the Nisan Committee, 2011).

of months they work does not decline significantly until up to close to the official retirement age.[42] It would be worthwhile therefore for the government and the Knesset to reconsider raising the retirement age while at the same time adopting arrangements to compensate specific groups, if necessary, who are liable to be particularly affected by the change in the short run.

**b. Infrastructure**

In view of the expected slowdown in the growth of the labor force relative to the population, one of the ways to maintain or accelerate the rate of growth in per capita GDP is to increase productivity in the economy.

In view of the expected deceleration in the growth of the labor force relative to the population, one of the ways to maintain or accelerate growth in per capita GDP is to increase productivity in the economy. Israel's level of productivity is low relative to other developed countries. In order to achieve such an improvement, it is the job of fiscal and monetary policy to first of all ensure a stable economic environment,[43] given the regional geopolitical developments and the situation of the global economy. Another basic condition for sustainable growth is an efficient government framework that will ensure civil order, property rights and fair conditions for competition in the market, while at the same time not imposing an excessive bureaucratic burden on individuals and on the business sector. In order to increase productivity, what is also required is the development of an efficient and sufficiently large infrastructure that will support private investment and the needs of the population. It is especially important to expand the mass transit systems and the availability of public transportation in order to improve the access of the population to employment centers, while increasing accessibility to a variety of cheaper housing solutions.

In recent years, various events and developments have revealed the problematic situation of the infrastructure.

In recent years, various events and developments have revealed the problematic situation of the infrastructure, particularly in the areas of electricity, the railways, water and firefighting. These include: appeals to limit the consumption of electricity during peak hours along with an "emergency plan" to increase the capacity of electricity production, the limitations on the use of the railways by soldiers on Sundays, the imposition and then cancelation of the "drought levy" on household water consumption alongside the desalination of water using an expensive method due to the lack of desalination capacity, and failures in firefighting capabilities and their upgrade only after the failures were revealed in the Carmel forest fire. Although in some of the cases, justifications can be found for the delay in preparing and implementing plans at one stage or another, the overall picture demonstrates that the development of infrastructure is not being carried out at a pace that is consistent with the needs of the economy. The situation is particularly worrying since in most of the aforementioned areas, including the delayed reform of the seaports whose service indices are lower than international standards, the problems were identified many years ago.

[42] The analysis was performed on a panel of female workers for the period 2000–09 and was based on the reports of their employers to the Income Tax Authority. This analysis makes it possible to monitor the employment behavior of a woman during this time.

[43] Y. Lavi and M. Strawczynski (2001), "The effect of policy variables and the increase of business sector GDP and its components (factors of production and productivity) in Israel, 1960 to 1995", Bank of Israel Review 73, pp. 109–141.

The delays in the development of infrastructure are not exclusively due to—or even mainly due to—budget constraints. Some of the most important investment projects are being delayed due to a lack of decision making regarding specific details within the overall reform, such as for example in the area of employee-employer relations. This is partly due to assigning low weight to the cost of a lack of progress. Thus, decisions and their implementation are postponed again and again until a crisis situation develops and only then is progress achieved, and in general at a higher cost. Situations like these have been especially characteristic of the Electricity Company's development plans, the upgrade of the ports and the reform of the firefighting services.

Important infrastructure projects are being delayed because low weight is assigned to the cost of a lack of progress.

**c. The discovery of natural gas and its effects**

One of the main developments in the Israeli economy during the last two years was the discovery of significant amounts of natural gas within Israel's economic waters. Two large reservoirs of natural gas have so far been discovered (Tamar and Leviathan) and according to geological appraisals the potential amount of natural gas is double or more than what has been found so far. These discoveries will significantly reduce the dependence of the Israeli economy on the import of energy products (see Section 2.1 of Chapter 7), while at the same time bringing down the costs of electricity production and reducing air pollution. This is particularly important in view of the problems with the supply of gas from Egypt and the uncertainty regarding its continuation. The recent discoveries will provide for the needs of the Israeli economy for several decades and the possibility of exporting some of the gas is currently being considered. At the end of 2011 and beginning of 2012, supply contracts were drawn up between the gas producers and the Israel Electric Company and other consumers in Israel. These agreements are meant to open the way for the construction of infrastructure, such that the supply of gas will begin in mid-2013. At this stage, due to the regulatory difficulties in obtaining approval for building a gas intake facility in the North of the country (which has already delayed the start of the gas supply from 2012 to 2013), gas will be supplied by an undersea pipeline from Tamar (off the northern coast of Israel) to the Ashkelon area. At the same time, it is important to make rapid progress in laying an additional pipeline that will transport the gas directly to the North of the country, from the point of view of both economic efficiency and maintaining the security of supply.

