Recent Economic Developments

119

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Part 1: Review of Recent Economic Developments, April to September 2007

Main developments

In the period reviewed—the second and third quarters of 2007—economic activity continued expanding. Developments in that period indicate that the economy was at an advanced stage of the growth cycle. This conclusion is supported by the contraction of the output gap, with a slowing of the rise in productivity and an increase in wages––and hence a rise in unit labor costs—and the creation of upward pressure on prices, mainly domestic prices. The economy has already shown a growth trend in the three years 2004–06, and according to initial National Accounts estimates, GDP is expected to rise again at a similar rate, 5.4 percent, in 2007.

All the components of the composite state-of-the-economy index rose in the period reviewed, although the pace slowed in the third quarter. Data in the Bank of Israel's Companies Survey also point to continued expansion in economic activity in 2007:Q3. According to companies' responses in the survey, activity increased in all the principal industries, and reflected the rise in domestic demand. Particularly noteworthy was the marked recovery in the construction and tourist industries in the third quarter, after a long period of modest increases.

The current account of the balance of payment showed an increase in the second quarter, due to further increases in all export categories. This constitutes an important part of the rise in GDP, which a characteristic feature of small open economies.

The gradual improvement in the labor market was maintained: in 2007:Q2 the participation rate and the employment rate both rose. The unemployment rate fell, indicating that the increase in the demand for workers exceeded the increase in supply, and this was expressed in an accelerated rise in the cost of labor. The improvement in the labor market was evident also among the low-educated in the population, whose participation rate went up steeply, reflecting the continued rise in the supply of labor, and showing that the economy has not yet reached its potential GDP.

Despite the sustained growth in the period reviewed, the cumulative rise in the CPI over the previous twelve months was only 1.4 percent; this was due to the fact that the CPI is strongly affected by the exchange rate of the shekel, and the latter showed a trend change in the period reviewed. Over the period as a whole the shekel appreciated against the dollar, offsetting the domestic inflationary pressures. The strengthening of the shekel derived from the current account surplus, and among other things, also the weakness of the dollar on the world markets resulting from the deficit in the US balance of payments, concern over the slowdown in US growth and the crisis in the US subprime mortgage market reactions to which were felt in many part of the US economy.

Against the background of the developments at the time, and to increase the chances of reaching the inflation target while preserving financial stability, the Bank of Israel cut its nominal interest rate in the first months of the period reviewed. Towards the end of the period, the interest rate was raised in the light of the rapid rate of growth, the persistent narrowing of the output gap, the rise in expectations of inflation in domestic prices and the depreciation of the shekel against the dollar. Once the shekel had appreciated again against the dollar, the interest rate announced in September (for October) was left unchanged, against the background of the reduction of the Federal Reserve interest rate that reduced the differential between the rate in Israel and that in the US.

Israel's capital market was also affected by the upheavals in the world's financial markets resulting from the subprime crisis, and underwent a trend change in the period reviewed. Overall, it showed that is was relatively robust, which can be attributed to Israel's general positive macroeconomic fundamentals. At the beginning of the period reviewed share prices continued along their upward path, but the positive trend reversed about mid-June, mainly because of the sharp drops in the capital markets in Europe and the US. At the end of August the downward trend eased, and share price increases were recorded, and at the end of the period new peaks were reached.

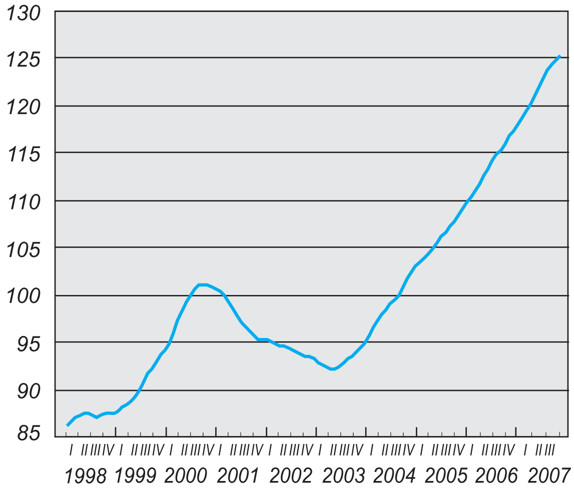
Part 2 of this publication gives a broader review of two subjects—the policy of subsidizing daycare centers and the multi-year budget.

Aggregate and by-industry real activity

National Accounts data confirm that the growth trend that started in the middle of 2003 continued in 2007:Q2. GDP rose at an annual rate of 5.2 percent, and business sector product grew by 5.9 percent. Both are rapid rates of growth,

Figure 1.1

Level of economic activity,* 1998-2007
(index: 2004 average=100)



* The composite index including the change in economic activity trend growth.
**To September 2007.

but slightly slower than that in the first quarter, because in that quarter some of the figures were exceptionally high––constituting a correction for the decline in activity in the Second Lebanon War. GDP growth in the second quarter reflects a marked increase in domestic uses (Table 1.1).

Private consumption increased in 2007:Q2, in particular consumption of durables, which surged by 24 percent (in annual terms). Data on the sales revenue of the commerce and services industries serve as a good indicator of private consumption. According to data of the Central Bureau of Statistics (CBS), the sales revenue of all the industries included in those groups continued rising (Table 1.2), with the rise in business services heading the list. Another indicator of private consumption is provided by sales of the chain stores, and these also point to a sustained steep rise in the period reviewed.

The rate of increase in fixed capital formation in 2007: Q2 was slower than that in the first quarter. This was due mainly to a decline in the rate of increase in investment in the principal industries from the first quarter to the second, and a fall in residential investment.

Gross domestic investment rose steeply in 2007:Q2 and took place against the background of the relatively low rate of real interest. Public consumption rose in the second quarter, after remaining level in the previous two quarters.

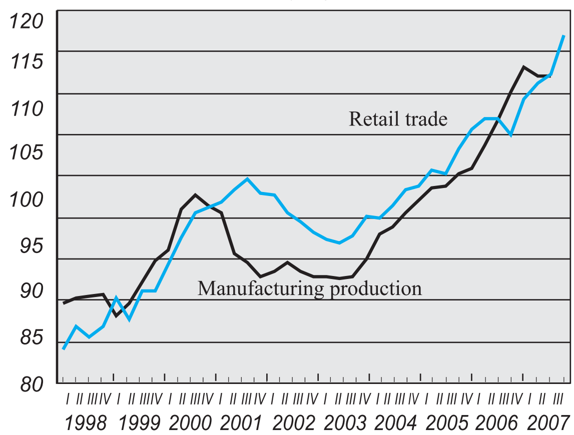
The preliminary National Accounts estimates for 2007 suggest a rapid rise of around 5.4 percent in GDP, a similar rate of growth to that in 2004–06. Business sector product is expected to increase by 6.2 percent, slightly below the rate in the last few years.

Economic indicators also show that the fast rate of expansion of economic activity was maintained. The composite state-of-the-economy index continued rising in the period reviewed (Table 1.2 and Figure 1.1), although it rose slightly slower in the third quarter. All components of the index rose: the goods and services imports and exports indices rose fast, and the rise in the index of manufacturing output (trend data) was also notable—at the end of the period reviewed it had reached its level of the end of 2006. All manufacturing industries posted increases, the most marked being the high-tech and medium-high-tech industries, resulting from increased investment and companies' higher rate of capital utilization (Figure 1.2).

Imports of goods and of services increased steeply in 2007:Q2. The rise in goods imports encompassed all its components—consumer goods, raw materials and capital goods. The rate of increase in exports of goods and services excluding diamonds, ships and planes rose sharply in the second quarter due to the surge in manufacturing exports that derived from the accelerated increase in exports of high-tech and medium-high-tech goods.

Figure 1.2

Manufacturing production* (index, average 2004=100) and large-scale retail trade** (index, average 2002=100), 1998-2007
(Seasonally adjusted)



* To August 2007.
** To September 2007.

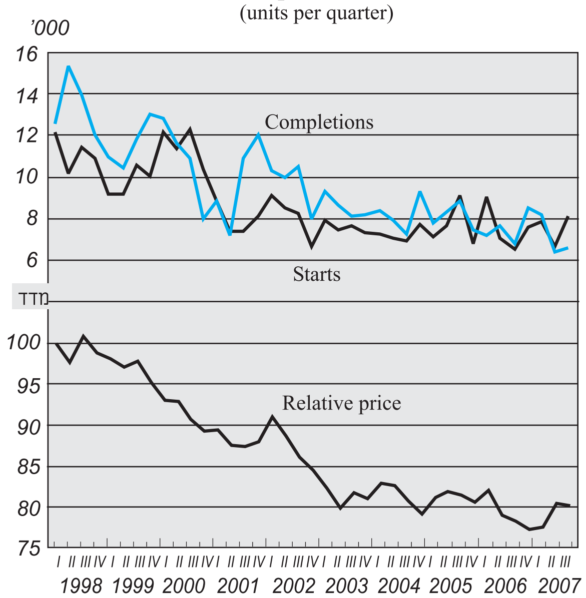
Figure 1.3

The hotel industry: monthly bed nights
of tourists and Israelis,* 1998-2007

* To September 2007. Seasonally adjusted.

Figure 1.4

Housing starts and completions,*
and relative price,** 1998-2007
(units per quarter)



* Original data, to July 2007. Third quarter 2007 extrapolated.
** Prices of owner-occupied dwellings relative to CPI.
To July 2007.

The Bank of Israel Companies Survey for 2007:Q3 shows that economic activity continued to expand. Companies reported that the steep rise in activity in all industries was continuing, reflecting the persistent increase in domestic and foreign demand. According to the survey, output and sales of the manufacturing industry—mainly domestic sales but export orders too—went up considerably. In the commerce industry sales rose faster than previously and companies expect this to continue in the next quarter. Companies in the business services industry reported on greater sales revenue from both domestic and export sales. Companies reported expectations of continued increases in activity in the next quarter.

