Chapter 1
The Economy and Economic Policy

- Developments in the economy were particularly positive this year, and were reflected in several areas; GDP grew by 5.1 percent, led by an increase in high-tech exports; rapid growth has continued now for more than three years; unemployment fell to its lowest this decade and reached 7.7 percent this year; the debt to GDP ratio fell significantly; the surplus in the current account was very high, and foreign investment in Israel reached record levels. The pace of growth and market stability were all the more impressive in light of several shocks, primarily the Second Lebanon War.
- The character of economic growth changes gradually as the recovery part of the economic cycle nears its full potential and the long-term growth components—expansion in factors of production and increase in productivity—become more important.
- Continued growth worldwide, particularly in the high-tech industries, the relatively low number of terror attacks and the macroeconomic policies provided the favorable background conditions for economic growth. The impact of the war was modest.
- The government budget deficit was lower than the ceiling, and public expenditure grew in line with its target. While the public debt to GDP ratio fell considerably, its level was still high. An increase in defense spending following the war sharpens the challenges faced by fiscal policy.
- The consumer price index fell by 0.1 percent this year, that is inflation significantly deviated below the lower boundary of the target range. The sharp appreciation of the shekel, influenced by the dollar's global weakness, greatly contributed to this deviation, which occurred in the second half of the year.
- As a response to the sharp fall in prices which began in September, the Bank of Israel reduced the interest rate by a cumulative 1.5 percent in the last quarter of 2006 and the beginning of 2007. This followed the rise in the interest rate at the beginning of the year, when inflation exceeded the target range.
- Long-term forces are acting to increase the current account surplus, though the sharp increase of the surplus this year was mainly affected by one-time factors.
- The resilience of the banking system improved, though that of insurance companies declined. It is important to step up the regulation of institutional investors, particularly the insurance companies.
- The low employment rate in certain segments of the population and the low incomes of workers with poor levels of education are central causes of poverty. It is recommended that a number of steps be taken to increase employment and the earning potential of these populations, including an earned income tax credit system in line with the government's decision, and a cut in the number of foreign workers.

1. MAIN DEVELOPMENTS

Rapid growth continued this year, led by the business sector, first and foremost by high-tech exports.

The growth trend, which characterized the economy in the preceding two years, continued this year, both in terms of pace and its major features: a rapid and steady rate of growth—GDP grew by 5.1 percent this year; growth was focused in the business sector; it was reliant on favorable background conditions and a supportive macroeconomic policy; it was led by an expansion in demand, first and foremost the rapid increase in high-tech exports, with supply rapidly adjusting to satisfy demand, without creating, up till now, real pressures that would slow down growth. This continuity was expressed this year in other fields: unemployment, the budget deficit and public debt all continued to decline, while capital flow into and out of the economy

Table 1.1
Israel: Basic Economic Data,[a] 1990–2006

	1990–1995	1996–1999	2000	2001	2002	2003	2004	2005	2006
Mean population ('000s)	5,156	5,902	6,289	6,439	6,570	6,690	6,809	6,930	7,053
Population growth rate (percent)	3.5	2.5	2.7	2.4	2.0	1.8	1.8	1.8	1.8
Israelis employed ('000s)	1,713	2,061	2,216	2,265	2,284	2,330	2,401	2,494	2,574
GDP (NIS billion, 2005 prices)	347	463	528	525	520	528	553	582	612
GDP growth rate (percent)	7.2	3.9	8.7	-0.6	-0.9	1.5	4.8	5.2	5.1
Per capita GDP ($ '000s, current prices)	14.0	18.1	19.2	18.4	16.6	17.2	18.0	18.7	19.9
Unemployment rate (percent)	9.3	8.0	8.8	9.3	10.3	10.7	10.4	9.0	8.4
Real wage per employee post (percent change)	0.3	2.2	6.2	3.0	-6.0	-3.0	2.5	1.8	1.6
Nominal wage per employee post (NIS per month, current prices)	3,244	5,625	6,791	7,072	7,023	6,859	7,000	7,220	7,493
Inflation rate (during the year, percent)	13.1	6.9	0.0	1.4	6.5	-1.9	1.2	2.4	-0.1
NIS/$ exchange rate (percent change, during the year)	9.1	7.9	-2.7	4.8	9.8	-6.4	-1.2	6.2	-8.9
Public expenditure as a share of GDP	53.2	50.8	48.1	50.8	51.8	51.2	48.9	47.1	46.5
Tax revenue as a share of GDP	36.9	36.8	37.8	37.8	37.1	36.2	36.4	36.4	36.9
Actual budget deficit (percent of GDP)	3.1	3.4	0.7	4.4	3.8	5.4	3.7	1.9	0.9
Gross public debt (percent of GDP)[b]	119.1	100.3	87.0	92.2	99.8	102.3	100.9	97.0	87.8
Goods and services exports ($ billion, current prices)[c]	17.5	28.0	39.4	34.8	32.4	35.6	43.4	47.5	53.6
Goods and services imports ($ billion, current prices)[c]	23.2	33.1	40.3	38.4	36.1	37.2	43.6	48.4	53.0
Current account (percent of GDP)	-2.6	-2.6	-0.8	-1.1	-0.9	1.2	2.4	3.3	4.9
Net external debt (percent of GDP)	25.3	12.1	4.9	0.8	-2.4	-5.5	-8.8	-16.8	-21.3

[a] Annual averages.

[b] At year end. The ratio is calculated according to the revised definition of GDP. Hence its level in each year is lower than that reported in previous Bank of Israel Annual Reports.

[c] Excluding diamonds.

SOURCE: Based on Central Bureau of Statistics data.

Table 1.2
Basic Economic Data: International Comparison,[a] 1996-2006

	2005				2006				Average 1996–2006			
	Israel	US	Euro zone	OECD	Israel	US	Euro zone	OECD	Israel	US	Euro zone	OECD
GDP growth rate	5.2	3.2	2.2	3.1	5.1	3.3	3.2	3.7	3.6	3.2	3.0	3.2
Per capita GDP growth[b]	3.4	2.3	1.5	2.4	3.2	2.3	2.5	2.9	1.3	2.0	2.5	2.4
Per capita GDP ($'000s, current prices)[b]	18.7	42.0	31.5	32.4	19.9	43.0	33.5	33.4	18.2	36.0	25.0	24.7
Population growth rate[b]	1.8	0.9	0.6	0.7	1.8	0.9	0.6	0.7	2.2	1.2	0.4	0.7
Civilian labor force participation rate	55.2	75.1	72.3	72.7	55.6	..	72.6	73.2	54.2	76.4	70.0	71.8
Unemployment rate	9.0	5.1	7.8	7.0	8.4	4.6	7.4	6.5	9.0	5.0	8.2	7.2
Inflation rate (during year)	2.4	3.4	2.3	2.6	-0.1	2.5	1.9	3.1	3.4	2.5	2.3	4.9
Exports as percent of GDP[c]	36.8	10.9	49.5	46.5	38.3	..	..	..	31.4	10.6[d]	44.8[d]	40.7[d]
Gross investment as percent of GDP	17.7	19.6	22.4	23.4	17.6	..	..	..	20.0	19.1[d]	22.1[d]	22.7[d]
National saving as percent of GDP	20.6	12.5	21.1	21.5	22.5	..	..	..	19.9	15.5[d]	21.8[d]	21.7[d]
Current account as percent of GDP	3.3	-6.4	-1.0	-1.0	4.9	-6.6	-1.0	-1.2	-0.1	-4.1	-0.1	-0.5
Public expenditure as percent of GDP	47.1	36.6	46.4	43.5	46.5	36.5	46.2	43.3	49.8	35.7	46.9	44.2
Tax revenue as percent of GDP	36.4	25.4[e]	39.2[e]	37.9[e]	36.9	..	..	..	36.9	28.0[f]	39.7[f]	36.7[f]
Gross public debt as percent of GDP[g]	97.0	61.8	74.7	61.9	87.8	60.9	73.6	61.3	97.1	61.5	77.8	64.3

[a] Figures for the US, euro zone and OECD countries are simple averages of the countries in each group.
[b] Population data for the US, euro zone and OECD countries for 2006 are estimates.
[c] For Israel, exports excluding diamonds.
[d] Average for the period 1996–2005.
[e] Data for 2004.
[f] Average for the period 1996–2004.
[g] At year end.
Source: OECD Economic Outlook, 2006; World Economic Outlook, 2006, and Bank of Israel.

continued to rise, as did the current account surplus in the balance of payments, and the capital markets continued to adjust themselves gradually to the structural changes that have been introduced in the markets in recent years. The strength of these trends was demonstrated by their resilience in light of the war in the north. This durability was one of the expressions of stability that prevailed this year in various markets, a stability which was expressed by a modest reaction to several additional shocks, and which allowed, *inter alia*, the creation of an unprecedented negative interest rate gap vis-à-vis abroad. The most prominent of the changes seen this year was the drop in inflation to significantly below the lower boundary of the target range, as well as the strength of other processes, among them the sharp drop in public debt and the considerable growth in the current account surplus. The character of economic growth changes gradually with the recovery part of the cycle nearing its full potential and the rise in importance of the long-term growth components: an expansion in factors of production and an increase in total factor productivity, which stems from the production processes becoming more efficient.

The favorable underlying conditions were the rapid global growth and the relatively low number of terror attacks.

The favorable underlying conditions refer to continued solid growth worldwide, particularly in the high-tech industries, which allows for a rapid growth in exports, as well as continued improvement in the security situation in terms of terror attacks. The positive effect of these factors was expressed also in the scope of foreign investment in the economy, in the drop of the country's risk premium, in the peaks registered in the capital markets and in their stability, etc. In contrast, the economy was harmed by the fighting in the north and the continued deterioration in the terms of trade. The effect of the fighting though was relatively modest.

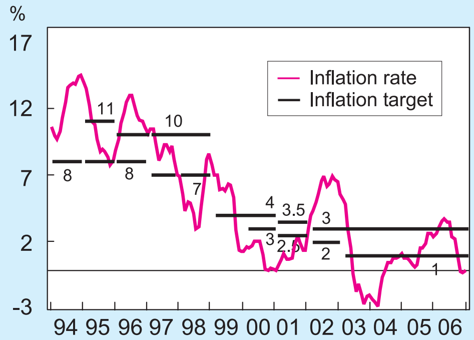
The more the economy integrates into the world economy, the more affected it is by global developments. Apart from the demand for exports and the price of oil, the effect of several other processes also stood out: the global weakening of the dollar and its impact on the exchange rate and inflation; the rise in interest rates worldwide; the availability of more capital worldwide and a growing trend for mergers and acquisitions, which increased the inflow of capital, particularly of foreign direct investment; the shocks in the emerging markets in mid-year.

Economic policies achieved the fiscal targets, but inflation fell below the lower boundary of the target.