The gas discoveries will significantly reduce the dependence of Israel on energy imports, while bringing down the costs of electricity production and reducing air pollution.

The availability of the gas creates the possibility, in addition to the replacement of higher-emission and more expensive fuels for the production of electricity, of other uses that can increase the value added to the economy. Particularly significant is the potential to use the gas as a replacement for gasoline by means of, inter alia, conversion to methanol (using available technologies) or by expanding the use of electric vehicles. In general, the government should let the private sector weigh the business considerations as to which other uses of the natural gas are worthwhile, but it is important that it ensures the existence of physical and regulatory infrastructure that will allow the optimal use of these resources.

It is important that the government ensure the existence of physical and regulatory infrastructure that will allow the optimal use of the natural gas resources.

Countries whose governments used the revenues from natural resources to increase public expenditure during the extraction period experienced a real appreciation and cumulative economic damage.

Alongside the significant advantages of the gas discovery, international experience also points to economic risks as a result of their development.[44] Countries that have benefited from a high level of revenues from the exploitation of natural resources have in many cases experienced a real appreciation of the exchange rate that has harmed the ability of other industries to compete (the "Dutch disease"). In the case that the resources are available for a long but limited period, a significant period of time will be needed for the rehabilitation of the tradable goods sector when production has finished and national income will be adversely affected. It has been found that government policy with respect to revenues is of critical importance. Countries whose governments used the revenues from natural resources to increase public expenditure during the period of production experienced a real appreciation and cumulative economic damage, which in some cases offset most of the advantages provided by the natural resources. In addition, it was found that such revenues were often used for over-investment in projects with low returns.

In March 2011, the Knesset approved legislation for an "excess profit tax" on the revenues from the production of oil and gas. This law significantly increased the payments to the government from the production of these resources, which includes both royalties and corporate tax. The law established significant exemptions for gas fields whose production begins before 2014. This is meant to speed up the development of gas supply in view of the disruptions in the supply of gas from Egypt and the rapid depletion of the Yam Tethys reservoir, which are making it necessary to use expensive and more-polluting sources of energy. According to the structure of the tax and the plans for production, significant revenues are expected to flow to the State Budget only towards the end of the decade.

Establishing a sovereign wealth fund, in which government revenues from the "excess profit tax" will be deposited, will reduce the risk of "Dutch disease", and is also justified on the basis of a just intergenerational distribution of revenues.

The "excess profit tax" law also specifies that tax revenues will be deposited in a sovereign wealth fund[45] and in mid-February 2012 the government approved its structure. The fund was designed on the basis of international standards for the management of similar funds (the "Santiago Principles"), such that its management will be consistent with its targets, and in particular the separation between the fund and the State Budget. The fund will invest the government revenues from the "excess profit tax" abroad and, apart from its contribution to reducing the risk of "Dutch disease", its creation is also justified on the basis of a just intergenerational distribution of revenues since the gas fields are a non-renewable resource that also belongs to future generations. The exploitation of the gas in the present will facilitate lower energy prices and a flow of direct revenues from the corporate tax and royalties to the State Budget and therefore it is correct to deposit at least the "excess profit tax"

[44] See Box 7.2 in the Bank of Israel Annual Report for 2010 and Section 1.2 of Chapter 7 of this report. For a comprehensive review of the economic research on this subject, see F. Van Der Ploeg (2011), "Natural Resources: Curse or Blessing", Journal of Economic Literature, 49:2, 366–420.