The tourist industry has recovered from the Second Lebanon War in the summer of 2006, and from April 2007 tourist entries into Israel and tourist bed nights rose steeply (seasonally adjusted, Figure 1.3). Recovery in this industry is a slow process, but in the months under review activity reverted to its pre-war level (Table 1.2 and Figure 1.3). According to the Companies Survey for 2007:Q3, the tourist industry rallied strongly after a period of modest increases. The Survey also reports a steep decline in the constraints on tourism: both the demand constraint and the supply constraint were lower than their levels before the war. Companies in the hotel industry, on average, reported expectations of further increases, albeit smaller, in reservations.

The Companies Survey also indicated a noticeably faster increase in activity in the construction industry, following the gradual upward trend prevailing since the beginning of 2006. Expectations for the next quarter, however, were more moderate, apparently due to concern over increases in input prices. According to CBS data, the upward trend in the number of apartment sales evident since the beginning of the year continued in 2007:Q2, as did the decline in the stock of new apartments available for sale that started in 2006:Q2. This indicates a fall in the number of building starts and in the replenishment of stocks. Apartment prices rose in the period reviewed, despite the appreciation of the shekel against the dollar (Figure 1.4).

The labor market

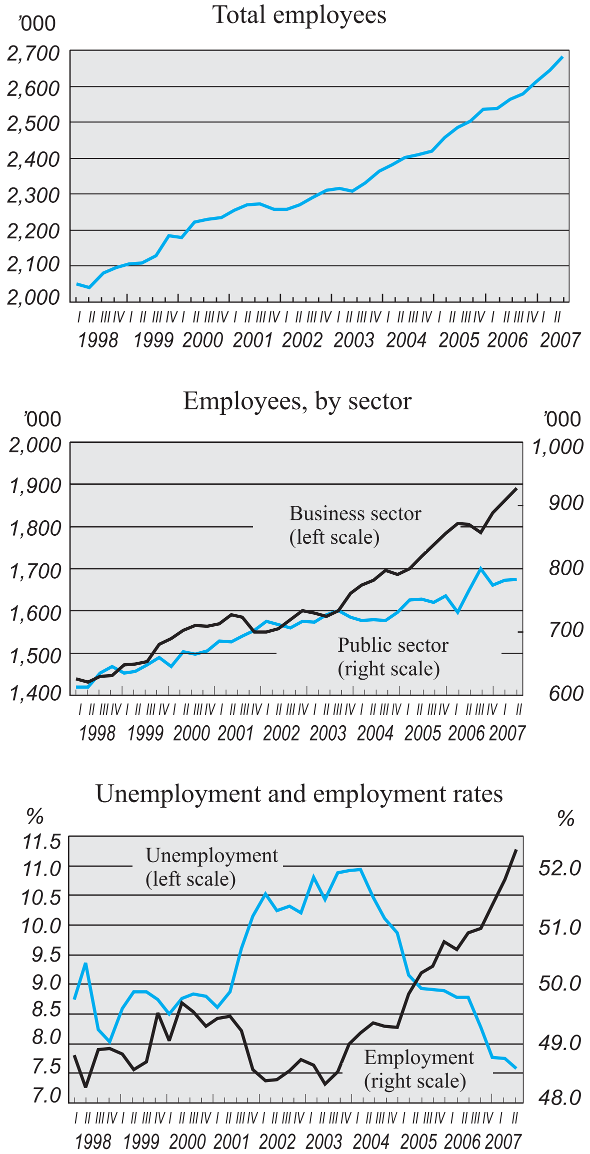
The economic growth in the first half of 2007 was reflected in the labor market. According to the CBS Manpower Survey, the unemployment rate fell slightly in the second quarter, to 7.6 percent,[1] continuing along the downward path that started at the beginning of 2004. This, despite the continued rise in the participation rate (Table 1.3 and Figure 1.5). The combination of these two—the drop in the unemployment rate and the rise in the participation rate—shows that the demand for labor increased faster than did the supply, an indication of continued economic growth. Despite the significant improvement in employment indicators in the last

[1] According to CBS trend data, the unemployment rate rose a little in July and August, to 7.8 percent.

Figure 1.5

The labor market, 1998-2007*

Total employees



* To June 2007. Seasonally adjusted.

few years—the participation rate reached 56.6 percent and the employment rate, 52.3 percent in 2007:Q2—the rates in Israel are still lower than those in the OECD countries, where the average rates in 2006 were 72.9 percent and 65.5 percent respectively. There are several reasons for the low participation rate in Israel, particularly among men; these include Israel's distinctive demographic features and the deterioration in the conditions offered by the labor market as opposed to the stability in unemployment and income support benefits.[2] Despite this, the economic growth trend and the rise in demand for labor was of some benefit to the low educated (those with 0–12 years of education): their unemployment rate fell in the second quarter, and their participation rate and employment rate rose.

The rise in the participation and employment rates reflects mainly the increase in the number of women in employment, while the number of work seekers remained steady. The number of employed men rose more slowly, and the number of work seekers actually fell a little.

About 90 percent of the increase in employment in the second quarter reflects the rise in workers in part-time employment, about 30 percent of whom would prefer to have full-time jobs.

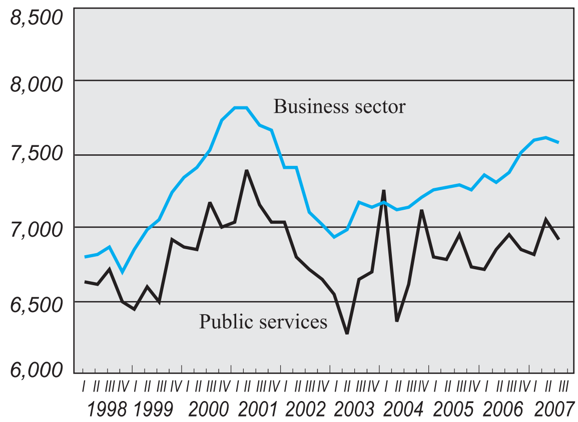
Most of the rise in employment in 2007:Q2 was in the business sector, but it differed from industry to industry: at the top of the list were the construction, business services, commerce and vehicle repair industries, while in the electricity and water industry the number of employees fell.

Labor costs rose markedly in the period reviewed. The average real wage per Israeli employee post continued upwards at a faster pace (Figure 1.6). In the second quarter and at the beginning of the third (April to June) the nominal wage continued rising at a rate similar to that in the previous quarter. As the average price level fell by about one percent

Figure 1.6

Real wage per employee post, 1998-2007*

(NIS, 2004 prices)



* To July 2007. Seasonally adjusted.

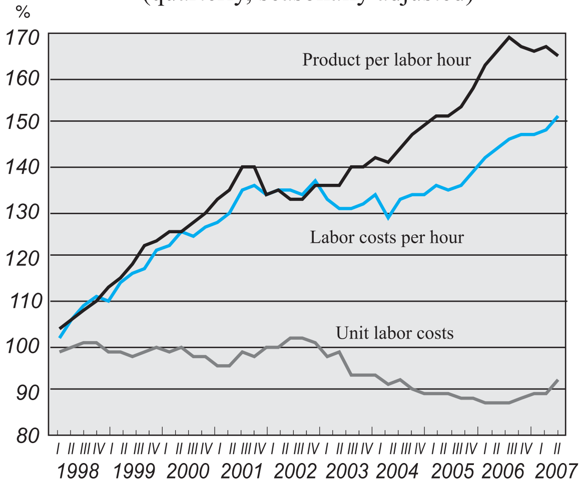
[2] M. Dahan (2007). Why Did the Participation of Israeli Men in Labor Decline? The Economic Quarterly 54(1), 7–28.

from its level in the equivalent period in 2006, the real wage rose faster than did the nominal wage. The number of employee posts and the number of hours worked also increased considerably.

The rise in labor productivity in the business sector (business sector output divided by the number of employee hours) moderated, which could be an indication that the economy is approaching full realization of its potential GDP. As a result of the stabilization of labor productivity and the increase in labor costs, unit labor costs rose in the second quarter, after holding steady in the previous three quarters and declining before then (Figure 1.7).

Figure 1.7

Index of nominal unit labor costs (gross) in the business sector, 1998-2007*
(quarterly, seasonally adjusted)



* To June 2007.

In April 2007 the minimum wage was raised from NIS 3,585 to NIS 3,710. On the one hand a rise in the minimum wage could harm employment,[3] but on the other, could help reduce poverty among working families.[4] The minimum wage is scheduled to be updated again in December 2007, but in the light of the Economic Arrangements Law for 2008, is likely to be deferred. When the minimum wage was raised, there was a concurrent significant increase in the size of the Enforcement Unit in the Ministry of Industry, Trade and Labor, which will help ensure that it is implemented. In June an agreement to improve the application and enforcement of labor laws, and to extend it to employment agencies was signed by the government, the employers and the Histadrut (federation of labor).

According to National Accounts data, the number of non-Israeli workers dropped in the second quarter of 2007. Nonetheless, although their share of the total number of employees in the business sector declined, it remains high, both historically and by international comparison, and in that quarter it stood at 10.6 percent (unadjusted data).

At the end of July 2007 the two-year trial period of the Mehalev (welfare to work) Program[5] ended. It was replaced by a new program called Lighting the Path to Employment,[6] which is implementing the recommendations of the Second Dinor Committee.[7] The program is aimed at those aged up to 45, and its aim, like that of its predecessor, is to bring recipients of income support payments into the labor market. Nevertheless, the report of the National Insurance Monitoring Committee and the Brookdale Institute shows that it was actually the older population (aged 45 to 54) that showed the greatest improvement: the proportion whose situation improved (i.e., they found employment or increased their work hours) was 15.3 percent higher than the average of their age group.[8]

In July the Histadrut and the Manufacturers Association signed a compulsory pension agreement for all employees. According to the agreement, which becomes effective in January 2008, every employee aged over 21 in the same job for at least nine months will be entitled to a pension.