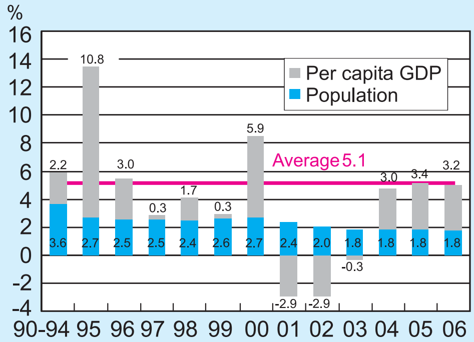
Macroeconomic policies met their fiscal targets—the deficit was lower than the target while the increase in public expenditure was in line with its—though the price stability target was not reached: inflation was significantly below the lower boundary of the target range. The policy mix supported growth: though the direct contribution of fiscal policy to demand was contractionary, as expressed in the cyclically-adjusted deficit, the tax rate was reduced, and the maintenance of fiscal discipline, significantly cutting both the deficit and public debt, contributes to a reduction in the country's risk premium and is important for long-term growth, market stability and the central bank's ability to keep the real rate of interest low. The government took advantage of the cyclical increase in tax revenues to reduce the deficit, and together with the proceeds from privatization this helped reduce public debt rapidly this year, though this is still high by international standards. Missing the inflation target was explained

Figure 1.1
Key Economic Indicators, 1990–2006

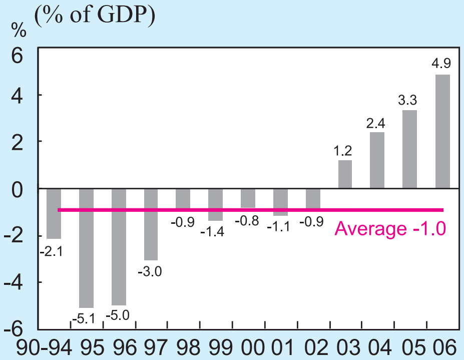
Inflation Rate and Target, 1994–2006



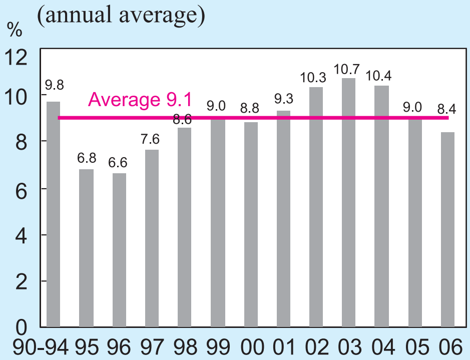
Growth Rate of GDP, 1990–2006



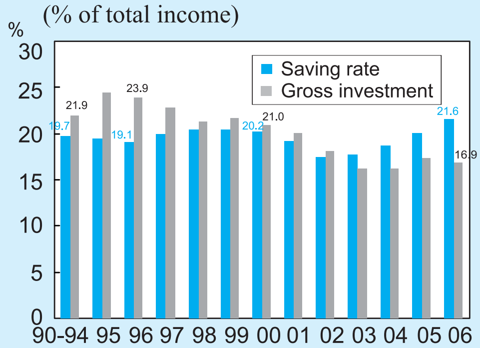
Balance of Payments Current-Account, 1990–2006
(% of GDP)



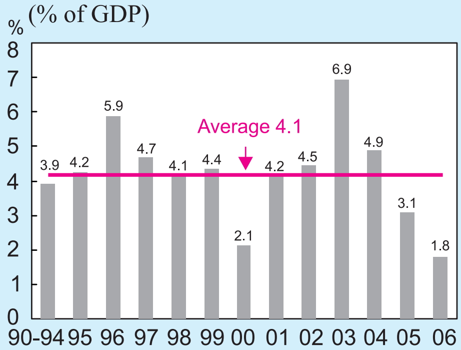
Unemployment Rate, 1990–2006
(annual average)



Gross National Saving Rate and Investment, 1990–2006
(% of total income)



Public-Sector Overall Deficit, 1990–2006
(% of GDP)



SOURCE: Based on Central Bureau of Statistics data.

mainly by two external developments which were difficult to foresee in the second half of the year: the weakening of the dollar, which caused the shekel to appreciate rapidly, and the sharp drop in oil prices. Toward the end of the year, the Bank of Israel cut the interest rate several times, and in contrast to earlier rate cuts these were relatively fast and created an unprecedented negative interest rate gap with the US rate of interest. Nevertheless, it will still require some time before inflation returns to within the target range. The effect of monetary policy on activity this year was slight: it did not contribute to an expansion in activity, as the real rate of interest rose, but it also did not create significant braking forces.

Unemployment fell to its lowest rate this decade.

The labor market continued to improve: unemployment fell to an average of 8.4 percent during the year, the lowest rate this decade, while both the participation and employment rates rose, and there was a slight rise in wages. An increase in labor supply supported output meeting the enhanced demand. Economic growth reduced the unemployment rate among groups with all levels of education, though among those with low levels of education the rate remains very high. Unemployment among the educated workforce fell to a particularly low rate, which points to a developing supply constraint in the high-tech industries, though this effect did not yet register this year. The number of foreign workers increased this year, and this has a negative impact on Israelis with little education, both those in work and those wishing to join the labor market.

The surplus in the current account grew considerably.

The current account surplus grew considerably this year, to an exceptionally high level. This increase reflects a combination of long-term processes, which act to improve the account, and short-term forces, which contributed to this year's exceptional growth. The improvement in the current account could be seen in all its components—the balance in goods and services, the income account and current transfers. A significant increase was registered in nonresidents' investments in Israel and in Israelis' investments abroad, both of which reached unprecedented levels this year. The increase in capital outflow reflects a continuing adjustment to the structural changes in the capital market and bringing into parity the taxation on investment income from abroad, as well as the drop in government borrowing and the fall in the interest rate gap vis-à-vis abroad. Among nonresidents' investments in Israel, direct investment was particularly prominent, concentrating on export-oriented companies.

Price developments in various markets reflected the characteristics of growth and other forces. The fall in the consumer price index expressed the effect of external forces, which together with the expansion in supply, acted to offset the upward pressure on prices created by the expansion in demand, a pressure that was registered in various price indices. The rise in real wages was moderate, while unit labor costs fell further, despite the significant rise in demand for workers; this was due to, *inter alia*, the increase in supply of labor. The surplus in the current account and the inflow of capital into the economy contributed to the trend of real appreciation of the shekel during the year, and strengthened the effect of expanded demand in the economy in the same direction.

The capital market was characterized this year by a boom, stability, and resilience to shocks, while processes that are transforming the financial system deepened. Thus the trends of recent years continued, based on the improvement in the economy's underlying conditions, a reduction in government involvement in the market and a continuing adjustment of the market to structural changes in it, with a deepening and sophistication of the market. Among the most prominent processes were: changes in the composition of the asset portfolio, including the rise in the share of tradable assets and those issued by the business sector; changes in asset management, foremost of which was the fall in the banks' share and the rise of the institutional investors'; and changes in sources of funding of the business sector, including the rise in the share of non-bank sources particularly through corporate bonds. The resilience of the banking system improved, though that of insurance companies was somewhat worse this year despite the economic growth.

The capital market was characterized by a continuation of the boom, stability and the adaptation to structural changes in the market.

Poverty in Israel has reached high levels in recent years, and is high in international comparisons too. Incidence of poverty is particularly high among large families, among those with low levels of education and families with few wage earners. For some time poverty has worsened, particularly among those groups who were already poor to begin with. However in 2005 and in the first half of 2006, there was some fall in poverty according to certain measurements, and GDP growth improved the situation for some of the poor—those with closer involvement in the labor market––though this improvement was smaller than for the rest of the population. Several economic factors contribute to the rise in poverty, such as a relative drop in demand for unskilled workers as well as government steps, such as the significant increase in foreign workers up to 2002 and the sharp cutback in welfare payments, though these cutbacks were intended to encourage greater participation in the workforce and may reduce poverty in the long run.

According to certain measures, poverty fell somewhat, though the rate was still high.

The main goal of economic policy is to support sustainable growth. To this end, it must maintain fiscal discipline, price stability and financial stability, while ensuring a proper level of public services as well as confronting poverty. In order to maintain fiscal credibility, the government must remain committed to expenditure and deficit targets while significantly reducing the ratio of the public debt to GDP. In order to maintain financial stability, the regulatory mechanism for institutional investors needs to be strengthened, particularly for insurance companies. While growth is important, it is not sufficient in reducing poverty. The effort to reduce poverty requires government measures to improve the integration of various segments of the population into the labor market, as well as the income of those on the lowest wages. This policy must also include a significant reduction in the number of foreign workers, the implementation of a negative tax system etc. Attention should be drawn to those segments of the population where poverty is particularly high—Arabs, especially the Bedouins (see Box 2 in Chapter 8) and the ultra-Orthodox. Alongside this, the policy must also ensure a decent living for the elderly and others who cannot work. A fuller discussion on policies required for the coming years is given at the end of this chapter.

Economic policy must maintain fiscal discipline, and price and financial stability, while ensuring a proper level of public services and addressing poverty.

2. GDP AND ITS USES

GDP grew by 5.1 percent. Up to now, there has been no real pressure to slow down the growth rate.

The growth trend that began with the economy's emerging from recession in 2003 continued this year, both in its pace and in its major characteristics. The pace of growth was rapid and stable: GDP grew by 5.1 percent this year, similar to the rate of growth in the past two years; growth was concentrated in the business sector, which grew by 6.4 percent this year, relied on favorable underlying factors, and was led by an expansion in demand, primarily a rapid increase in exports, with supply quickly meeting this without creating real pressures that would slow down the pace of growth. The strength of these trends was demonstrated in their resilience despite the war in the north. The cyclical growth in utilization played a pivotal role in supply responsiveness up to now, while this year the expansion in long-term supply—based on expanding the factors of production and the increase in productivity beyond the cyclical effect—took on greater importance.

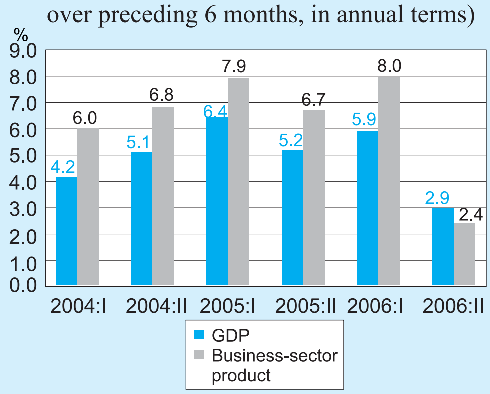
The effect of the Second Lebanon War on the economy was moderate.

The underlying factors that supported the rapid growth this year were a continuation from the previous two years: continuing world growth, the improvement in the security situation in terms of terror attacks, and macroeconomic policy, led by the maintenance of fiscal discipline. Two factors had a negative impact on the economy this year: a) the war in the north (from mid-July to mid-August)—which had but a modest effect on the economy, estimated at half of a percentage point[1] (see Box 2 in Chapter 2)—caused only a temporary drop in level of

Figure 1.2

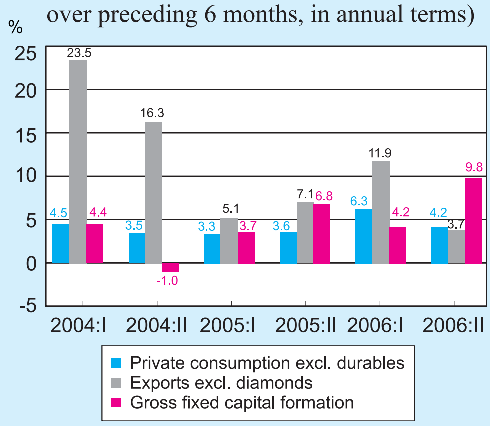
a. GDP and Business-Sector Product, 2004–06

(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)



b. Exports, Private Consumption and Gross Fixed Capital Formation, 2004–06

(seasonally adjusted data, rate of change over preceding 6 months, in annual terms)



SOURCE: Based on Central Bureau of Statistics data.

[1] This estimate refers to GDP lost due to the war. The direct costs beyond the loss of output (expenditure on the fighting, replenishing supplies, property damage etc.) were some three times higher than this.

activity; this recovered rapidly with the end of hostilities, without impacting on the growth trend; and b) the continuing deterioration in the terms of trade, due to the rise in the price of oil, caused a loss of income estimated at 0.6 percent of GDP this year. In contrast to the previous two years, where rapid growth was helped by a fall in real interest rates, this year monetary policy did not contribute to an expansion in activity.