[45] The excess-profit tax proceeds will be reduced to fully offset the additional collection due to the cancellation of the planned reduction in the corporate tax up until 2016 and the increase in its rate that was instead implemented. Consequently, the proportion of revenues to be included directly in the State Budget, instead of being deposited in the fund, will increase.

in a separate fund that will be used by the State over time. As is common practice in other countries that have created such funds, the fund will transfer an amount derived from the profits on its investments each year to the State Budget[46] but will accumulate the government revenues from the tax. The decision to create the fund even before any significant amounts of the "excess profit tax" are received will help to ensure that the long-term planning of the government budget is based on correct assumptions regarding the size of the resources that will be available during the coming decade. To this end, it is important to decide that the revenues from future tenders of licenses and concessions for the search for oil and gas and additional minerals discovered in the future will be channeled to the fund rather than to the current budget.

[46] In order to prevent shocks in the budget as a result of changes in the capital markets, the fund will transfer the profits on the basis of an average return over a number of years.

Table 1.A.1
Israel: Basic Economic Data,[a] 2003–11

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| Mean population (’000) | 6,690 | 6,809 | 6,930 | 7,054 | 7,180 | 7,309 | 7,486 | 7,624 | 7,766 |
| Population growth rate (percent) | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 | 1.9 |
| Israelis employed (’000) | 2,376 | 2,448 | 2,543 | 2,625 | 2,735 | 2,832 | 2,841 | 2,938 | 3,025 |
| GDP (NIS billion, 2008 prices) | 567 | 595 | 624 | 659 | 696 | 724 | 730 | 765 | 801 |
| GDP growth rate (percent) | 1.5 | 4.8 | 4.9 | 5.6 | 5.5 | 4.0 | 0.8 | 4.8 | 4.7 |
| Per capita GDP ($ ’000, current prices) | 17.7 | 18.5 | 19.2 | 20.5 | 23.1 | 27.4 | 26.0 | 28.6 | 31.3 |
| Unemployment rate (percent) | 10.6 | 10.3 | 8.9 | 8.3 | 7.3 | 6.0 | 7.5 | 6.7 | 5.6 |
| Real wage per employee post (percent change) | -3.0 | 2.5 | 1.0 | 1.3 | 1.6 | -0.7 | -2.6 | 0.7 | 0.3 |
| Nominal wage per employee post (NIS per month, current prices) | 6,909 | 7,051 | 7,220 | 7,468 | 7,630 | 7,921 | 7,974 | 8,247 | 8,558 |
| Change in real income of family in lowest quintile (percent) | -1.8 | -1.9 | 4.4 | 5.4 | 1.9 | -1.4 | 1.2 | 3.9 | .. |
| Rate of employment in 25-64 year age group (percent) | 66.2 | 66.7 | 67.5 | 68.6 | 70.1 | 70.9 | 70.1 | 71.2 | 72.1 |
| Inflation rate (during the year, percent)[b] | -1.9 | 1.2 | 2.4 | -0.1 | 3.4 | 3.8 | 3.9 | 2.7 | 2.2 |
| NIS/$ exchange rate (percent change, during the year)[b] | -6.4 | -1.2 | 6.2 | -8.9 | -7.1 | -0.9 | -2.1 | -4.9 | 4.7 |
| Nominal effective exchange rate (percentage change during the year)[b,c] | 3.5 | 4.4 | 0.0 | -3.4 | -1.4 | -8.3 | 3.5 | -7.1 | 3.6 |
| Bank of Israel interest rate (%) | 7.5 | 4.2 | 3.7 | 5.1 | 3.9 | 3.7 | 0.8 | 1.6 | 2.9 |
| Nominal yield on 10-year government bonds (%) | 9.2 | 7.9 | 6.7 | 6.4 | 5.6 | 6.1 | 5.4 | 4.9 | 5.1 |
| Real yield on 10-year government bonds (%) | 4.9 | 4.3 | 3.7 | 3.8 | 3.4 | 3.5 | 2.9 | 2.2 | 2.4 |
| Public expenditure (percent of GDP) | 49.8 | 47.1 | 45.1 | 44.6 | 43.5 | 42.6 | 42.7 | 42.3 | 42.0 |
| Tax revenue (percent of GDP) | 35.2 | 35.3 | 35.4 | 35.7 | 36.1 | 33.7 | 31.3 | 32.3 | 32.6 |
| Actual budget deficit (percent of GDP) | 5.1 | 3.6 | 1.8 | 0.8 | 0.1 | 2.0 | 5.1 | 3.7 | 3.3 |
| Gross public debt (percent of GDP, year-end) | 99.3 | 97.7 | 93.7 | 84.7 | 78.1 | 77.1 | 79.5 | 76.1 | 74.2 |
| Goods and services exports ($ billion, current prices)[d] | 35.6 | 43.0 | 47.1 | 53.0 | 60.6 | 72.0 | 61.9 | 71.4 | 78.7 |
| Goods and services imports ($ billion, current prices)[d] | 37.2 | 43.7 | 48.5 | 53.2 | 63.8 | 75.3 | 58.1 | 68.1 | 81.6 |
| Current account (percent of GDP) | 0.5 | 1.7 | 3.1 | 4.8 | 2.7 | 0.9 | 3.6 | 2.9 | 0.1 |
| Net external debt (percent of GDP) | -3.9 | -8.2 | -15.6 | -19.8 | -23.0 | -21.7 | -26.6 | -24.4 | -24.6 |