The government

An analysis of budget performance in 2007:Q3 shows that it was substantially less than what is consistent with the maximum budget deficit for the year of 2.9 percent of GDP, similar to the performance in previous years. From the beginning of the year until September, a surplus of NIS 7.7

3 K. Flug, N. Kasir and Y. Rubinstein (2000), The effect of the minimum wage on employment in (selected) unskilled-labor-intensive industries in Israel. Bank of Israel Discussion Paper Series.

4 For a fuller discussion, see the Bank of Israel Annual Report 2006, Box 5.5, pp 224–27

5 For a description see the Bank of Israel Annual Report 2005, Box 5.1, pp 201–06

6 Details of the program can be found (in Hebrew) on the Ministry of Industry, Trade and Labor website.

7 For details see the report of the Mehalev Program Review Committee, the Prime Ministers Office, June 2007 (Hebrew).

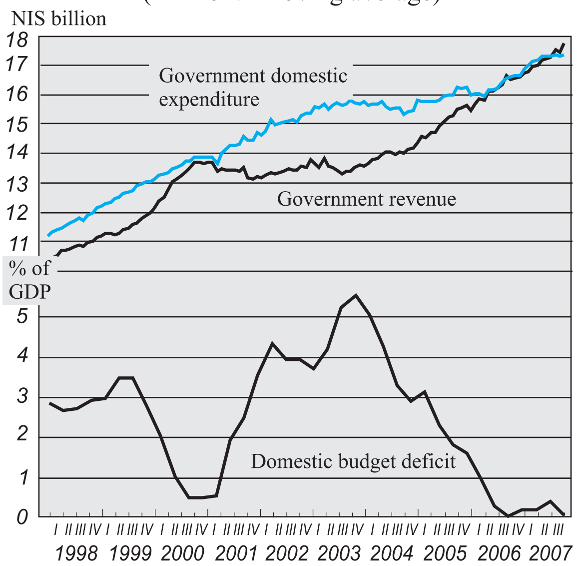
8 For details see the Assessment Research of the Mehalev Program, Report No. 4—"Follow-up findings on the effect of the Mehalev program: on those who were entitled at the start of the program (the "stock") after fifteen months of the operation of the program, and new applicants (the "flow"), six months after submitting a claim," the National Insurance Institute and the Meyers-Joint Brookdale Institute, July 2007 (Hebrew).

billion was accrued in the overall budget excluding credit (Table 1.4 and Figure 1.8). The cumulative domestic surplus excluding credit was NIS 15 billion more than the seasonal pattern that would have been consistent with adherence to the maximum deficit. This surplus reflects the continued acceleration in government tax revenues and expenses below the seasonal path.

The steep upward trend of tax revenues persisted in the period reviewed, and since the beginning of the year were NIS 11.7 billion higher than the seasonal pattern consistent with the budget. The government's tax revenues have been increasing constantly over the last few years, and the Ministry of Finance forecasts turned out to be below the actual revenues. The further rise in government revenue from taxes (direct taxes, and even more so, from indirect taxes) in 2007:Q3 is a reliable indicator of the extension of the growth trend in the period reviewed. Most of the increase in the third quarter, compared with the third quarter of 2006, was the result of the sharp fall in indirect tax revenues during the Second Lebanon War in that year. Excluding the effect of the sale of Iscar,[9] total tax revenues to date were 12.5 percent higher than in the whole of 2006, and direct tax revenues were 13 percent higher. The increase in direct tax revenues was due mainly to a rise in income tax receipts. Land and capital market tax receipts rose substantially.

Figure 1.8

Government revenue and expenditure, 1998-2007*
(12-month moving average)



* To September 2007.

Government expenditure was consistently below the level consistent with full performance of the budget, with the exception of July, when the Ministry of Defense spent heavily. Although expenditure since the beginning of the year was 3.4 percent higher in real terms than in the equivalent period in 2006,[10] they are still lower than the figure consistent with full performance of the budget. Underspending reflects, among other things, low performance of the social welfare budgets. Underspending over a long period points to a problem in the system of budgeting or to inflexibility in transferring funds between ministries.

With regard to financing activity, to date the government has borrowed a net NIS 0.7 billion. In the period reviewed the government repaid about NIS 17.7 billion of debt, a high amount, indicating high budget revenues and underspending. In the third quarter the government borrowed about NIS 21 billion.

The government's careful control of its expenditure in the last three years, despite the budget costs of the Second Lebanon War, the continued growth trend, and the rise in tax revenues, all these make it more probable that this year too the government's deficit will be far below the ceiling set, and that the national debt/GDP ratio will continue to fall.

The balance of payments

In the second quarter the surplus in the current account, seasonally adjusted, was $ 1.9 billion, higher than in the first quarter (Table 1.5). A current account surplus is relatively new in Israel, and it reflects trend changes in savings and investment in the economy. The surplus is the result of the major role played by exports in heading growth in the current growth cycle. Balance of payments data since the beginning of the year indicate some decline in the surplus in 2007. This can be explained by the rise in the rate of investment and a decline in private savings.

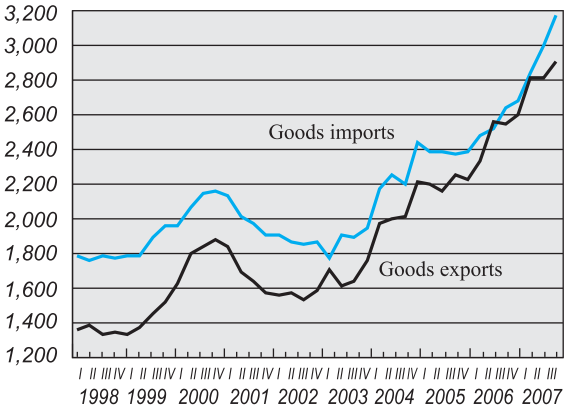
The rise in the current account surplus in 2007:Q2 despite the fall in the goods and services account was due to the increase in the income account. The goods and services account in 2007:Q2 showed a deficit, as it had in the previous two quarters. The deficit in the goods and services account was the outcome of an increase in exports with a larger increase in imports.The rise in goods and services

[9] Exceptional receipts of NIS 3.75 billion were recorded in August 2006 from the Iscar sale.

[10] In the equivalent period in 2006 expenditure was low because the 2007 budget had not been approved.

Figure 1.9

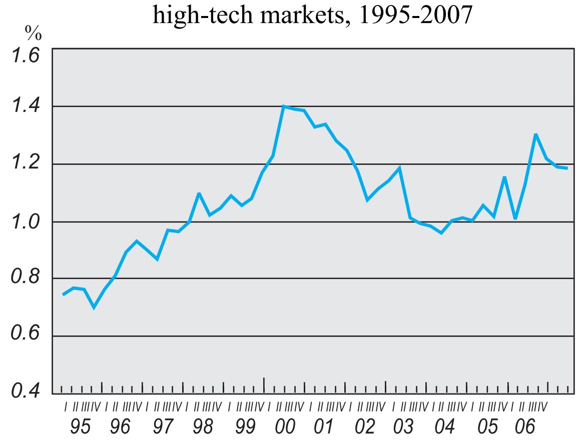
Foreign trade,* 1998-2007
($ million per month)



* Excluding ships, aircraft, diamonds, and fuel.
Seasonally adjusted. To September 2007.

Figure 1.10

Israel's share of the US and European
high-tech markets, 1995-2007



* Seasonally adjusted. To June 2007.

imports is consistent with the developments in domestic uses (consumption, investment and exports). An analysis of the components of the goods and services account shows an increase in the deficit in the goods account (Figure 1.9). The higher trade deficit in the period reviewed reflects a fast rise in imports while exports made no progress in the second quarter and showed a slower rate of increase in the third quarter. All components of goods imports maintained a high level compared with their levels in 2006, with imports of current consumer goods increasing most rapidly. This was due to the surge in domestic demand, expressed by the rise in private consumption. The moderate rate of increase of goods exports in 2007:Q3 was headed mainly by exports of the medium-high-tech industries, which rose significantly. High-tech exports increased more slowly, in line with the growth of world demand, so that Israel's market share of high-tech imports to the US and Europe edged up in the period reviewed (Figure 1.10).

The surplus in the services account grew in the second quarter, after falling in the preceding three quarters. The increase in the surplus in the services account despite the increase in imports of services stems from the considerable increase in exports of services.

The terms of trade index[11] deteriorated in the second quarter by 2 percentage points, after an improvement in the preceding two quarters. The worsening of the terms of trade is a result of the increase in fuel prices, without which the terms of trade would have improved by 0.9 percentage points. The deterioration in the terms of trade impacts on real income, as it reduces the amount of imports that can be bought at any given level of exports, and also creates pressure for a real depreciation.

The income account in respect of investments in the balance of payments in the second quarter of 2007 resulted in a surplus of Israelis' income abroad above the economy's expenditure on nonresidents' investments in Israel. The surplus in the income account followed a continued deficit over the past year. This improved trend in the income account in recent years can be partly explained by a higher increase in financial assets of the economy abroad than the growth in liabilities.

An analysis of Israel's financial account in the period reviewed shows that it was characterized by a net capital export.

Global developments

The latest forecast for world growth by the International Monetary Fund (in September 2007) predicts that growth will reach 5.2 percent in 2007 and 4.8 percent in 2008, following faster growth in 2006 (Table A.6). The considerable drop in growth rates derives mainly from the deceleration in the US growth rate and in those countries that have strong trading links with the US. According to the IMF data, world growth continues due to the rapid growth in the emerging and developing markets (led by China).

[11] The terms of trade index is defined as the change in export price indices relative to the change in import price indices (excluding ships, planes and diamonds).