The adjustment of supply to meet rising demand is gradually changing: the increase in utilization has neared its completion, and the expansion in production capacity is now more important.

The continuation of rapid growth for more than three years emphasizes the adjustment of supply to meet the rise in demand, with a gradual change in the characteristics of this adjustment. Up till now, the response of supply was greatly dependent on the increase in utilization, which is characteristic of a recovery, expressed in a sharp rise in general productivity, while labor input and capital stocks increased only slightly. This process also tempered the rise in real wages and output prices and contributed to the fall in unit labor costs; these acted to moderate production costs, and hence contributed to the continued rapid expansion in output. The potential for increasing output by raising utilization and closing the output gap has been almost completely used, so now expanding production capacity becomes more important: in the past two years a slowdown has been apparent in the rate of increase in productivity and in the rate of decline in unit labor costs, while unemployment among the educated workforce has reached particularly low levels. This year, in addition, there has been a significant rise in investment in the principal industries in the economy, the first since the recovery, a large acceleration in the number of employed in the business sector compared to the previous two years, as well as a process of real appreciation during the year. Developments in manufacturing this year demonstrate the changes on the supply side. (See the section on manufacturing in Chapter 2).

The increase in supply this year reflected not only the response to demand, but also a long-term expansion in production capacity.

The expansion in supply this year reflected not only the response to demand but also a long-term expansion of production capacity, which is a basis for sustainable growth: the average rate of increase in total factor productivity since the beginning of the decade is higher than in the preceding decade, due to, among other things, the improved quality of the work force (Box 1 in Chapter 2); the increase in investment enlarges production capacity and points to the expectation of continuing growth; growth in labor supply stems partly from long-term trends (see below); the economy's competitiveness, as expressed by the success of its high-tech exports, also supports the ability of the economy to continue growing rapidly. However, the pace of long-term growth in productivity is lower than in developed countries, and this apparently reflects low productivity in non-tradable industries (construction and some of the service industries).

In the expansion of demand, which is leading the economic growth, exports are most noticeable.

In the expansion of demand, which is leading the economic growth, exports are most noticeable, and that has a positive implication for the ability to sustain growth, for as long as global growth continues. The relative contribution of exports to growth this year remained as in 2005, and was significantly lower than in the years 2003 and 2004. This confirms the consolidation of growth in the economy: exports spurred the recovery, and therefore their contribution to growth at the start of the process was particularly high; later, domestic demand also reacted, and its contribution to growth grew steadily until it stabilized in the past couple of years. The contribution of local public consumption increased this year, further to its increase in 2005. However the cyclically-adjusted deficit of the public sector continued to fall, and in this context its direct effect acted to restrain activity. In contrast, the affirmation of fiscal discipline and the reduction of the tax rate continued to contribute this year to the encouragement of activity in the economy both on the demand and the supply side.

The rate of growth in private consumption was relatively low.

The rate of growth in private consumption, especially that of durables, was relatively low this year, similar to the development in the previous year. This was despite a number of factors that were expected to push up the rate, primarily the significant increase in disposable income—a result of rapid GDP growth and a continued reduction in direct tax rates—and the rise in the value of the public's asset portfolio. Possibly contributing to this only modest growth in consumption were the lowering of consumers' expectations during the year, the negative impact on national income following the deterioration in terms of trade, and the depreciated exchange rate, which raises the prices of durable goods, most of which are imported. The slow pace of consumption increase is also linked to individuals' decisions that refer directly to the savings rate.

The rate of national savings is high.

The rate of private savings did not fall this year—as a percentage of disposable private income it actually rose—and the national savings rate was higher both than in previous periods and in international comparisons. There were several opposing factors acting this year on the savings rate: pushing the rate up were the boom in the business cycle, consumers' expectations that their situation would get worse in the future, and perhaps even the war. An increase in the value of the public's asset portfolio and a rise in public savings, meanwhile, were expected to reduce the private savings rate. However, the increase in public savings came as a surprise, and it is reasonable to assume that the public has not yet managed to respond to this.

Several long-term factors are acting to increase the savings rate.

In addition to the short-term effects one can point to several long-term trends which apply an upward pressure on the savings rate: a) demographic changes: a fall in the dependency rate (rate of children and elderly in relation to the working age population) in the present and expectations of a rise in the future as the population ages; b) government policies that reduce the generosity of the welfare safety net and its credibility: the decrease in generosity is expressed in the erosion of benefits, in the fall in the public sector's share of financing health expenditure, etc. The weakening in credibility of the social welfare net stems, for example, from the government's readiness in recent years to strike at, *post factum*, payments for old age—pension rights of those covered by pension funds, the value of budget-financed pensions and old-age allowances; c) the government's gradual exit from being involved in the provision of pension plans: the reduction in share of earmarked bonds in particular and of government bonds in general of pension fund assets and the gradual transfer of public sector workers from budget-financed (non-contributory) pensions to contributory pension plans; d) a rise in inequality in the economy, which generally raises the average savings rate, as the marginal propensity of the individual to save rises with income; and e) structural changes in the capital market, which broaden the variety of savings options, among them expanding the ability to save abroad.

Difficult though it is to quantify the effect of these long-term trends, it appears that their importance is great, as the growth in the national savings rate is continuing, and is not unique just to this year. The emergence from the recession in 2003 could explain the growth since then, but it does not explain why this year it reached the highest level for more than a decade. The fact that it increased in recent years despite the significant and consistent reduction of the public deficit while affirming fiscal discipline, strengthens the possibility that there has been a change in individuals' behavior, who are not offsetting their private savings accordingly. The overlap between the period of economic recovery and some of the changes in policy makes it all the more difficult to separate the cyclical component from the long-term component in the rise in savings.

Investment in the principal industries grew significantly this year, for the first time since emerging from the recession.

Investment in the principal industries grew considerably this year, for the first time since the recovery. This reflects a near exhaustion of the surplus capital stocks that accumulated during the recession, as well as expectations of continued growth. The increase in investment was supported by high rates of return on capital and the low cost of borrowing, owing to the relatively low real rate of interest and the booming stock markets. The change in the investment trend focused on machinery, equipment and transport vehicles. The increase in investment in intangibles (principally software) has continued for several years and reflects the expansion of the high-tech industries. Investment in residential construction rose slightly this year, for the first time after a long-standing decline, though this rise does not express a recovery of the industry and an increase in demand for new housing; it stems entirely from a considerable growth in renovations, part of which concerned the repair of war damage in the north, while the number of building starts fell further, and there are no signs of any excess demand in the housing market. It is difficult to explain why demand for residential property has not grown with economic recovery, although it appears that activity in this industry is not low relative to demographic needs, and a significant part of the growth in income in recent years has translated into an expansion in the gaps in housing demand and prices between the center and the periphery, and not to a rise in actual building. (See the section on construction in Chapter 2).

Along with the cyclical growth in investment in the principal industries this year, the rate of investment as a percentage of GDP has shown a long-term downward trend for a decade now. This trend reflects the exhaustion of the stage of accelerated capital formation, which characterizes a young economy, the completion of the process of absorbing immigration from the beginning of the 1990s, a further fall in the balance of migration to Israel in recent years and the drop in the share of capital intensive industries. This trend came to a halt in recent years, and the rate of investment (excluding inventory fluctuations) stabilized.

The improvement in the current account has continued for a decade and has been supported by long-term forces, but this year's high level of surplus is not sustainable.

These developments in savings and investment are reflected in the trend of the current account in the past decade and its exceptional surplus this year. The improving trend in this account in the past decade expresses a downward trend in the investment rate and fluctuations in the national savings rate with no clear trend (Figure 2.4). In the past three years the improving trend in the current account has continued, though its source was the stability in the investment rate while the national savings rate rose. Apart from this trend, this year registered a random fall in inventories and an unsustainable increase in the savings rate. Therefore, though the long-term forces act to improve the current account, and the economy may maintain a surplus in this account for some time to come, the high level of the surplus this year is not sustainable. The forces that will put downward pressure on the surplus, as well as other forces that have pushed to expand it, are discussed in section 5 below.

3. FISCAL POLICY

The government deficit totaled 0.9 percent of GDP; the public debt to GDP ratio fell sharply to about 88 percent.

The government deficit totaled 0.9 percent of GDP this year, considerably lower than the ceiling of 3 percent of GDP, and the deficit in 2005 of 1.9 percent. In so doing, the government has kept within its deficit ceiling for three consecutive years. It has also kept to its expenditure target.[2] The (gross) public debt to GDP ratio also fell sharply by 9 percentage points, further to a more modest fall in the previous two years, and totaled 88 percent, a particularly low level when viewed over time, and similar to the level in 2000.[3]

The sharp drop in deficit and debt expresses in addition to fiscal discipline, favorable circumstances and one-time factors.

The rapid drop in both deficit and debt this year is all the more outstanding when taking into account that it was achieved despite the cost of the fighting in the north, and an additional reduction in tax rates. However, the fall expresses, in addition to the government's strong commitment to fiscal discipline, particularly favorable circumstances, one-time factors, not fully accounting for war costs, as well as problems in managing the budget (underspending in civilian ministries). The fall in deficit reflects the rapid economic growth, and one-time tax revenues, as well as developments in government expenditure: about half of the reduction in deficit this year stemmed from a continued drop in public expenditure as a proportion of GDP. The government also reduced the effect of the war on the budget framework this year, as detailed below. Contributing to the reduction in the public debt to GDP ratio were the low deficit, the rapid growth, high proceeds from privatization, redemption of the public's debt to the government (mostly mortgages), the appreciation of the shekel and a lower rise in the consumer price index than that of output prices.

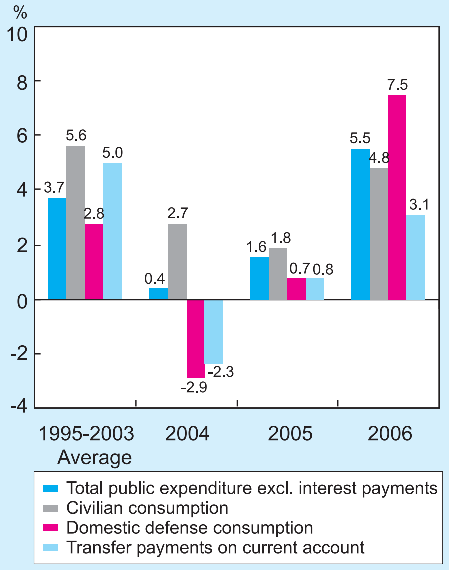
The reduction in debt is very important, though it raises the question regarding the correct balance between the rate of reduction and the need to meet defense and civilian needs.

The reduction in deficit and debt, particularly important in light of the high level of debt in Israel by international standards and the importance attached to it by the

[2] The expenditure target refers to an increase in public expenditure in the Budget Law on the previous year, and not in relation to actual expenditure. Certain expenditures on the Disengagement were excluded from the target, but the target was still reached even taking into account these expenditures. It should be noted that civilian compensation paid for war damages was not registered as an expenditure but as a loss of tax revenue.

[3] This year the method of calculating GDP in Israel was changed, in order to bring it into line with accepted definitions abroad. This change increases the GDP estimate, and therefore the level of various aggregates which are calculated relative to GDP, in each year, are lower than that reported in the past. The debt to GDP ratio according to the new method is lower by 4-5 percentage points than that published in the Bank of Israel Annual Report 2005, for each recent year.