[a] Annual averages.
[b] Rate of change during year.
[c] The shekel exchange rate against the currencies of Israel's trading partners, weighted according to the volume of Israel's trade with them.
[d] Excluding diamonds.
SOURCE: Based on Central Bureau of Statistics data.

**Table 1.A.2**
**Basic Economic Data: International Comparison[a], 2000-2011**

| | Avarage 2000-2009 | | | | 2010 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Israel | US | Eurozone | OECD | Israel | US | Eurozone | OECD | Israel | US | Eurozone | OECD |
| GDP growth rate | 3.6 | 1.7 | 1.4 | 1.7 | 4.8 | 3.0 | 1.8 | 3.1 | 4.7 | 1.7 | 1.6 | 1.9 |
| Per capita GDP growth | 1.5 | 0.7 | 0.8 | 1.1 | 2.9 | 2.0 | 1.5 | 2.6 | 2.8 | 0.8 | 1.3 | 1.4 |
| Population growth rate | 2.0 | 1.0 | 0.5 | 0.6 | 1.8 | 1.0 | 0.3 | 0.5 | 1.9 | 1.0 | 0.3 | 0.5 |
| Civilian labor force participation rate, ages 25-64 | 73.4 | 79.2 | 75.1 | 75.2 | 75.5 | 78.3 | 77.5 | 76.2 | 75.9 | .. | .. | .. |
| Unemployment rate | 8.7 | 5.5 | 8.3 | 6.5 | 6.7 | 9.7 | 9.9 | 8.3 | 5.6 | 9.0 | 9.9 | 8.0 |
| Inflation rate (during year) | 2.1 | 2.6 | 2.1 | 2.7 | 2.7 | 1.6 | 1.6 | 1.9 | 2.2 | 3.2 | 2.6 | 2.9 |
| Exports (percent of GDP)[b] | 34.5 | 10.8 | 38.1 | 24.8 | 38.7 | 12.7 | 40.9 | 27.0 | 38.2 | .. | .. | .. |
| Gross investment (percent of GDP) | 18.7 | 18.7 | 21.1 | 20.8 | 16.0 | 15.2 | 19.2 | 18.6 | 18.7 | .. | .. | .. |
| National saving (percent of GDP) | 20.0 | 14.5 | .. | .. | 18.9 | 11.9 | .. | .. | 18.8 | .. | .. | .. |
| Current account (percent of GDP) | 1.3 | -4.7 | 0.2 | -1.2 | 2.9 | -3.2 | 0.2 | -0.6 | 0.1 | -3.0 | 0.1 | -0.6 |
| Public expenditure (percent of GDP) | 47.3 | 36.8 | 47.5 | 40.7 | 43.6 | 42.5 | 51.0 | 44.6 | 43.0 | 41.9 | 49.3 | 44.0 |
| Tax revenue (percent of GDP)[e] | 35.2 | 26.8 | .. | .. | 32.3 | 24.8 | .. | .. | 32.6 | .. | .. | .. |
| Gross public debt (percent of GDP) | 88.0 | 62.8 | 76.8 | 75.5 | 76.1 | 94.2 | 92.9 | 97.9 | 74.2 | 97.6 | 95.6 | 101.6 |

[a] Figures for the eurozone and OECD countries are weighted averages of the countries in each group, as published in the OECD Economic outlook.

[b] For Israel, exports excluding diamonds.

SOURCE: OECD data base; OECD Economic Outlook, 2011; IMF World Economic Outlook, 2011 and Bank of Israel.