The reason for the deceleration in the US growth rate stems mainly from the crisis in the subprime mortgage market,[12] which began about a year earlier, and its effects could be seen in the period reviewed. The crisis erupted following a rise in the interest rates in the US in recent years, as a result of which many households were unable to meet their mortgage payments. This led to a drop in real estate prices in the US, and hence real estate companies found difficulties in meeting their own financial commitments. As a result uncertainty increased greatly, causing the cost of credit to rise. Against this background, the LIBOR rate[13] rose sharply and created the fear of a credit crunch. The increase in the LIBOR rate also put a halt on the expansion in economic activity by making credit more expensive for the private sector; these developments caused a slowdown in the expansion of US demand for private consumption, and affected too those countries that have trading links with the US. As a result of the liquidity crisis the US Federal Reserve cut its discount rate, and the number of government bonds increased in the period reviewed. The flow of money out of the financial markets generated sharp fluctuations in the dollar exchange rate. As a result of the developments in the financial markets and their repercussions, the US central bank cut its interest rate significantly by 50 basis points in September, to a level of 4.75 percent—the first cut in over a year. The rate of growth in the US in this period remained below 2 percent, and is expected to remain so in 2008 too. In contrast, the US labor market has been stable with unemployment at 4.7 percent (in September).

Following the liquidity crisis, the rate of growth in the eurozone fell in 2007 and reached an estimated 2.5 percent, a slightly lower rate that earlier forecast. The IMF also lowered its forecast for growth in the eurozone to 2.1 percent for 2008. At the beginning of the period reviewed the European capital markets registered sharp rises; as the fear grew of a credit crunch due to the US subprime mortgage crisis spreading to Europe, the European capital markets absorbed several lurches, and a move to less risky investments was seen. By the end of the period, due to the monetary involvement of the central banks the liquidity crisis was averted from becoming a general financial and economic crisis, and the share indices rebounded.

The crisis in the US has also shown signs of reaching the Japanese share market: in Japan too mixed trends and relatively low growth data have been registered, and in the second quarter of the year even negative growth. On the other hand the emerging markets continue to demonstrate strong performance—rapid growth, a surplus in the current account, falling inflation and striving toward budgetary discipline—and therefore their level of risk is expected to continue falling.

The price of oil increased sharply in the period reviewed, and in September prices rose above the $80 a barrel mark. This was despite the forecasts of economists around the world at the beginning of the year which predicted moderate rises in oil prices, and their stabilizing at around $60. The high rises in oil prices caused a worsening in the global terms of trade and a rise in prices of consumer goods.

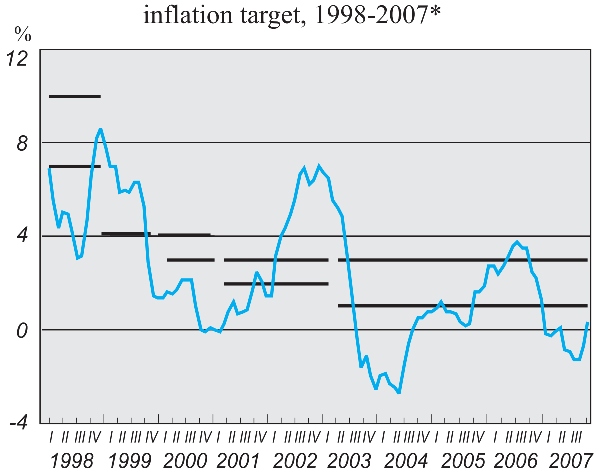
A slowdown in the world economy could lead to a fall in Israeli exports, which would be seen in a fall in demand and some slowdown in GDP growth.

Prices, monetary policy and the money and capital market

The consumer price index rose by 2.3 percent during the period reviewed. Since the beginning of the year the general price index has risen by 2.3 percent and over the past 12 months has risen a total 1.4 percent, close to the lower limit of the inflation target (Table 1.7, Figure 1.11). At the beginning of the period reviewed (April and May) the CPI increased moderately, and accordingly inflation expectations for the next 12 months fell considerably, and there was concern that inflation would undershoot the target. On the other hand in the months June to August the CPI rose considerably and hence there was some risk of the 12-month inflation

Figure 1.11

Inflation in previous 12 months and the inflation target, 1998-2007*



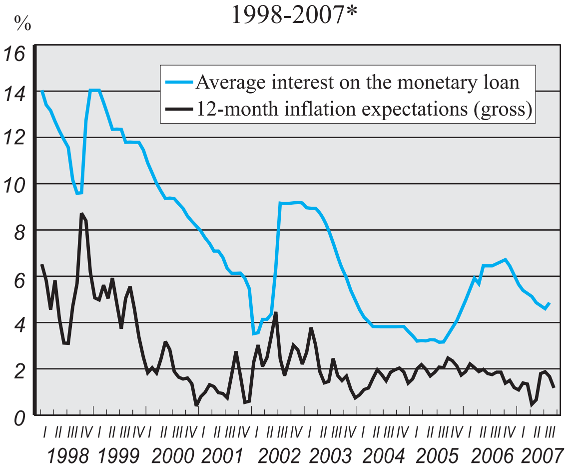
* To September 2007.

[12] Subprime mortgages are mortgages given to borrowers with problematic credit histories, at particularly high rates of interest, due to the inherent risk.

[13] The rate at which banks lend to, and borrow from, each other.

Figure 1.12

Interest and inflation expectations, 1998-2007*



* 12-month inflation expectations as calculated by the Bank of Israel Monetary Department. To September 2007.

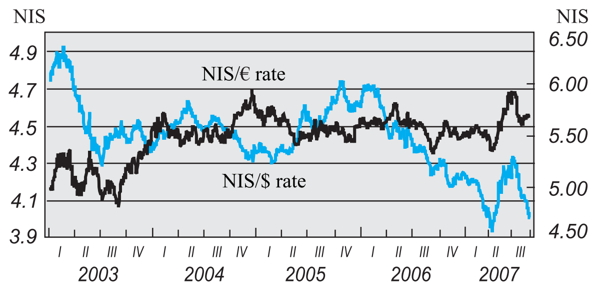
figure overshooting the target. In September the CPI fell again, mainly due to the appreciation of the shekel against the dollar. There are three main forces acting on the CPI: domestic demand, which during the period caused a rise in those prices affected by local factors—rapid growth and a contracting output gap; changes in the exchange rate trend (expressed mostly in the housing market and in the prices of tradable goods), which at the beginning of the period caused a fall in prices and in the middle of the period acted in the opposite direction; prices of imported commodities such as oil, which increased sharply in the period reviewed, causing a rise in prices of imported goods.

Inflation over the past 12 months was negative for most of the period reviewed, and the dominant factor behind this was the appreciation of the shekel against the dollar. In July the trend turned, though inflation remained lower than the lower limit of the inflation target range; in August it returned to the lower limit of the inflation target. The changes in inflation were influenced also by the changes in the nominal interest rate. According to the classical model a rise in the nominal interest rate reduces domestic demand through the differential in the interest rate and the exchange rate. In the first months of the period the nominal interest rate was cut from 4 percent to 3.5 percent in order to encourage inflation to return gradually to within the inflation target by the end of the year, while maintaining financial stability. At the end of the period the interest rate was raised in light of rapid economic growth and the expectation that this would continue, the persistent contraction in the output gap that put pressure on local prices, and the expected increase in domestic inflation. In September the Bank of Israel left the interest rate unchanged at 4 percent, due to the weakening of the dollar against the shekel, which offset the rise in prices and raised the probability of inflation over the next 12 months falling within the target range of price stability. This was against a background of a weakening dollar worldwide and a contraction in the negative interest rate differential between the shekel and the dollar during the period (after the interest rate cut in the US by 0.5 percentage points). This narrowing of the differential brought about a rise in demand for the shekel at the expense of the dollar and affected the trends in the exchange rate.

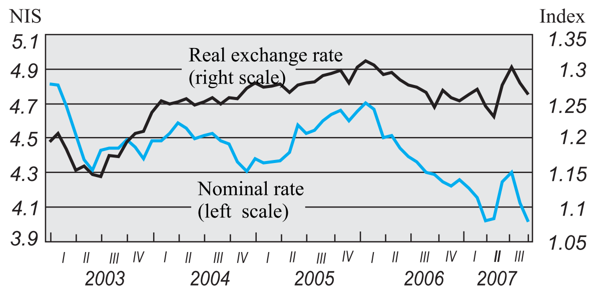
Trends in the nominal exchange rate changed during the period reviewed: in April the shekel appreciated, from mid-May to the beginning of August the shekel depreciated, and at the end of the period reviewed it strengthened again. The strengthening of the shekel was influenced by the surplus supply of foreign currency as a result of Israel's surplus in the current account and Israelis' sales abroad. This is against a background of Israel's falling risk premium, due to the consistent fall in the debt/GDP ratio, while maintaining fiscal discipline and despite uncertainty in the security situation; an additional reason for the shekel's appreciation against the

Figure 1.13

The nominal NIS/$ and NIS/€ exchange rates,* 2003-07



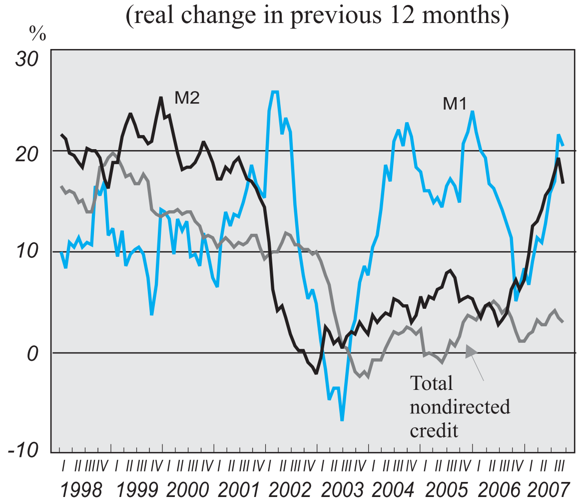
The real and nominal NIS/$ exchange rates,** 2003-07



* To September 2007.
** The real exchange rate is calculated on a monthly basis.