Figure 1.3
Public Expenditure, Real Rates of Change, 1995–2006 (deflated by index of business-sector product prices)



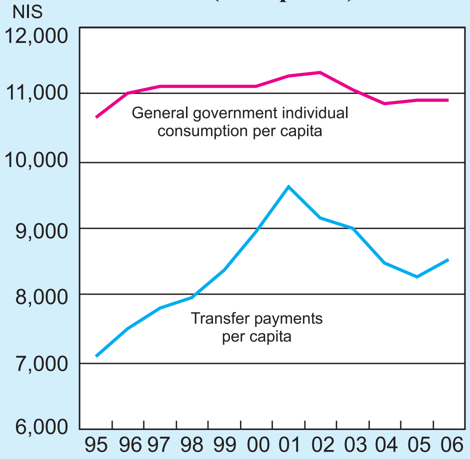
SOURCE: Based on Central Bureau of Statistics data.

markets, contributed to the affirmation of fiscal credibility and supported several important developments which continued this year: the drop in the economy's risk premium and its rates of interest, the Bank of Israel's ability to bring the interest rate gap with abroad to an unprecedented negative level, and the maintenance of stability in the capital markets despite significant shocks. The drop in debt—local government borrowing was negative this year—also frees up resources to the private sector and encourages significant processes in the capital market, among them a rise in the importance of institutional investors in financing the business sector through corporate bonds, and changes in the composition of the public's asset portfolio. The reduction in debt also supports important changes in its management—the reduction in indexation and the extension of maturities—as well as in its trade. (See section 7 below, and for further discussion, Chapters 4 and 6). Despite the great importance of reducing the debt, a question arises concerning the correct balance between the pace of debt reduction and the need to meet defense and civilian needs, including ensuring a decent level of public services and reducing social inequalities. Some answer to this was given in the government decision in mid-2006 to raise the public expenditure growth target to 1.7 percent from 2007 and to set a deficit target of 1 percent of GDP in 2009. However, the particularly rapid drop in debt on the one hand and the rise in defense spending following the war on the other makes the question all the more demanding.

Public expenditure as a share of GDP reached its lowest level since the late 1960s; it now stands at a rate prevalent in developed countries.

The share of public expenditure in GDP fell this year, for the fourth consecutive year, and reached its lowest level since the 1960s, a rate similar to that prevalant in developed countries. In the past two years spending on interest payments has fallen following the reduction in debt and the fall in interest rates, while the growth in both civilian and defense public expenditure has accelerated. The acceleration this year stemmed primarily from the war effect, and defense spending as a share of GDP rose after having fallen consistently in the preceding three years. The government greatly reduced the effect of the expenditure on the fighting on the budget framework for this year, by cutting expenditure on non-defense spending as well as by deferring a considerable part of the additional spending onto the budgets of 2007-2008. Underspending by the civilian ministries helped this year to finance the defense spending, although

Figure 1.4
Transfer Payments and General Government Individual Consumption per Capita, 1995–2006 (2005 prices)



SOURCE: Based on Central Bureau of Statistics data.

repeatedly underspending is a problem in terms of budget management and fulfilling the priorities within it.

Steps that the government has taken in recent years—strict fiscal realignments in 2003 and the "From welfare to work" policy—have been expressed in sharp cutbacks in transfer payments and a more modest cutback in the level of services supplied by the public sector. In 2005 a change in this trend became apparent and became more so this year: after four years of erosion in per capita transfer payments, this year they grew. Per capita civilian public expenditure also grew after falling or remaining unchanged in previous years.

Tax revenues as a proportion of GDP rose this year thanks to the rapid growth and one-time deals.

Tax revenues as a proportion of GDP rose this year, despite a reduction in tax rates, thanks to the rapid growth and one-time deals (foremost of which was the sale of Iscar) which brought in heavy tax payments. The increase in tax revenues while reducing tax rates, so that tax revenues as a share of GDP have almost not changed, has persisted since the economy emerged from recession in 2003. This demonstrates the effect of growth on tax revenues, principally through the increase in profitability of companies and the self-employed. The reduction in tax rates this year stemmed from the implementation of decisions taken in previous years, and the reduction of VAT, and the government avoided raising taxes in order to finance the war. The significant reduction in tax rates in recent years has brought down the burden of taxation, and particularly the rate of tax on labor, to the average rate in developed countries. (For a discussion on the reduction of corporate taxes in Israel in international comparisons, see Box 2 in Chapter 6).

4. THE LABOR MARKET

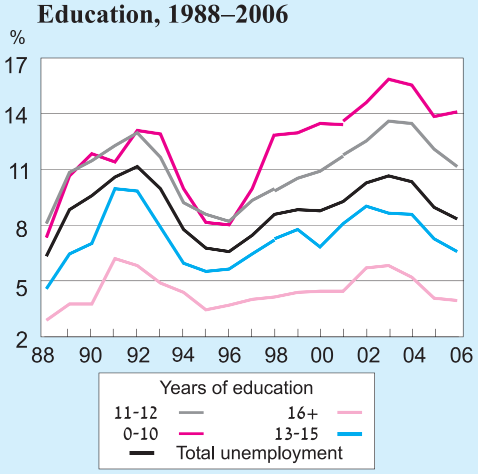
The unemployment rate fell to 8.4 percent.

Improvement in the labor market continued this year: the unemployment rate fell to 8.4 percent (annual average), while both employment and wages rose. The strength of the improvement could be seen in the fall in unemployment to its lowest level since 2000, which itself was a record in the previous boom period. Hence it appears that the improvement reflects forces beyond the cyclical recovery.

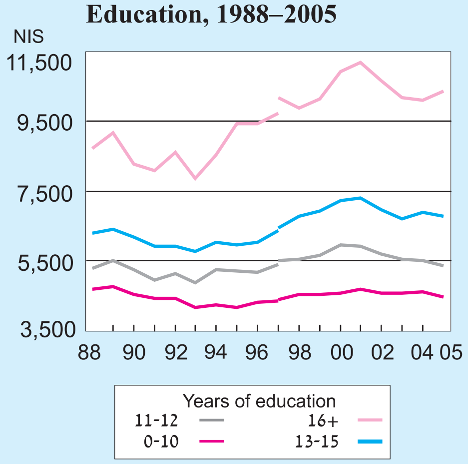
The improvement in the labor market this year reflects an increase in the demand for labor and in the supply of labor. The rise in demand was the more significant, as

Figure 1.5

a. Unemployment Rate, by Years of Education, 1988–2006



b. Real Wages[a] by Years of Education, 1988–2005



[a] 2005 prices.

SOURCE: Based on Central Bureau of Statistics data.

unemployment fell despite an increase in the participation rate, and this teaches us that apart from the rise in productivity and utilization, there was also an expansion in factors of production. The increase in labor supply supported the moderate increase in wages relative to the growth in productivity, as expressed in the fall in unit labor costs.

Several factors acted to increase the supply of labor.

The increase in supply of labor stems partly from long-term trends, including the continual rise in women's participation rate and a rise in the share of those with high levels of education in the workforce. Apart from the long-term trends, the increase in labor supply may also stem from government policies that encourage going out to work: cutting child allowances (for the effect of this on going to work, see Box 2 in Chapter 5) and income supplements, and a tightening of the eligibility criteria for unemployment benefits. The rise in men's participation rate has continued since the economic recovery began, a period that overlaps the changes in policy, and so it is hard to relate this increase to these changes, although the fact that this year the rate reached its highest level in a decade, in contrast to the long-term trend of its decline, could indicate that the said changes did have some effect. The increase this year in the participation rate of those with low levels of education (9-12 years of schooling), while among the more educated it remained almost unchanged, points to the same conclusion. The gradual raising of the retirement age also acts to increase the supply of labor, albeit slowly. Despite these developments, the employment and participation rates in Israel are low relative to developed countries.

The composition of growth in the economy this year was also reflected in labor market developments: growth in employment in the business sector, which led the growth, was higher than in the public services. The rapid increase in the number of employees in the R&D and information technology industries expresses the accelerated development of exports in the high-tech service industries. Expansion of employment in commerce and services, as part of the trend of their increasing share of GDP, continued this year.

The unemployment rate among those with low levels of education remains high.

Economic growth reduced the unemployment rate both among less, and more educated workers. However, the unemployment rates among the less educated remained very high. Unemployment among those with high levels of education fell to a particularly low rate, which points to the development of significant supply constraints in those industries intensive in skilled workers, foremost of which are the high-tech export industries, though the effect of this constraint was not felt this year. An analysis of unemployment and real wages among various professional workers in manufacturing points to the development of supply constraints regarding professional workers. (See Table 2.11 in the section on manufacturing in Chapter 2).

The number of foreign workers increased this year, and the policy to reduce this number was loosened. Their presence hits Israeli unskilled workers particularly hard.

The number of foreign workers rose this year, and the policy for reducing their number was considerably loosened: the number of permits for legal workers rose, efforts to enforce the law on illegal workers and their employers were slack, and several proposals to raise the cost of employing legal workers were rejected. All of which was inconsistent with the government's declared policy to reduce the number of foreign workers and despite the damage associated with their employment: their presence hits the wages of Israeli unskilled workers as well as their chances of finding a job, and accentuates inequality in the economy. It is also contradicts the government's policy of integrating these Israelis into the labor force, and harms incentives to become more efficient and adopt new technologies, consequently affecting productivity and long-term growth.

5. THE BALANCE OF PAYMENTS

The surplus in the current account grew this year to an exceptionally high level.

This year there was a surplus of $6.8 billion in the current account, equivalent to 4.9 percent of GDP. This is the fourth consecutive year of a surplus in the current account, and this year the surplus was almost double that of last year, hitting an exceptional level when viewed both historically and by international comparison. The surplus was exceptional also in its timing and persistency: the increase in surplus in recent years occurred while the economy grew rapidly, in contrast to earlier experience; periods of rapid growth in the past have been characterized by an increasing current account deficit, while a surplus in the current account was registered only during recession years and after the Economic Stabilization Plan (1985), and did not last more than two consecutive years.

It was a combination of long-run processes and short-term forces that created such a large surplus in the current account this year. The combination, in terms of developments of savings and investment, has been discussed above. The structural changes in the capital market in recent years focused on lifting restrictions on the export of capital, thereby encouraging Israelis to invest abroad, and supported the economy's ability to translate the widening gap between savings and demand for local investment into a net export of capital.

a. The current account

The improvement in the current account this year was apparent in all its components: the goods and services account, the income account and in current transfers. The cyclical forces that contributed to the improvement this year were partly external to the economy, increasing exports and improving the income account, and partly domestic forces, contributing to a slowdown in imports.

The high level of the surplus in the current account is not sustainable.

The increase in the current account surplus and its high level this year raise the question over how long it can continue. As mentioned earlier, long-term factors are operating in the economy improving the current account, and there is no reason for the surplus in the current account not to continue for some time yet, just as there was a deficit for many decades and the country accumulated large net liabilities vis-à-vis abroad. However this large surplus is not sustainable for several reasons: a) part of the improvement in recent years, and particularly this year, stems from temporary factors, either in direction or at least in their size; b) the existence of a large surplus is itself expected to put downward pressure on the surplus, through the real appreciation of the currency. GDP growth led by demand is also expected to create such a pressure. Though during 2006 there was a real appreciation that began in the second quarter, it is still too early to declare that this is the start of a balancing act, as in the previous two years there was no real appreciation of the shekel despite a surplus in the current account, and the level of the real exchange rate remained largely depreciated in a long-term view. Taking the annual average, there was no real change in the exchange rate in 2006 compared to the previous year; c) by international comparison, Israel's surplus in the current account this year was exceptional, particularly when taking into account the surplus in liabilities vis-à-vis abroad. (For more details see Chapter 7).