Figure 1.14

Monetary aggregates and credit, 1998-2007*
(real change in previous 12 months)



* To September 2007.

dollar is the weakness of the dollar globally due to the deficit in the US balance of payments and the fog that surrounds the US economy. The sharp depreciation of the shekel from mid-May to the beginning of August stemmed from the recovery of the dollar worldwide, against a background of an improving trend in the US balance of payments, as well as the expanding negative interest rate gap in May and June. At the end of the period reviewed the rise in the local interest rate, together with the expectations of, and an actual cut, in the US interest rate acted to strengthen the shekel against the dollar. Over the entire period reviewed the shekel appreciated against the dollar from NIS 4.14 to the dollar at the beginning of April to NIS 4.01 to the dollar at the end of September (Figure 1.13).

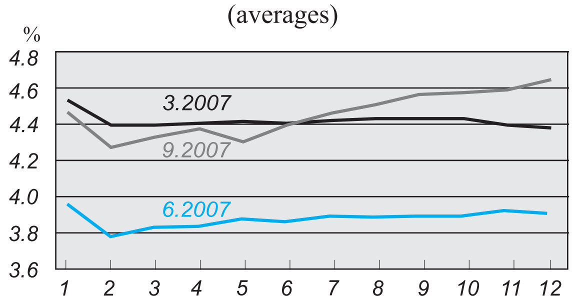
These developments in the shekel exchange rate against the dollar were expressed during the period reviewed in the inflation expectations for the next 12 months: in April and at the beginning of May these expectations fell sharply, from mid-May they rose and at the beginning of August they fell again. Inflation expectations derived from the capital market for the coming 12 months were on average 1.2 percent, close to the lower limit of the target range (Table 1.9 and Figure 1.12). Local forecasters expect, on average, that at the end of 2007 inflation for the next 12 months will be 1.6 percent.

The rate of expansion in the means of payment (M1) and the monetary aggregates considerably during the last 12 months, far faster than the inflation rate plus the GDP growth rate (Table 1.8 and Figure 1.14). In recent years the short-term pass-through between the money supply and prices has weakened, and so the weight of this aggregate in determining policy has been secondary. An analysis of the asset component of the M2 aggregate shows that in the past year short-term deposits and time deposits of up to one year grew markedly, and the rate of expansion in unrestricted banking credit was similar to that in 2006. From the beginning of 2007 until the end of August the business sector raised an unprecedented sum of NIS 65 billion from institutional investors and the public through bonds.[14] Following the subprime crisis raising funds on the stock exchange slowed down, after large sums had been raised in the previous year. The public's asset portfolio continued to rise in the period reviewed, an increase which stemmed mostly from the share component in Israel, which grew both as a result of the rise in share prices and due to the increase in issued capital.[15]

The *makam* yield curve (Figure 1.15) reacted to the changes in interest rate: at the beginning of the period reviewed it fell along its entire length, and at the end of the period it

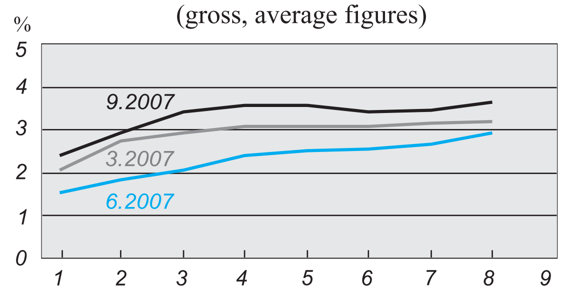
Figure 1.15

Makam yield curve, March 2007 to September 2007
(averages)



Months to maturity

Yield curve of CPI-indexed Treasury bonds,*
March 2007 to September 2007
(gross, average figures)



Years to maturity

* Excluding the yield on CPI-indexed 10-year bonds.

[14] For comparison, in the entire year 2006 the business sector raised only NIS 47 billion through bonds.

[15] In the second quarter the value of new issues doubled compared to the first quarter, but in the third quarter less capital was raised, possibly due to the collapse of the Heftziba company and the liquidity crisis in the US.

rose. The slope of the curve moderated and the difference between the short term (two months to maturity) and the long term (year to maturity) stood in September 2007 at about 0.4 percentage points. According to forecasters' predictions, the Bank of Israel interest rate is expected to rise and to reach, on average, 4.2 percent at the end of the year.

Similarly, the CPI-indexed (up to 5 year) bond yield also changed its trend: in the second quarter of the year yields were relatively low, while in the third quarter yields rose to above the level at the beginning of the year. Future yields on CPI-indexed bonds rose at the end of the period reviewed, though their level was still lower than in previous years (Table 1.9).

The capital market demonstrated mixed trends in the period reviewed: at the beginning of the period (April till the beginning of June) share prices continued to climb, as they have done in recent years, and reached new records of high daily volumes; in mid-June this positive trend came to a halt and in mid-July share prices fell; this was consistent with the falls on stock markets worldwide due to the subprime mortgage crisis in the US and the resulting credit crunch around the world. The falls in share prices worsened in August with the announcement of the collapse of the Heftziba company. In particular real estate shares plummeted, returning to their level at the end of 2006. Despite the falling share prices, share indices remained higher than at the beginning of 2007. In mid-August the trend changed and prices began to rise in world markets and in the local capital market, owing to the monetary intervention of central banks. The local capital market, like developing economies in the world, was influenced by two opposing factors: on the one hand, impressive economic data pointed to a stable economy and forecasts of rapid growth; on the other hand, the jolts in the world markets also affected the Israeli capital market and led to falling share indices. These trends were reflected in a rise in the implied volatility/standard deviation of the local capital market. In July the underwriting reforms came into force. As in the developed economies, a new system of underwriting has been introduced, which makes the process of public stock issues easier, and so encourages foreign investors. The main principles of the reform are: security proposals are made public even prior to receiving the authority's approval; sale of securities to institutional investors is possible not necessarily through tender, but based on discretion; additional restrictions on conflict of interest among underwriters; publication of quantities of securities offered and the offer price separately from the prospectus at a time close to sale, in order to minimize exposure.

Table 1.1 National Accounts,[a] 2006-07

		2006		2006		2007	Last month for which data available
	2006	III	IV	I	II	II[b]	
GDP	5.2	-0.3	7.9	5.6	5.2	4.5	Jun
Business-sector product	6.5	-2.7	10.3	6.5	5.9	4.9	Jun
Private consumption	4.5	4.8	8.3	9.6	4.3	6.7	Jun
Gross domestic investment	5.3	-16.5	84.4	-8.9	31.2	16.5	Jun
Fixed investment	10.1	34.0	6.8	6.8	6.0	12.8	Jun
Goods and services exports[c]	5.9	-11.5	13.1	8.1	13.3	5.2	Jun
Goods and services exports							
excl. diamonds	10.1	-13.1	10.5	7.1	13.2	3.9	Jun
Goods and services imports[d]	3.3	-10.9	44.0	4.9	18.4	12.4	Jun
Goods and services imports							
excl. diamonds	5.1	-9.7	25.0	20.2	16.5	12.1	Jun
Public sector consumption	2.3	14.0	0.8	-0.9	7.4	5.2	Jun
Public sector consumption	1.5	8.7	-0.1	4.8	1.4	3.7	Jun
excl. defense imports	3.9	-2.1	16.9	6.0	7.9	7.0	Jun

[a] Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.
[b] Compared with 2006:II
[c] New calculation, without subsidies.
[d] New calculation, without taxes.
SOURCE: Central Bureau of Statistics.

Table 1.2 Indicators of Business Activity,[a] 2006-07

		2006		2007				
	2006	III	IV	I	II	III	Apr 06-Sep 07[b]	Last month for which data available
Composite state-of-the-economy index	4.1	7.2	6.6	8.0	9.0	6.8	7.7	Sep
Large-scale retail trade	4.3	-6.9	16.5	6.5	4.1	16.7	7.7	Sep
Manufacturing production								
(excl. diamonds)	8.4	12.6	10.5	-3.4	-0.1	5.9	4.4	Aug
Index of revenue in commerce	5.4	-2.6	12.7	12.4	8.0	6.2	8.7	Aug
Index of commerce and services revenue	8.2	2.7	11.2	15.9	6.6	0.7	9.2	Aug
Index of export - services	-2.1	-4.9	-16.1	116.9	18.2	-1.3	20.2	Sep
Tourist arrivals	-3.8	-84.3	104.1	108.8	24.7	54.2	24.0	Sep
Residential construction[b]								
Starts	-1.5	-28.0	11.5	-12.9	-5.1		3.0	Jul
Completions	-7.0	-23.7	14.2	13.3	-16.8		-13.4	Jul
Nonresidential construction[b]								
Area of starts	54.7	6.6	-10.0	-56.1	-32.9		-32.9	Jun
Survey of companies (net balance, percent)[c]								
Weighted balance of the business sector	28	14**	34	24	29	38		Sep
Output of manufacturing firms	29	21	26	25	24	43		Sep
Sales by trading firms	33	26	39	29	33	25**		Sep

[a] Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted except for construction industry data.

[b] Change from equivalent period one year earlier

[c] The net balance is defined as the difference between the number of firms reporting a rise and those reporting a decline, as a proportion of all reporting firms.

** Not significant at 10% level.

SOURCE: Central Bureau of Statistics.

Table 1.3 Indicators of Labor Market Developments,[a] 2006-07

	2007		2006			2007		Apr 07-Sep 07[b]	Last month for which data available
	II	III	III	IV	I	II	III		
	('000s)		percent change from previous quarter						
Civilian labor force	2,902		0.0	0.7	1.3	1.2		3.0	Jun
Israeli employees	2,682		0.6	1.2	1.3	1.4		4.1	Jun
Of which: in general government	783		4.5	-3.3	1.1	0.1		2.5	Jun
in business sector	1,890		-1.1	2.6	1.6	1.6		4.8	Jun
Foreign workers and Palestinians									Jun
(unadjusted)	345		4.1	2.2	3.4	-6.0		3.5	Jun
Average hours worked weekly per									Jun
employee	36.4		-0.3	2.2	0.0	-1.1		1.7	Jun
Labor input in business sector									Jun
(incl. foreign workers and									Jun
Palestinians)	91,035		0.7	3.6	0.9	0.1		5.4	Jun
Of which: Israelis	80,687		-0.2	4.1	0.6	0.8		6.4	Jun
Labor input in general									Jun
government (Israelis)	16,650		3.3	-1.5	4.5	-2.9		3.4	Jun
Unemployed	220		-5.6	-5.5	0.9	-0.9		-9.3	Jun
Work seekers	204	207	-3.3	-2.7	-1.3	-0.5	1.2	-6.9	Jul
Claims for unemployment benefit	65	64	-1.4	-3.6	-2.5	-0.1	-2.5	-7.7	Sep
Real wage per employee post[c]	7,431		1.2	0.9	0.2	1.4		3.3	Jul
In general government	7,162		1.6	-1.4	-0.5	3.6		2.0	Jul
In business sector	7,558		0.9	1.9	1.0	0.2		3.8	Jul
Nominal wage per employee post[c]	7,663		0.7	0.1	0.3	1.5		2.5	Jul
In general government	7,387		0.9	-2.3	-0.3	3.9		1.3	Jul
In business sector	7,793		0.5	1.0	1.1	0.3		3.1	Jul
Participation rate			55.5	55.7	56.1			1.4	Jun
Employment rate			50.9	51.3	51.8			2.8	Jun
Unemployment rate			8.3	7.8	7.7			-13.6	Jun
Depth of unemployment[d]			38.9	36.7	42.1			-19.0	Jun

[a] Seasonally adjusted.

[b] Compared with April 2006 - September 2006 (unadjusted).

[c] Including foreign workers and Palestinians.

[d] Percent of unemployed seeking work for more than six months (unadjusted).

SOURCE: Central Bureau of Statistics, Labor Force Survey, except for data on Israelis, non-Israelis, and labor input in the business sector, and total Israelis employed, which are the Central Bureau of Statistics' National Accounts estimates.

Table 1.4 Government Budget Performance vis-à-vis Deficit Target, 2006-07

	2006	2006		2007			Apr 07-	Last month for
		III	IV	I	II	III	Sep 07	which data available
Domestic deficit as percent of GDP	0.2	-1.2	-3.6	5.1	1.2		1.2	Jun
Deviation from domestic budget path, excl. credit extended[a] (NIS billion)[b]								
Government revenue	10.0	3.0	0.7	4.1	3.6	4.0	1.9	Sep
Government expenditure	0.3	4.1	-0.1	-2.2	-2.1	-0.8	-6.9	Sep
Domestic deficit	-9.6	1.1	-0.8	-6.3	-5.7	-4.8	-8.8	Sep
Total government surplus (deficit)	-5.5	-2.0	-8.1	6.4	-0.8	2.2	6.5	Sep
	Real percentage change from respective period, previous year							
Government tax revenue	7.0	7.3	7.4	7.3	5.4	9.1	5.5	Aug
of which: income tax, net	12.3	19.5	7.8	10.6	4.0	-2.2	-0.9	Aug
VAT, gross	4.7	-1.7	6.5	0.4	2.3	10.1	6.2	Sep
Government expenditure	3.4	7.1	6.5	9.0	3.8	0.5	2.1	Sep
National insurance allowances	3.2	2.3	8.8	4.8	4.5	1.8	3.9	Aug
of which: Unemployment benefit	-3.8	-4.9	-0.9	-7.4	-7.9	-10.6	-7.5	Aug
Income support	-7.1	-6.7	-5.9	-6.6	-5.8	-8.7	-6.8	Aug
National insurance contributions received from the public	2.3	3.4	6.3	2.9	6.1	10.9	8.2	Aug

[a] The path was determined on the basis of a deficit of percent of GDP.

[b] The change from the respective period in the previous year does not take seasonal adjusment into account.

SOURCE: Based on Ministry of Finance and National Insurance Institute data.

Table 1.5 Foreign Trade, Balance of Payments, and the Reserves,[a] 2006-07

		2006		2007			Apr 07-Sep 07[b]	Last month for which data available
	2006	III	IV	I	II	III		
	Percent change from previous period[c]							
Trade in goods[d]								
Goods imports	8.1	4.6	1.6	6.3	5.4	5.8	18.2	Sep
Of which: Consumer goods	10.7	2.5	0.6	18.2	3.5	5.3	26.1	Sep
Capital goods	4.6	6.7	1.6	8.9	4.0	9.4	21.7	Sep
Intermediates	8.6	4.5	1.8	1.5	6.7	4.7	14.5	Sep
Goods exports	13.6	-0.9	2.5	7.9	0.0	3.5	10.7	Sep
Of which: Manufacturing	14.1	-1.2	2.5	7.0	0.8	4.1	10.4	Sep
Of which: High-tech	20.3	-3.4	1.8	3.5	1.7	0.3	4.0	Sep
	$ million							
Balance of payments								
Goods and services exports	62,992	15,532	16,304	16,645	17,205			Jun
Goods and services imports	61,892	15,202	16,491	16,768	17,620			Jun
Balance of trade in goods and services	1,100	330	-187	-123	-415			Jun
Current account	7,990	2,316	1,835	1,335	1,957			Jun
Financial account (excl. foreign exchange reserves)[e]	-2,092	-1,133	-1,799	-577	-2,460			Jun
Of which: Nonresidents' direct investment[e]	3,575	5,787	4,168	2,945	1,933			Jun
Nonresidents' portfolio investment[e]	2,023	-381	1,561	1,094	521			Jun
Residents' direct and portfolio investment abroad[e]	5,509	2,451	3,699.0	3,818.0	4,477.0			Jun
Net foreign debt (precent of GDP)[e]	-23.0	-19.5	-23.1	-24.1	-24.4			Jun
Bank of Israel reserves, end-period[e]	29,055	27,627	29,055	30,503	28,968	29,128		Sep

[a] Seasonally adjusted.

[b] Compared with April 2006 - September 2006 (unadjusted).

[c] The change relates to the dollar values of imports and exports, not to their volumes.

[d] Data on trade in goods do not include ships, aircraft, diamonds, and fuel.

[e] Unadjusted data.

SOURCE: Central Bureau of Statistics.

Table 1.6 Indicators of Economic Development in Advanced and Developing Countries[a]

(annual rate of change, percent)[b]

	2003	2004	2005	2006	Projection 2007	Projection 2008
World GDP	4.0	5.3	4.8	5.4	5.2	4.8
Advanced countries	1.9	3.3	2.5	2.9	2.5	2.2
Developing countries	6.7	7.7	7.5	8.1	8.1	7.4
World trade	5.4	10.6	7.5	9.2	6.6	6.7
Advanced countries						
Imports	4.1	9.1	6.1	7.4	4.3	5.0
Exports	3.3	8.9	5.8	8.2	5.4	5.3
Developing countries						
Imports	10.3	16.4	12.1	14.9	12.5	11.3
Exports	10.8	14.6	11.1	11.0	9.2	9.0
Commodity prices (US$)						
Oil[c]	15.8	30.7	41.3	20.5	6.6	9.5
Nonfuel	6.9	18.5	10.3	28.4	12.2	-6.7
Inflation (CPI) in advanced countries	1.8	2.0	2.3	2.3	2.1	2.0
Short-term interest[d] (%)						
Dollar deposits	1.0	1.4	3.8	5.3	5.2	4.4
Euro deposits	2.3	2.1	2.2	3.1	4.0	4.1
Unemployment rate in advanced countries	6.5	6.3	6.0	5.6	5.3	5.5

[a] According to World Economic Outlook, Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

[b] Except for unemployment and interest rates.

[c] Average price per barrel in 2006 was $64.27.

[d] Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), October 2007.

Table 1.7 Selected Price Indices,[a] 2006-07

		2006		2007				
	2006	III	IV	I	II	III	Apr 07-Sep 07[b]	Last month for which data available
	Rate of change during quarter							
CPI	-0.1	-0.8	-0.9	-0.2	1.2	1.3	2.3	Sep
CPI excl. housing, fruit and vegetables	0.9	-0.8	-0.7	-0.1	1.7	0.1	1.7	Sep
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	1.4	-0.5	-1.4	0.6	1.2	0.6	2.4	Sep
Index of housing prices	-6.1	-0.3	-2.9	-0.3	-0.1	4.7	4.3	Sep
Wholesale price index	2.1	-0.6	-2.8	1.6	2.5	1.9	6.1	Sep
NIS/$ exchange rate	-8.9	-2.7	-3.5	0.0	-0.4	-2.3	-2.7	Sep
NIS/currency-basket rate	1.5	-2.1	0.2	0.2	0.9	1.0	2.1	Sep
	Rate of change over previous 12 months							
CPI	2.1	2.0	-0.2	-0.6	-1.1	0.9	2.3	Sep
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.6	2.8	1.0	0.5	0.0	0.7	2.4	Sep

[a] Rates of change during period, percent.

[b] Change in last six months.

SOURCE: Central Bureau of Statistics.

Table 1.8 Monetary Aggregates and Nondirected Bank Credit, 2006-07 (annual terms, percent)

		2006		2007					
	2006	III	IV	I	II	III	Comulative in previous 12 months	Apr 07-Sep 07	Last month for which data available
Rates of change								During period	
M1[a]	13.7	11.0	-1.3	21.0	23.3	37.8	20.0	25.1	Sep
M2[b]	4.9	10.0	9.5	22.8	19.3	21.3	16.8	17.6	Sep
M3[c]	7.4	6.4	6.9	19.8	13.7	21.5	14.8	15.7	Sep
Nondirected bank credit	3.6	2.4	-0.5	3.8	7.0	5.3	3.2	2.7	Sep
Unindexed local-currency credit	12.3	13.9	18.0	20.0	17.3	-3.4	10.9	0.6	Sep
CPI-indexed credit	1.1	-0.3	-7.1	-6.3	1.4	9.4	-0.4	5.5	Sep
Credit in and indexed to foreign currency	-7.6	-14.2	-23.7	-13.0	-7.7	23.5	-7.3	2.9	Sep

[a] Narrow money supply (cash in the hands of the public and demand deposits).