The goods and services account registered a surplus this year.

This year saw a surplus in the goods and services account, for the third consecutive year. The improvement in this account explains one third of the growth in the current account surplus this year, as exports led growth in the economy. The improvement reflects rapid growth in exports, influenced by factors external to the economy, and a slow rise in imports affected by domestic factors. The growth in exports rests principally on the expansion of global demand, with the contribution of the depreciated real exchange rate only a secondary factor. However the depreciated exchange rate did contribute to a slowing down in imports. The improvement in the goods and services account this year occurred despite the further deterioration in the terms of trade, due to a rise in fuel prices worldwide.

The pace of growth in exports of goods and services (excluding diamonds) was higher than in 2005, and also higher than the growth in GDP. This year, in contrast to the previous one, the rapid growth in manufacturing exports stood out, while exports of services slowed down, due to the impact of the war in the north on tourism. Tourism declined this year.[4]

[4] For an analysis of the impact on tourism see Box 2 in Chapter 2, and also *Recent Economic Developments*, No. 116, Bank of Israel, February 2007.

The economy's specialization in high-tech industries has a range of implications.

High-tech exports, both manufactured goods and high-tech services, led the expansion in exports this year, further to the trend of recent years. This reflects both the long-run trend of the economy's increasing specialization in human capital intensive industries as well as the world boom in high-tech industries in recent years. The Israeli economy has benefited from specializing in industries where world demand has developed particularly fast[5] and is reaping the fruits from this. Apart from its significant contribution to growth, this specialization has many additional implications, among them: a) it increases relative demand for educated workers, and therefore contributes to increasing the wage gap between them and those with low levels of education; b) technological exports—in particular in the services industries—are less intensive in their use of raw materials and physical capital, so their proportionate rise acts to moderate the import of raw materials and investment assets and to reduce physical investment in the principal industries; and c) alongside exploiting the economy's comparative advantages, increasing specialization in the high-tech industries involves a reduction in the diversification of risk, and the economy's sensitivity to any impact on exports of these industries increases. However, two characteristics of technology exports help to moderate this risk: these exports are not of a single industry, but are made up of a range of sub-industries, and they are also intensive in skilled workers whose ability to move from one industry to another is relatively high. The risks associated with high-tech exports though could come from two factors in the global markets: demand and competition. The effect of the global crisis on high-tech industries in the Israeli economy at the start of the decade demonstrated the impact of a drop in world demand. A long-term analysis also shows that the ICT industry is highly cyclical compared to both global and domestic business cycles, though it contains many sub-industries both in manufacturing and services (Box 5 in Chapter 2). The entry of developing countries into these industries could pose tough competition for Israeli exporters. The impact on exports of electronic communications equipment at the start of the decade demonstrates the possible effect of competition from these countries and the speed with which this process could happen.[6]

The rate of growth in imports of goods and services (excluding diamonds) was this year similar to growth in GDP, mainly due to the depreciated level of the real exchange rate, which makes imports more expensive. The effect on the output gap was modest, as the high price of imports was expressed in restraining overall demand, and not in increasing the demand for import substitutes. The effect of the exchange rate stood out in the slow increase in imports of durable consumer goods, although contributing to this was also the expectation of a lowering of the purchase tax on vehicles and the change in the price thresholds between vehicle licensing groups.

[5] For example, the information technology industry, which includes several high-tech industries, as a share of business-sector product is far higher than in developed countries (Box 5 in Chapter 2).

[6] The impact of competition from the developing countries on the electronic communications equipment industry is discussed in the chapter on manufacturing in the Bank of Israel Annual Reports of 2003 and 2004.

The fall in the income account deficit has continued for several years and expresses two factors: one is the fall in net liabilities abroad, as a result of a net export of capital in recent years; and the second is a rise in the interest rates abroad this year, which increased income for Israel, being a net asset holder of debt instruments.

b. The financial account

Two features that characterize the financial account in recent years are the significant rise in residents' investment flows abroad and nonresidents' investment flows into Israel, and the transformation of the Israeli economy into a net capital exporter. The increase in investment flows in both directions, which reached unprecedented levels[7] this year, expresses the increasing integration of the economy into the global economy, as a result of both global processes and domestic developments. The transformation of the economy into a net exporter of capital—its net capital export totaled some $7.6 billion this year—is a mirror image of the creation of surpluses in the current account.

Israelis' investments abroad continued to increase this year.

The increase in residents' investment abroad expresses the continuing adjustment in the public's asset portfolio to structural changes which reduced the restrictions on capital exports in recent years (such as the change in investment rules for institutional investors), as well as the response to the equalization of taxation on income from investment abroad. The reduction of government borrowing locally and the drop in the interest rate gap with abroad also acted to increase the outflow of capital. Israelis' investments abroad (excluding the Teva transaction) concentrated this year too on debt instruments, a comparatively safe asset, and is all the more prominent against a background of the sale of equity instruments to nonresidents. This emphasizes the insurance aspect of Israelis' investment abroad, and is expected to carry with it a stabilizing influence on the economy, as it should ensure a relatively stable flow of income during times of shocks. Nevertheless, the increased investment in equity instruments (shares) abroad was also noticeable this year.

Nonresidents' investment in Israel grew too.

The continued rise in nonresidents' investment in Israel, which focuses on equity instruments, reflects the improved condition of the economy—as expressed, *inter alia*, in the lower risk premium—the availability of global capital seeking investment opportunities, alongside the global trends of mergers and acquisitions, and the success of Israeli companies that have attracted foreign investors. Nonresidents have increased their involvement in the government bond market, influenced, *inter alia*, by the market maker reform. The high level of foreign investment in Israel continued toward the end of the year too, despite the hostilities in the north. There was also a prominent growth in direct investment this year, which focused on export-oriented companies.

Nonresidents' direct investment makes an important contribution to the economy, although one must consider all its features and implications. The importance lies in its

[7] Two very large transactions—the Israeli company Teva's investment overseas and a foreign company's investment in Israel (through the acquisition of Iscar)—considerably increased these flows.

One should consider all the implications of foreign direct investment in Israel.

being an important source of funding for the economy; that it is likely to contribute to growth directly through capital accumulation and indirectly through the transfer of know-how and technology and through utilizing economies of scale of the acquiring multinational companies; that it enjoys a relatively long-term investment outlook and is therefore less sensitive to shocks; and that it allows the economy to share some of its risks with nonresidents, which becomes increasingly important against the background of risks associated with the economy's increasing specialization in advanced industries. However, to estimate the contribution of this investment, one must also look at the following aspects: a) not all direct investment contributes to capital accumulation in the economy; part of it is simply the transfer of ownership of existing capital. The proportion of that investment directly contributing to the accumulation of capital out of total foreign direct investment has grown since the beginning of the decade, but fallen in the past two years; b) a large part of direct investment is concentrated in export-oriented industries. Alongside the advantages associated with this, there is also a danger that unique know-how accumulated in Israel, and on which much of the success of this export has been built, will be transferred abroad before the Israeli economy has reaped its benefits to the full; and c) some of the direct investment in Israel enjoys generous government aid in the form of investment grants or tax breaks. Since this investment could, as mentioned, conceal disadvantages to the economy, it would be preferable not to offer too many incentives and to exercise a cautious approach in granting tax benefits. (For a fuller discussion on foreign direct investment and its implications see Chapter 7).

6. INFLATION AND MONETARY POLICY

a. Inflation

The CPI fell in 2006 by 0.1 percent.

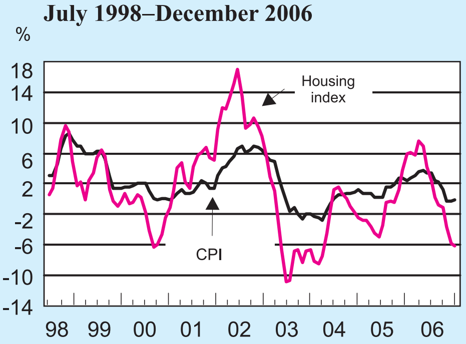
The CPI fell in 2006 by 0.1 percent, in other words inflation this year was significantly below the lower boundary of the target. During the year the inflation rate changed considerably; for most of the first half, inflation reached higher than the upper boundary of the target, in the third quarter, it was within the target range while in the fourth quarter, it fell to below the lower boundary. To understand the inflation developments of the year, one must examine three subjects: the exchange rate, the price of fuel and economic growth.

The changes in the exchange rate played a pivotal role in the turnaround in inflation developments during the year.

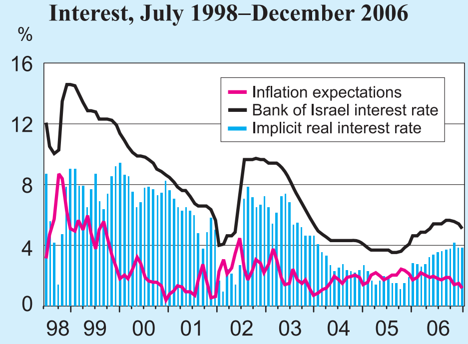
The changes in the exchange rate during the year played a pivotal role in the turnaround in inflation developments and in its low rate for the year. While at the beginning of the year the shekel depreciated, pushing up prices in the period, later on in the year the shekel appreciated significantly and continually against the dollar, mostly due to the dollar's weakness globally. This appreciation of the shekel had a decisive part in the fall in inflation in the second half of the year. The appreciation contributed both to the fall in prices of tradable goods and to the sharp drop in the housing price index, which has a weighting of more than 20 percent in the CPI.

Figure 1.6

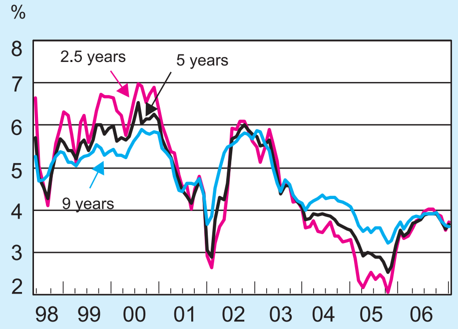
a. Rates of Change of Selected Price Indices in the Last 12 Months, July 1998–December 2006



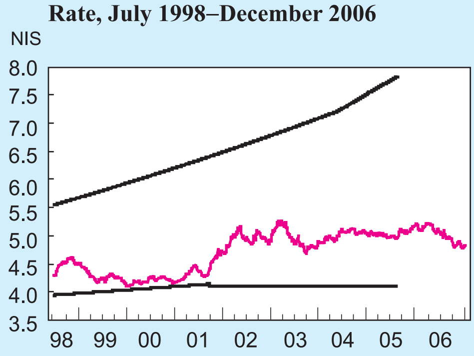
b. Bank of Israel Interest Rate, Inflation Expectations, and Implicit Real Interest, July 1998–December 2006



c. Real Indexed Interest Rates, July 1998–December 2006



d. NIS/Currency-Basket Exchange Rate, July 1998–December 2006



SOURCE: Based on Central Bureau of Statistics and Bank of Israel data.

The effect of fuel prices on the annual inflation rate was slight, but did contribute significantly in the turnaround in inflation developments during the year. In the beginning of the year, oil prices continued to rise globally, but later they fell sharply, contributing to the drop in inflation in the second half of the year.