[b] M1 plus short-term local-currency unindexed deposits.

[c] M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

Table 1.9 Interest Rates, Yields, and the Share-Price Index, 2006-07
(quarterly average, percent)

		2006		2007			Apr 07-Sep 07[a]	Last month for which data available
	2006	III	IV	I	II	III		
Nominal interest								
SRO deposits	4.1	4.3	4.1	3.3	2.8	2.7	2.8	Aug
Nondirected local-currency credit	8.4	8.7	8.3	7.8	6.9		7.4	Sep
Effective local-currency credit	5.3	5.6	5.5			3.7	3.7	Aug
LIBID 3-month dollar intrest	5.1	5.3	5.2	5.2	5.2	5.3	5.3	Sep
Yield to maturity on:								
12-month *makam*	5.5	5.8	5.1	4.5	3.8	4.5	4.2	Sep
5-year bonds	3.7	3.9	3.6	3.2	2.9	3.4	3.1	Sep
Risk premium[b]	0.3	0.3	0.3	0.2	0.2	0.2	0.2	Sep
Expected inflation	1.8	1.8	1.4	1.3	1.0	1.6	1.3	Sep
General Share-Price Index (change)	5.4	5.2	7.5	10.1	11.0	-0.7	10.1	Sep

[a] Compared with April 2006 - September 2006.

.[b] As measured by the 5-year credit-defalt-swap (CDS) market

[c] Derived from the yield gap between indexed and unindexed bonds held by tax-exempt institutional investors, minus the x-day effect on the price of the bond.

SOURCE: Bank of Israel.

Part 2: Broader Review of Selected Issues

Subsidizing childcare: A step to encourage going out to work

As part of the efforts to stop the worsening poverty and deepening social gaps, and in an attempt to reduce transfer payments, the Israeli government has begun taking steps to encourage going out to work. Among these, the government has begun subsidizing the cost of going to work through subsidizing childcare, which according to Labor Force Surveys of the Central Bureau of Statistics is the main reason for not going out to work among women.

In 2005 the government increased subsidies for daycare centers and pre-nursery playgroups in order to increase the rate of participation in the workforce among parents of young children, and in 2007 it was decided to extend this considerably with an additional NIS 67 million in subsidies in each of the years 2008-2010.

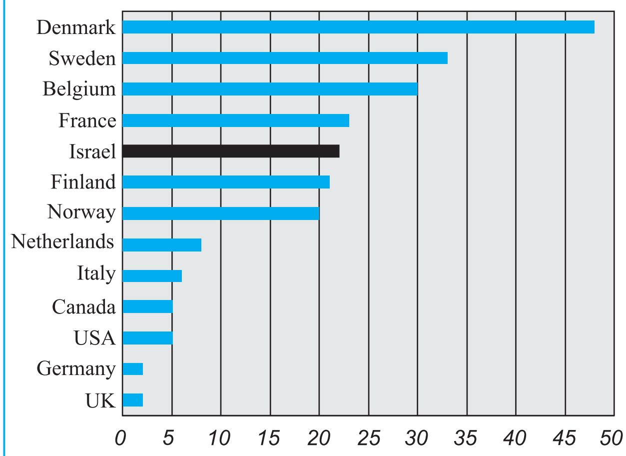
International experience

Research elsewhere shows that subsidizing daycare centers for children significantly increases the rate of participation in the labor force and the number of weekly hours worked among mothers of pre-school-age children, who have difficulties integrating into the labor force because of the need to care for their children.[16] For this reason, despite the fall in the fertility rates in western countries and the drop in transfer payments, these countries saw an increase in the public support rates for childcare from the 1980s.[17]

The countries that operate public childcare facilities and pre-nursery school playgroups can be divided into two: countries that operate these services on a relatively large scale (covering more than 20 percent of children aged 0-3 years), and those that operate these services on a relatively small scale. In the first group, the rate of public support is very high, subsidizing on average 80 percent of the childcare costs. Israel is in this group, and in 2004 some 22 percent of children aged 0-3 were in public daycare centers or playgroups (Figure 1).

Figure 2.1

Share of Children Aged 0-3 in Public Daycare Centers in Selected Countries (percent[a])



* Percent of all children aged 0-3.

SOURCE: Osnat Fichtelberg-Barmatz, *Government assistance in financing infant care in other countries,* Ministry of Industry, Trade and Labor Information sheets (2006) (Hebrew).

There are two main systems popularly practiced in the world for subsidizing daycare facilities for children: the first, practiced in most Scandinavian countries, is direct funding, that is subsidizing different services such as daycare centers, or providing facility allowances etc.; the second system is indirect funding, that is providing assistance through tax reductions on the cost of childcare services. This second system supports only working parents, and is practiced in the US and Canada, and partly in France, Belgium and Norway. Israel practices the first system of direct funding , and the subsidy is conditional on the parent being part of the labor force.

Experience in Israel

The findings in Israel also indicate a link between appropriate, subsidized frameworks for childcare and going to work: In the Central Bureau of Statistics' Social Survey of 2004, one third of parents of young children reported that they had not found suitable work because of the issue of looking after their children.[18] In a research on the integration of Arab mothers

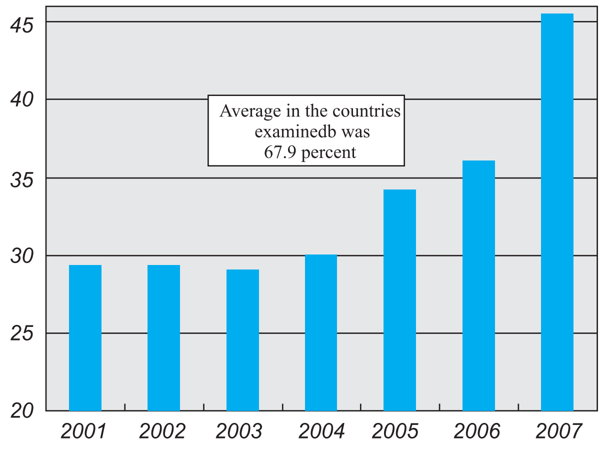
[16] See for example P. Lefebre and P. Merrigan (2005), "Low-fee ($5/day/child) Regulated Childcare Policy and the Labor Supply of Mothers with Young Children: a Natural Experiment from Canada," CIRPEE.

[17] S. G. Gabel and S. B. Kamerman (2006), "Investing in Children: Public Commitment in Twenty-one Industrialized Countries," University of Chicago.

[18] Some of this was through choice and some through not finding appropriate care at a reasonable price. The survey does not allow us to differentiate between these two reasons.

Figure 2.2

Average Rate of Subsidy on Daycare Center Fees in Israel,[a] 2001-07 (percent)



[a] The subsidy was calculated as the weighted average of all children aged 0-3, excluding those receiving support from the welfare services, who comprise less than 2 percent of those children, and excluding children in Moshavim (co-operative settlements).
[b] Italy, Sweden, Finland, Belgium, Denmark, Norway, Germany, the Netherlands, Canada and the USA.
SOURCE: Osnat Fichtelberg-Barmatz, *Government assistance in financing infant care in other countries,* Ministry of Industry, Trade and Labor Information Sheets (2006) (Hebrew), and based on Ministry of Industry, Trade and Labor data.

in the labor force it was found that applying the law of free education for children aged 3-4 in Arab villages raised the rate of participation of mothers by seven percentage points.[19] Further research in Israel found that lowering the cost of childcare, even by small amounts, brought about an increase in the rate of participation among mothers.[20]

Israel is included among those countries that operate public childcare facilities on a relatively large scale, so we would expect to see high rates of support, but actually the country subsidizes only at a rate of 45 percent[21] (in 2007). Data from the daycare center and pre-nursery school playgroup unit of the Ministry of Industry, Trade and Labor shows that a further 5 percent is subsidized by women's organizations.

[19] Analia Shlosser (2006), "The Effect of Free Pre-School Education on Labor Supply among Arab Women: Findings from a Natural Experiment", Economic Quarterly (September) (Hebrew only).

[20] Yaakov Ish Shalom, "Childcare Facilities and Going to Work among Mothers of Young Children," the Authority of Labor Force Planning, Ministry of Labor and Welfare, Jerusalem 2000. (Hebrew only).

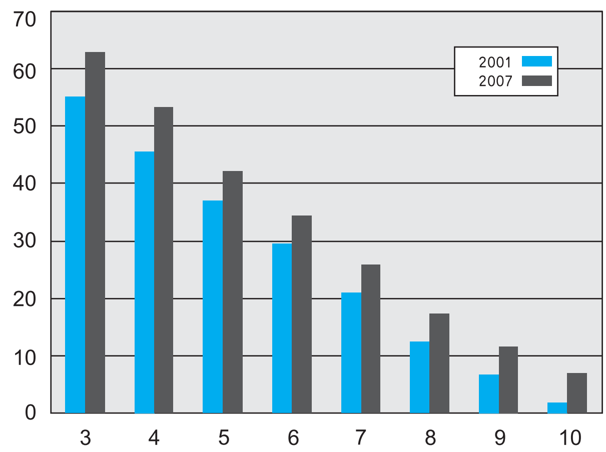
[21] Out of the total funding of children aged 0-3, not including children subsidized by the Ministry of Welfare, who count for only some 2 percent of the total.

In recent years the rate of subsidy given to all levels of subsidized income has also increased considerably; and the maximum income for each level of subsidy has also risen, though the rate is still lower than the average in countries reviewed[22] (Figures 2 and 3).