The expansion of demand in the economy, which has continued now for more than three years, is expected to push prices up for as long as demand grows, although the pace of increase in demand was slower than that of GDP, which acted as a moderating force on the rise in local prices. The rapid response of output to the rise in demand also contributed to this, partly against a background of expansion of production capacity; productivity continued to increase this year, investment in the principal industries grew, and labor supply expanded relatively fast, which dampened the upward pressure on wages. Moreover, the expansion in domestic demand was directed largely to the commerce and services industries, which are intensive in unskilled workers whose rate of unemployment is still high, allowing an increase in employment without pushing up their wages. While upward pressure on prices from the demand side was moderate, the effect of demand this year on the indices excluding housing and energy, and on the local component of the CPI, could be seen in higher rises than in the general CPI (see Chapter 3), as well as in a steeper rise in GDP prices and in private consumption than in 2005.

b. Monetary policy

In terms of monetary policy, one can differentiate three periods during the year.

Monetary policy operates within an inflation-target regime to maintain price stability. The Bank of Israel exercises a flexible policy to achieve the target over time through the interest rate, while ensuring financial stability and taking into account real economic activity. In terms of monetary policy, one can differentiate three periods during the year. In the first months of the year, the process of raising the interest rate, which began at the end of the previous year, continued. This was due to inflation exceeding the upper boundary of the target range and against a background of the depreciation of the shekel at the beginning of the year, continued economic growth and rising interest rates in the US. With the return of inflation to within the target range, and both the shekel's depreciation and the rise in the interest rate in the US coming to a halt, so the interest rate in the economy also stopped rising. The outbreak of hostilities in the north created a fear of a rise in the economy's risk premium and of an impact on stability, and the Bank of Israel took the step of raising the interest rate. In practice, the markets remained stable and there was no need for any further rise in the interest rate. By the end of the year the Bank of Israel had begun cutting the interest rate consistently and significantly, by 1 percentage point in three months (including January 2007). This was against a background of an appreciating shekel and a fall in oil prices globally, and hence inflation falling sharply to negative levels at the end of the year. (For a full discussion on this see Chapter 3).

Seeing inflation significantly miss its target raises the question of whether monetary policy was both timely and in the correct measure.

Seeing inflation significantly miss its target raises the major question of whether the reaction of monetary policy in cutting the interest rate was both timely and in the correct measure. In this context, one must point out three things: the difference in nature of the forces pushing prices down and of monetary policy, the effect of the war and the interest rate gap with the US.

The fall in inflation in the second half of the year was due mainly to the weakening of the dollar and the drop in oil prices.

The change in the inflation path in the second half of the year was due mostly to two external forces: the weakening of the dollar globally, which translated into a sharp appreciation of the shekel against the dollar, and the fall in oil prices. The common thread between these two forces in this period was that they both developed very rapidly and they were difficult to forecast, that their persistence was uncertain, and that their effect on prices contrasts with some of the long-term factors. The difficulty of monetary policy in reacting quickly to changes of this nature—and hence to prevent temporary deviation below the inflation target—lies in the consideration of "smoothing the interest rate" (Box 1 in Chapter 3), which refers to moderate changes in the interest rate, *inter alia*, in order to maintain financial stability. This tendency toward smoothing interest rates leads to being more cautious when cutting the interest rate, the more uncertain the persistency of the forces that brought about the drop in prices; and this is to avoid a sharp rise in the interest rate if the forces should suddenly switch directions. The consideration of avoiding such a sharp interest rate cut in 2006 was doubly valid when taking into account long-term underlying factors that acted this year to raise prices, i.e. the continuing rapid growth. In any case, given the strength of these external factors this year, and taking into account monetary policy's delayed effect on inflation, a sharper reduction in the interest rate would apparently not have prevented the deviation from the target.

The Second Lebanon War contributed to a delay in beginning the process of lowering the interest rate. The process of raising the interest rate against a background of factors as described above, ended some months beforehand; during the hostilities, the interest rate was raised, as a precautionary measure, given the assessments at the time that the economy's risk premium would rise, and to ensure the markets' stability. In hindsight it appears, somewhat surprisingly, that the fighting had no real effect on the capital markets, and possibly the hike in the interest rate could have been avoided. Nevertheless, inflation would still have strayed from its target even without the rise in the interest rate, and the Bank of Israel's actual readiness to raise the interest rate given the situation may well have contributed to the stability of the markets.

At the end of the year, the Bank of Israel interest rate dropped below that of the US.

The process of lowering the interest rate at the end of the year brought the Bank of Israel interest rate to below that of the US. The contraction of the interest rate differential vis-à-vis the US has gone on for some time. In 2005, the gap reached a particularly low level, and the process of contraction halted, so that for most of 2006 the Bank of Israel interest rate was only slightly higher than that of the US. By the end of 2006 the reductions in the Bank of Israel interest rate created a growing negative gap between it and the US interest rate. Improved underlying conditions of the economy and its performance since emerging from the last recession, and macroeconomic policies, particularly that of maintaining fiscal discipline, all contributed to lowering the economy's risk premium, allowing the reduction of the interest rate gap with the US, though these factors alone are not enough to explain how Israel can maintain a nominal interest rate significantly lower than that of the US without harming stability. This ability is explained by the background of several factors: the pressure on the shekel to appreciate from the surplus in the capital account and the inflow of capital, and the fact that inflation in Israel is lower than in the US. Despite this, as the reductions in the interest rate in Israel at the end of the year meant that it would bring the rate to below the US interest rate, the Bank of Israel exercised extra caution—a generally gradual reduction of the interest rate while examining the markets' reaction to this unprecedented situation.

Monetary policy did not create forces for slowing down activity in the economy.

Monetary policy, designed to achieve target inflation, did not create forces for slowing down activity in the economy. In contrast to the previous two years, when policy was decidedly expansionary—the real rate of interest fell considerably then despite rapid growth—this year the real rate of interest rose to a higher level than in 2004. However, monetary policy this year could not be characterized as being tight: the rise in the real rate of interest this year was expected with the contraction of the output gap, and the short-term real rate of interest was lower than the long-term rate. The Bank of Israel's behavior testifies to a policy that was not directed at restraining activity: the minimal gap between the Bank of Israel interest rate and the interest rate abroad—and at the end of the year this was even negative—shows us that considering the Bank's room for maneuver, as viewed at various points of time throughout the year, the possibilities for reducing the interest rate were greatly diminished; though the rise in the interest rate in the beginning of the year came against a background of an acceleration in the inflation rate and its deviation from the upper boundary, as well as a rise in inflation expectations, the rises later on in the year were not intended to restrict activity but rather to maintain financial stability against a rising interest rate in the US; the interest rate rise in August was intended to maintain stability against a war background; the opening of a negative interest rate gap with the US at the end of the year and its expansion to an unprecedented level, while real interest rates fell, were designed to return inflation to within the target range, but in fact supported further economic expansion.

7. THE CAPITAL MARKETS AND THE FINANCIAL SYSTEM

The capital market was characterized by prosperity, stability and resilience to shocks.

In 2006 the capital market was characterized by prosperity, stability and resilience to shocks, while deepening the processes transforming the financial system in Israel. This year saw a continuation of the trends registered in previous years, and which were based on the improved background conditions as well as continued processes of the capital market adjusting to many structural changes that had been introduced. The boom was expressed, *inter alia*, in the further rise in share prices and volumes of trading, in the increase in capital raised by the business sector and in the increase in value of the public's asset portfolio. The stability stood out this year against a background of several shocks, foremost of which was the war in the north. The drop in the economy's risk premium indicates an improvement in its situation, and it supported the maintenance of stability in the financial markets despite the low interest rate gap. The resilience of the banks improved, though the resilience of the insurance companies fell despite continued growth in the economy.

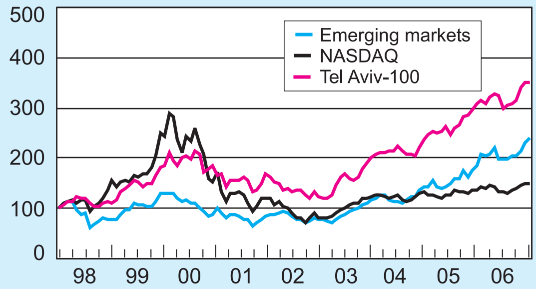
After several years of introducing many significant reforms to the capital markets, relatively few reforms were introduced in 2006. (For further details of this year's reforms see Chapter 4). However, the reforms implemented in previous years continued to affect fundamental changes this year occurring in the financial system, among them the fall of the banks' share of financial activity and the rising share of institutional investors, the increased investment by Israelis abroad and by foreigners in the local capital market, and the sophistication and deepening of the markets. These processes were expressed in the changes in the role, and in the functioning of the public debt in the capital market, in the structure of the public's asset portfolio and in the financing of the business sector.

Several processes that touch on the functioning of public debt in the capital market continued.

Concerning public debt a number of processes in the capital market continued and even intensified this year: a reduction in the amount of borrowing, structural changes in the debt and sophistication in debt trading. The continuing contraction of government involvement in the capital market frees up resources for the business sector and influences their composition, as well as bringing changes in the public's asset portfolio. The changes in the composition of public debt are expressed in the increased issue of unindexed bonds and in the lengthening of maturities, which reached unprecedented levels this year. This reflects the credibility of both fiscal policy and the price stability target. The share of designated bonds out of the total debt also continued to fall against a background of pension reform. Trading in government debt, and the sophistication and deepening of the market received a boost this year with the implementation of the market maker reform. (See Box 1 in Chapter 4). This was already making a contribution by the end of the year in increasing trading volumes in government debt and increasing nonresidents' participation in trading. The positive developments also contributed to a decline in bond yields this year relative to the end of 2005, though during the year these yields showed no small amount of volatility.

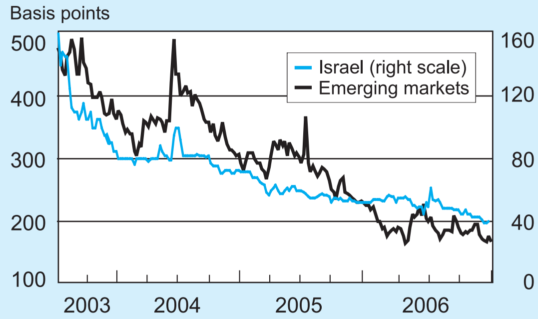
Figure 1.7

a. Share Index Developments in Israel and Abroad,[a] 1998–2006



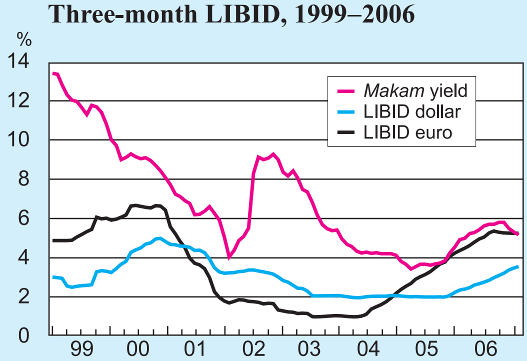
[a] Index of shares in emerging markets, Morgan Stanley.

b. Risk Premium, Israel[a] and the Emerging Markets,[b] May 2003 to December 2006



[a] Relative to the US on Israel government 10-year bonds.
[b] Index of emerging markets calculated by J.P. Morgan (excluding Argentina).

c. Yields on Three-month *Makams* and Three-month LIBID, 1999–2006

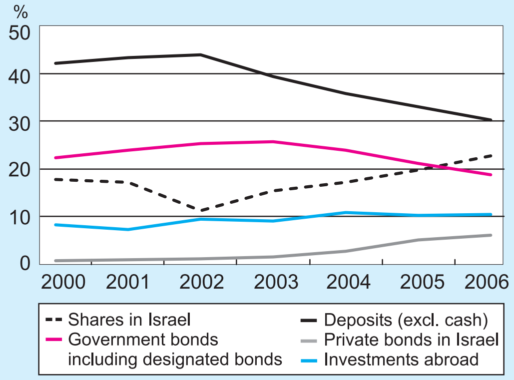


SOURCE: Bank of Israel calculations.

a. The public's asset portfolio

The rise in the value of the public's asset portfolio stemmed principally from the rise in share prices and was an expression of the booming capital market. The rise in share prices also significantly increased their weight in the portfolio. Several important changes have occurred in the characteristics of the

Figure 1.8
Components of Asset Portfolio,[a] 2000–2006



[a] Total assets include also *Makam* bonds, cash held by the public and other assets.

portfolio in recent years, in two aspects: its institutional structure and the asset composition. These changes stem from, among other things, the tax reform and changes in the investment regulations of institutional bodies, the pension reform and the reduction of public debt.

The banks' share in managing the asset portfolio continued to fall.

The most prominent change in recent years in the institutional structure of the asset portfolio, that is in the relative importance of those managing the assets, was the decline in the banks' share and the rise in that of the institutional investors. This process, feeding off various reforms, continued this year. Additionally, at the end of 2005 the banks sold provident and mutual funds to insurance companies and other parties with the implementation of the recommendations of the Bachar Committee. Two prominent developments this year in terms of the institutional structure were the considerable withdrawal from mutual funds—the reasons for which are not clear—and the negative accumulation in the provident funds, due to legislative changes made this year which reduce the attractiveness of these investments. The aim of the changes in provident fund legislation is to restrict the tax benefits on the savings until retirement age. However, this could harm incentives for medium-term saving, which may serve families as a source of financing for their children's higher education.

The changes in the portfolio composition included this year the further decline of non-tradable assets.

The changes in the portfolio composition (apart from the rise in the proportion of shares due to the rise in share prices) included this year the further decline of non-tradable assets (saving plans, bank deposits and designated bonds) and a rise in the share of tradable assets, as well as a fall in the share of government bonds and a rise in the share of assets issued by the business sector (shares and corporate bonds). These changes are particularly significant in terms of volatility in the portfolio value and the level of its risk, on one hand, and in terms of yield and risk diversification, on the other. The changes only partly reflect individuals' explicit decisions (such as moving from bank deposits to other channels), while a large part of the change in the asset portfolio's characteristics stems from investment decisions of institutional investors, such as pension and provident funds. This is most noticeable in the rise in the share component of the portfolio: households' activity in this market, whether directly or through mutual funds, is particularly small, and most of the growth in their share exposure came from institutional investors' policies. Nevertheless, in the past two years households have increased their exposure to shares directly through the considerable purchase of exchange-traded funds. (See Box 2 in Chapter 4). The share of assets abroad in the asset portfolio also continued to rise.

b. Sources of financing for the activity of the business sector

The large amount of funds raised by the business sector was maintained in 2006. This level was supported by positive background conditions, the accelerated growth combined with expectations that it would continue, the low level of real interest rate, the reduction in government borrowing and the increased participation of foreign investors.

Changes in the composition of sources of financing for the business sector continued; the issue of corporate bonds increased greatly.

In terms of the composition of sources of financing for the business sector, 2006 was also characterized by a firming of the processes that have continued for several years and which stem from structural changes in the capital market, from the reduced level of government borrowing and the increased involvement of foreigners. The structural changes caused the banks to lose share in the financing of the business sector and the institutional investors to gain, while improving the range of sources of financing for the business sector, enhancing the sophistication of the credit market and increasing competition therein. The process was supported by changes in institutionals' investment regulations, allowing them to buy business sector assets, and by the decline in government borrowing in general and the issue of designated bonds in particular, which prompted these investors to seek alternative investment assets. The result was a considerable issue of corporate bonds, which serve the business sector as an alternative to bank credit and the institutional investors as an alternative to government bonds. Though shares could also serve as such an alternative to both parties, most capital raised this year, as in the previous three years, was through bonds.

c. The stability of the financial system

The resilience of the banking system continued to improve, but the resilience of the insurance companies fell.

The banking system's resilience continued this year, against a background of a favorable macroeconomic environment: capital adequacy ratios and credit risk improved slightly. However, capital adequacy in the Israeli banking system is lower than in the developed countries, and credit risk indices are relatively higher than in the years prior to the recession. The resilience of insurance companies declined this year, despite the improved macroeconomic environment, and the resilience of provident funds registered only a slight improvement.

Insurance companies require increased supervision.

The structural changes in the financial system of recent years are expected to strengthen financial stability in the long term. Their contribution has already found expression in several developments, among them the increased credit diversification among various institutions, particularly following the fall in the banks' share of total credit. However these processes created new risks and changes in the relative importance of various players in the capital market, which call for an adjustment of the supervision and regulatory systems. Mostly, increased supervision of insurance companies is required, as their share of financing the business sector and managing the public's assets has greatly increased, after they bought a considerable share of the pension and mutual funds. This need is all the more prominent when taking into consideration the institutional investors' paucity of experience and know-how in managing credit risk, compared to the banking sector. Further steps required to strengthen the financial infrastructure are described in the next section, and are discussed in more detail in Chapter 4.

8. FUTURE TARGETS AND POLICY

The main objective of economic policy is to support sustainable growth. In order to do so, macroeconomic policy must maintain fiscal discipline, price stability and financial stability. In addition, there is a need to ensure the proper level of public services, and to pursue an ongoing policy to reduce poverty. A well-devised policy with regard to infrastructure and the enhancement of competition in the economy will contribute to growth and the quality of life.

a. Fiscal policy

The government must persevere in maintaining fiscal discipline.

The government must persevere in maintaining fiscal discipline over time. This will allow a significant reduction in the public debt to GDP ratio and a monetary policy which supports growth while maintaining price stability. Fiscal discipline is essential in maintaining the stability of financial markets, especially in an age of increasing openness in world capital markets that enables investors to quickly move to alternative markets when they sense a reduction in credibility and an increase in risk to their investments in the economy.

It is important to reduce the public debt/GDP ratio.

In recent years, the government has determined a series of long-term targets and has implemented a number of reforms which essentially define a long-run macroeconomic policy that is consistent with the main requirements for the support of enduring growth. Starting in 2005, the government has been working within the limits of a double long-term target: the ceiling on the deficit and the limit on the annual growth of expenditure. Meeting deficit and expenditure targets will enable a significant reduction in the debt to GDP ratio if growth in the economy continues. (For a long-term analysis, see Chapter 6). Taking into consideration its high level in Israel, a downward path for the debt ratio is essential. This reduction will also lower the government's interest rate expenses and will release budgetary resources for other uses. It should be mentioned that the international credit rating companies regard debt reduction as highly important. The government should also endeavor to achieve a downward path for the deficit itself and in this vein, the government's decision this year to set a target deficit of 1 percent of GDP for 2009 is consistent with this path.

The reduction of debt is highly important, and it is right to take advantage of the increased revenues from taxes in the good years and the receipts from privatization to reduce the debt rapidly, as has been done in recent years. However a question arises regarding the correct balance between the pace of debt reduction and various needs, including ensuring a suitable level of public services and reducing social gaps. Some answer to this was given in the government's mid-year decision to raise the ceiling for annual growth in expenditure to 1.7 percent. The sharp drop in debt on the one hand and the increase in defense spending following the war on the other, as became clear during the year, serve to highlight this question.

Policies face considerable challenges in the field of public expenditure.

Government spending as a share of GDP has fallen in recent years, and its level this year was the lowest since the 1960s, bringing Israel's expenditure as a share of GDP to a similar level to that found in the developed countries despite the high proportion spent on defense and interest payments. However policy is up against serious challenges in this field: a sizeable part of the restraint in expenditure in recent years was achieved through sharp cutbacks in National Insurance benefits. Though the cutbacks were part of a "From Welfare to Work" policy they were to the detriment of weaker segments of the population in the short term. It appears therefore that the potential for restraining public expenditure through cutting welfare allowances has been exhausted. The challenges have become sharper this year following the war in the north, as defense spending will grow to more than was expected: a considerable part of the additional defense budget due to the war expenses has been postponed to 2007-2008, and the possibility of further increases to the defense budget in the coming years is also being explored. These developments stress the need to declare the order of priority in the national budget between defense spending and civilian needs,[8] further to the declaration on the size of the expenditure in general and the desired pace of reducing the deficit and the debt. The government should ensure that the restriction on expenditure will not lead to circumventing the restriction through the increased use of tax exemptions. In this context one must refer to tax exemptions as expenditure when examining the cost of various programs such as the tax exemption path in the Encouragement of Capital Investments Law.

Alongside setting an order of priority, it is also important to act consistently to improve efficiency in the various expenditure components and to examine the efficiency of various programs. This annual report examines a number of such issues, for example Box 3 in Chapter 2 expresses doubt concerning the efficiency of the Encouragement of Capital Investments Law in its present form. Also, updating the basket of health services is not based on a structured cost-benefit examination, but rather only on an examination of the medical contribution of each medication. It is recommended to carry out a systematic economic cost-benefit analysis as a condition for adding any new technology to the basket. It should be mentioned that the arrangements for patients' partial payments toward their medications and the adoption of technologies that reduce treatment costs, create reserves in the health basket budget which are available for use by the health maintenance organizations (Chapter 8).

In recent years, the civilian spending by government ministries has been less than that budgeted. In 2005, this under-spending helped reduce the deficit, while this year it was used to finance the increase in defense spending due to the war, while keeping to the original budget. However repeated under-spending harms the efficiency of

[8] The multiyear analysis in Chapter 6 details such a calculation making certain assumptions regarding the defense budget and other variables.

government activities and the realization of the order of priority set in the budget. To improve budget management and transparency it is recommended that reserve items from all government ministries be centralized, that the "blanket cutbacks" which essentially ignore any order of priority be avoided, and that the cumbersomeness of transferring money from one budget item to another also be reduced. (See the full discussion on the government budget in Chapter 6).

The tax burden in Israel is similar to the average of the developed countries. The government should avoid cutting taxes beyond the current planned path.

A carefully considered reduction in tax rates contributes to growth, to the competitiveness of the economy and even to fiscal credibility if it is an indicator of the government's intention to restrain expenditure. Tax rates were significantly lowered in recent years and this year the reduction continued in line with a long-term plan which is being gradually implemented up to 2010. Currently, the tax burden in Israel is similar to the average of the developed countries and even slightly below. Therefore, tax receipts in the coming years should be used to continue reducing the debt to GDP ratio rather than reducing the tax rates beyond that outlined in the current plan.

b. Monetary policy

Macroeconomic policy to maintain price stability also operates within a framework of targets set by the government. Thus, monetary policy is assigned to maintaining the rate of inflation within the range of 1–3 percent. This year that target was not achieved, and inflation was significantly lower than that. At the end of the year, the Bank of Israel lowered the interest rate several times, creating an unprecedented negative interest rate gap with interest rates abroad. This ability to maintain such a gap without harming stability was made possible against a background of fiscal discipline, the reduction in Israel's risk premium, and price stability which has been maintained in recent years. The continued observance of fiscal discipline will assist the Bank of Israel in achieving the inflation target while supporting the level of activity in the economy.

It is important to complete the enactment of a new Bank of Israel Law.

As in other countries which have recently updated their laws regarding the activity of the central bank, it is important to complete the enactment of a new Bank of Israel Law. The new legislation should ensure the independence of the central bank and will clearly define its goals. The main goal should be defined as maintaining price stability in accordance with the target set by the government while supporting other objectives—including growth and employment—without compromising price stability and the proper functioning of the financial system. The Bank will be given full independence in employing the instruments necessary to achieve its goals. A monetary committee should be established, which will make decisions in the area of monetary policy. The committee, to be headed by the Governor of the Bank of Israel, will also include members from outside the Bank, suitably qualified and free of any conflict of interest.

c. The financial infrastructure

The many changes carried out in the financial infrastructure in recent years are expected to increase the resilience of the financial system in the long run, once its new structure has taken form. However there are still a number of steps required to strengthen the financial infrastructure:

Supervision of non-bank financial institutions, particularly of insurance companies, should be stepped up.

- Supervision of non-bank financial institutions, particularly of insurance companies, should be stepped up, as should treatment of any existing conflicts of interest among them, against a background of their rising importance in financing the business sector and in managing the public's assets. It is particularly important to increase the independence of the supervisor of insurance companies and his powers of enforcement, and to institutionalize the cooperation between the various regulatory bodies.
- The infrastructure of the markets should be further developed, including: further advancement of the repo market, the operation of the intra-day clearing system (RTGS) in 2007, the adoption of international accounting standards in 2008, the implementation of Basel II for managing risks in the banking system, and the enhancement of competition between banks in the household sector.

d. The labor market and the reduction of poverty

The low employment rate and the low incomes of workers with low levels of education are central causes of poverty.

Both economic indices and broader measurements of human development show that in many ways Israel resembles developed countries, and in certain areas stands even at the forefront. (See Chapter 2). Output per worker in Israel is higher than the OECD average. Despite this, the average standard of living in Israel, as measured by per capita GDP, is lower than in the OECD countries, and the incidence of poverty has reached high levels in recent years, in international comparisons too. Israel's low participation rate in the workforce is one of the central reasons for this per capita GDP gap. This rate together with low incomes for workers with low levels of education are the pivotal factors behind the poverty levels. A policy that supports sustainable growth is essential to reduce the disparity in living standards with the Western nations and to reduce poverty, but growth alone will not solve this problem. A policy is therefore required that would focus on increasing the participation rate, the enhancement of the earning potential of those with low levels of education, and supporting the working poor with low earning abilities.

It is recommended that several steps be taken to encourage going to work and to increase the incomes of workers with particularly low pay.

The proposed steps below are designed to achieve these goals through the encouragement of going to work and the increase in incomes for the particularly-low salaried workers. They are consistent with the "From Welfare to Work" policy and they are particularly required in light of the sharp cutbacks in benefits in recent years. Some of these steps focus directly on those segments of the population with low participation rates in the workforce, and with particularly high poverty rates, that is the ultra-Orthodox and the Arabs. The proposed steps are (for further discussion see Chapter 8):

- **A significant reduction in the number of foreign workers**: This should be given top priority, as the grave implications of their presence is more than just worsening poverty, and because this step does not involve significant budgetary outlay. In the past two years there has been considerable laxity on this score, and the number of foreign workers this year increased. The large-scale presence of foreign workers harms Israeli unskilled workers and increases wage gaps and poverty. The laxity in reducing the numbers is contrary to declared government policy, and is inconsistent with the government's intention to encourage Israelis with a low level of education to seek employment. Reducing the number of foreign workers becomes all the more important, the more that global production of goods dependent on unskilled workers moves to countries where wages are lower. With the contraction of local production in these industries, the major employment alternative for unskilled Israelis is in those fields which cannot transfer abroad—such as construction, hotels and catering, and cleaning services––where many foreign workers are employed. The readiness of foreign workers to work at low wages also diminishes the incentive to adopt new technologies, and therefore harms productivity for example in the construction industry. An intensive policy should therefore be implemented to bring down the number of foreign workers considerably; to vigorously enforce the prohibition of illegally employing foreigners; to raise the rate of expulsion of such workers from Israel; to reduce the number of legal permits for foreign workers to be employed in various industries and to increase the cost of their employment; to stipulate that in public projects, particularly for large infrastructure projects planned for the coming years, foreign workers will not be employed, neither directly nor indirectly through subcontractors, and to strictly enforce this requirement.
- **Earned income tax credit**: (Alternatively, but not accurately known as "a negative income tax"): The aim is to reduce poverty among working families while encouraging entry into the labor market. The government decided (in February 2007) to introduce such a tax system, and it is important that the details of the plan are designed for optimal effect. Box 4 in Chapter 5 analyzes the effects of earned income tax credit and minimum wages on the working poor.
- **Increased enforcement of the labor laws:** Enforcement of all labor laws should be stepped up, in particular the Minimum Wage Law, for all workers (including foreigners) and for all manpower companies, while making the punishment more severe. It should be noted that the government decided in February 2007 to increase the budget for enforcing the labor laws.
- **Subsidizing the cost of going to work:** This subsidy should be increased, including increasing daycare cover and subsidized nurseries (in the vein of decisions already taken) and the lengthening of day activities for children; subsidizing public transport to low-waged workers and improving its supply in areas of high unemployment. It is important that the subsidy is not given through tax credits, to ensure that the lowest wage earners will also benefit.

- **An improvement in the Mehalev employment center plan, the employment service, vocational training and education completion courses for adults:** It is important to continue with the Mehalev ("From welfare to work") program though changes should be made to the incentives for those operating it, with a stress on the quality of the work placements. The employment service should also be improved and the program of vocational training, which has been cut back in recent years, should be expanded. Government expenditure in these areas (active policy in the labor market) is significantly lower than the norm in the developed countries. (See Chapter 5).
- **Unemployment benefit:** Conditions for being eligible for unemployment pay—period of entitlement, period of previous employment—should be eased, which would increase the ability of the jobless to find suitable employment. In recent years, the criteria for unemployment benefit have been tightened, and they are strict, by international comparisons too.
- **Encouragement of Capital Investments Law:** Changes in the law are required to improve its effectiveness in encouraging employment in the periphery. To do so, there should be a link between the level of benefit and the increase in employment, as well as taking into account the socioeconomic situation of the locality when setting national priority areas. The analysis in Box 3 in Chapter 2 shows that, in its current form, the law's contribution to improving employment in the periphery is very slight, and it is also struck by many other flaws. So, reducing the resources allocated to it should be considered (both through the grant route and that of tax breaks) along with redirecting the resources to alternative tools in encouraging employment in the outlying areas. Similarly, expanding the law's employment channel which came into effect in 2003, which includes awarding grants that depend on a company's payroll, should also be examined.
- **Development of employment areas close to unemployment hotspots:** It is recommended that business be helped to develop close to Arab and ultra-Orthodox populations, as well as other peripheral areas, in order to minimize the locals' dependence on the few factories there. This is all the more important as workers with low levels of education, older workers and women show a lower tendency to commute.[9]

Alongside these steps which focus on the labor market, poverty should also be reduced among those populations unaffected by this market, principally the elderly. To do so, it is important, among other things, to ensure a decent standard of allowance by linking it to the median wage, or to the cost of an essential basket of goods, and to concentrate long-term care benefit on those that need it most. To improve the situation of the elderly in the future, a compulsory pension program is recommended—in February 2007 the government decided to take this action—and to subsidize insurance premiums for those on the lowest salaries.

[9] Natalia Presman and Arie Arnon, (2006), *Commuting Patterns in Israel*, Discussion Paper No. 2006.04, Research Department, Bank of Israel.

Clearly the key to reducing poverty in the long run and preventing its being passed from generation to generation is the improvement in the education system, particularly for the weakest populations who cannot supplement what is provided by the public sector with private education, as the wealthier populations do. So there should be an additional improvement in the allocation of resources to elementary education for the benefit of those on low incomes. Furthermore, it is recommended that pre-compulsory education and the provision of hot meals to school children be extended.

e. Infrastructure

In infrastructure, efforts should be made not just to increase supply, but also to restrain demand.

An appropriate level of infrastructure is essential to the proper functioning and growth of the economy. In recent years, large amounts have been invested in the expansion of infrastructure and a number of reforms have been implemented to increase competition in its provision. In some of the infrastructure sectors, such as roads, electricity and water, there should be an effort to restrain demand and not just to increase supply, in order that users bear at least part of the cost of the negative externalities that they are causing. Experience teaches us that not all reforms have fulfilled their expectations, and conclusions should be drawn from this regarding further reforms.

Clear preference should be given to encouraging public transport.

In recent years, significant investments have been made in roads and additional investment in inter-urban highways has progressed as part of a long-term program. However, the expansion of the road infrastructure alone will not solve the problem of overcrowding, particularly at the entrance to the large cities, which are centers of employment, and within the cities, and it involves not insignificant externalities (air pollution, use of limited land resources, etc.). Furthermore international comparisons of road density (Chapter 2) show that Israel has improved in this respect in recent years, and today fares far better than is commonly thought. In contrast, development of public transport lags considerably far behind the European norm. Therefore, it is important to give unambiguous priority to encouraging public transportation; investment should be made in new infrastructure, the existing system (particularly buses) should be improved and its use should be encouraged, and distortionary tax treatment that encourages the use of cars should be abolished.

Investment in the railway infrastructure in recent years, as well as that planned for the coming years, is unprecedented: a long-term development plan for Israel Railways, onsite work in preparation for the Jerusalem light rail system, and progress in the Tel Aviv light rail project. It is important that government expenditure on establishing light rail systems be part of a long-term plan. Additional light rail[10] lines in Tel Aviv should be promoted, as the efficiency of this rail system is highly dependent on the existence of a network of lines.

Travel by bus should be encouraged, and the quality of service should be improved. Tenders for new operators of routes should concentrate on quality of service, and not on royalties to be paid to the state.

Buses are an integral part of the public transport network, even with an enhanced system of intercity rail links and a new light rail service. Other than establishing

[10] Or Bus Rapid Transit (BRT), i.e. high capacity bus systems, with segregated right of way and preferential treatment at intersections.

public transport lanes—investment in which has grown in recent years—additional steps should be taken to encourage bus travel, including the reduction in price and the improvement in service. The reform of bus service in which concessions for operating bus lines, which until now were under the control of Egged and Dan, are granted to other companies has made travel on those particular routes significantly cheaper, but has had almost no effect on the prices of other routes still managed by the veteran bus companies. The bulk of activity remains in the hands of these companies, and therefore there is still much to do in this field. On routes with a high volume of activity, competition among several operators is preferable to awarding a sole concession to a regulated monopoly, as has been demonstrated by the Tel Aviv-Be'er Sheva route. The tenders for choosing new operators currently focus on the level of royalties paid to the government.[11] This distortion, which is equivalent to a tax on users of public transportation, should be removed, and the tenders should focus on the quality of service. The government should neither shirk from subsidizing a concession if the need arises.

The distortion in the tax system that encourages the use of cars should be corrected.

The distortion in the tax system in calculating the value of company cars should be eliminated. (The government took such a decision in February 2007). This distortion encourages the use of cars, as the marginal cost of driving a company car is effectively zero. With the improvement in the public transportation system, the price of traveling by car during peak hours should be increased through an appropriate levy, the restriction of the supply of parking in city centers, etc., though this step should be taken carefully so as not to drive businesses out of the cities and to worsen the problem of urban sprawl.

In the performance of the ports, no significant improvement has been seen since the implementation of the reform, though it may still be too early to assess any effect. The changes—currently delayed—in port tariffs are intended to encourage competition between the ports. It is also important that the future development of the ports is transferred to a third party, and is not linked to the existing two port companies.

[11] In certain cases, the royalties to the government have been at the expense of service to passengers. For a detailed discussion, see the section on Transportation and Communication in Chapter 2.