Raising support for childcare is one of the means to encourage grater participation in the labor market. In recent years the awareness of this has risen and as a result the budget for such facilities has been raised: In June 2005 the government approved a multi-year tax plan that included, inter alia, an increased budget for daycare centers and pre-nursery school playgroups.[23] The additional budgets were intended to extend the services on offer to children of a single, working parent, and for children with two parents working full-time. The expansion was achieved in three main ways: 1) extending the circle of children entitled to subsidies; 2) subsidizing afternoon nurseries and after-school childcare, particularly for single parents with two children or more; and 3) adding extra hours of activity to daycare centers and pre-nursery playgroups. The additions were allocated with a preference to communities which are ranked as high priority areas in the Ministry of Industry, Trade and Labor's employment track.

Figure 2.3

Rate of Subsidy on Daycare Center Fees in Israel, by Level of per Capita Income,[a] 2001-07



[a] The government subsidy is graded according to per capita income, divided into groups. The top income groups, 11 and 12, are not entitled to any subsidy, and the lowest, groups 1 and 2, receive a subsidy from the Ministry of Welfare and Social Services.

[22] See Figure 1.

[23] The additions set by the plan were of NIS 50 million, NIS 100 million and NIS 150 million in the three academic years 5766, 5767, and 5768 (2005/6, 2006/7, and 2007/8).

At the beginning of 2007 it was decided as part of the "Steps to reduce social gaps and to increase participation in the labor force" plan, to further subsidize daycare centers and afternoon nurseries at a cost of NIS 67 million in each of the years 2008-2010.[24] In the same framework it was decided to operate a trial program, starting in 2009, in which subsidies would be provided in the form of coupons for families found eligible by the level of their income. For example, working single mothers will be eligible for a coupon of NIS 300 per month to finance afternoon childcare for children up to the age of six and a coupon of NIS 700 on average per month to finance daycare facilities for infants up to the age of three, according to level of their income.[25]

In another attempt to increase the labor force, a proposal was put forward to expand support for parents through indirect subsidizing. In October 2006 a bill was introduced, which would give a parent tax credits on childcare expenses, or deduct expenditure on childcare from the parent's pre-tax income. Research shows that such a law would increase the rate of employment among women,[26] though it would not contribute to employment among low income earners. While the subsidy is primarily designed to encourage employment among mothers in the lower and middle deciles, as their income falls below the tax threshold anyway, they would not be able to take advantage of the tax recognition for childcare expenses. Among women that work, about 27.9 percent do not currently fully exploit the tax credits they are entitled to due to their children[27] and therefore would certainly not benefit from any additional tax benefits on childcare expenses. Women in the upper deciles would actually be the ones to benefit from the tax benefits, so this benefit would be regressive. Due to this problem with the proposed law, the Israel Women's Network suggested that the benefit be offered to parents as a couple, and not just to the mother: so if the mother does not pass the tax threshold then the tax credits transfer to her partner, allowing workers from all levels of the population to benefit. This solution would only partly reduce the regressive nature of the bill as the major beneficiaries would still be among the wealthier sectors of the population.

[24] As the change in support according to income level is not known, we cannot estimate at this stage the change in support per child.

[25] The cost of daycare facilities under Ministry of Industry, Trade and Employment regulation ranged between NIS 1,400 and NIS 1,700 per month in 2006. This includes state subsidies of 45 percent on average.

[26] See research carried out by the economic consultancy firm of Giza Zinger Even for The Israel Women's Network (http://ww.iwn.org.il/inner.asp?newsid=99, in Hebrew only).

[27] A. Brender (2005), "Tax Benefits for Women and Families in Israel: An International Perspective and an Examination of Take-up Rates," from the Adva Center's Fourth Annual Conference on Budget and Gender (Hebrew only).

The most effective way to subsidize childcare

Many families in Israel send their children to public daycare centers and pre-nursery school playgroups. However, the international comparison above shows that the direct public support for childcare is significantly lower than in other western countries examined. Indirect support (through tax reductions) was found to be less efficient in increasing the participation rate, as most of the subsidy reached the wealthier sectors of the population, whose participation rates in the labor force were already higher without the assistance. The direct subsidy of public childcare facilities is conditional on the parent being active in the labor force,[28] so raising the direct rates of support will increase the rates of participation more than indirect subsidies.

As the additional budgets for childcare began only recently, and since then no comprehensive research has been carried out, it is still not clear if they have been effective in raising participation rates and reducing poverty in Israel. Similarly it is not known if the subsidy graduation by family income maximizes the potential increase in the participation rate. In order to examine the effectiveness of the subsidy, a follow-up system that measures the efficiency of the allocation of these resources—particularly in comparison to other programs of support, including income tax credits—should be set up. It is highly recommended that before the coupon system is introduced, the government draw up such a tracking system, in order to ensure the desired effect on poverty and employment.

Initial analysis of government budget aggregates for 2008 and a multi-year forecast of budget development

An initial analysis of the state budget proposal for 2008, which was presented to the Knesset at the beginning of October, shows that it is consistent with the preset targets for the fiscal aggregates and therefore, if this proposal is approved there is every likelihood that the government will meet the targets; and this follows the government's meeting the targets set at the beginning of each of the past four years. The macroeconomic assumptions that underlie the budget proposal are consistent to a great extent with recent economic developments. The revenue forecast which was prepared early in the summer may today seem conservative compared to the macroeconomic assumptions, but this could be an advantage in light of the balance of risks to the forecast of world economic developments and its implications for growth in Israel. Budget expenditure is consistent with the

[28] According to the criteria of the Ministry of Industry, Trade and Employment, see http://www.moital.gov.il.

Table 2.1: Expected Supplements to the Budget up to 2012, Based on Government Decisions*

	2009	2010	2011	2012
	NIS million, at 2008 prices			
1. The education reform	624	1,179	1,733	2,287
2. Higher education	500	1,000	1,000	1,000
3. Defense	900	1,450	2,150	2,800
4. Social welfare plans"	400	830	900	900
5. Minimum wage	300	300	300	300
6.Light rail, central conurbation	-107	1,067	1,796	2,061
7. Light rail, Jerusalem	0	302	-58	-58
8. Pension funds reform	400	800	1,200	1,600
9. Aid to Holocaust victims	0	30	15	0
10. Public Works Department multi-year plan	-250	-250	-250	-600
11. Israel Railways multi-year plan	900	1,400	1,900	2,900
12. Aid to senior citizens and increased benefits	500	900	900	900
13. Update of health basket	635	1,225	1,225	1,225
Total	**4,802**	**10,233**	**12,811**	**15,315**
Legal supplement to 2008 figure	**4,000**	**8,070**	**12,210**	**16,420**

*All amounts are relative to the 2008 budget

Notes, by row numbers

1. Assuming that the agreement with the junior school teachers will be extended to high school teachers. Includes arbitration costs related to teachers' salaries.
2. The recommendations have not yet received government approval. Based on the agreement with the students alongside the Shochat Committee
3. According to the recommendations of the Shochat Committee.
4.The package of measures approved by the government (the cost of Earned Income Credits does not include the reduction in tax revenues)
5. Assuming there are no further increases after 2009 apart from the regular updates.
6. Establishment grant. The figure for 2012 is a preliminary estimate.
7. Establishment grant. Assuming that the final payment will be deferred to 2010 because of the postponement of the start of operation.
8. As stipulated by law and arrangements in force since 2004.
9. According to the Prime Minister's decision.
10. The division over the years is only an estimate, based on the development program of Derech Eretz Highways, adjusted for across-the-board cuts.
11. Estimate. Israel Railways' development budget has not yet had finally approval, but it has been decided that about NIS 26 billion will be transferred from the state budget by 2013.
12. According to the agreement in October 2007.
13. According to the agreement between the Ministers of Finance and Health. The agreement does not relate to the years after 2010.

SOURCE: Based on data from the Budgets Division of the Ministry of Finance.

multi-year ceiling on increases (a real rate of 1.7 percent annually) with an addition of one-off expenditures which the government has decided on due to the Second Lebanon War and the disengagement from Gaza. However in terms of expected development of the budget in the coming years, there is a significant gap between the expenditure ceiling as set by the government and the cost of multi-year programs that it has adopted in order to achieve its social goals and improve the infrastructure of the economy. The expenditure ceiling allows for an average real increase of only 1 percent a year in primary civil expenditure in the years 2009–2012. In contrast, the plans that the government has adopted call for an increase of more than 3 percent on average. It is important that the government make clear how it intends to deal with this discrepancy in order to establish fiscal policy's contribution to sustainable growth and to reduce the debt burden and the costs of public sector funding. Such clarification would also strengthen the credibility of the government's commitment to its declared aims in the areas of welfare and infrastructure.

The 2008 budget

The budget for 2008 was built on the basis of the expenditure ceiling as set by the government in 2006 with an additional NIS 2.5 billion to finance the cost of the Second Lebanon War and NIS 1.1 billion for the costs of the disengagement from Gaza. In contrast, the deficit ceiling was lowered considerably—to 1.6 percent of GDP—to be nearer the level of the actual deficit in the past three years. The government's forecast for economic growth in 2008 is 4.2 percent, similar to that of the Bank of Israel. Based on this forecast, budget income from taxes in 2008 is predicted to reach NIS 192 billion, and total income (excluding credit) to reach NIS 237 billion. The forecast of income from taxes according to the tax model of the Bank of Israel's Research Department is higher––NIS 196.5 billion—and there is a similar difference in the forecast for total income. Therefore, if the macroeconomic assumptions behind this forecast materialize, there is a high probability that the budget deficit will be lower than the ceiling of 1.6 percent of GDP, even if the full budget is spent. However, given the uncertainty regarding the strength of the expected deceleration in the global economy—and its implications for Israeli growth—it could be advantageous that the budget was built on conservative forecasts. According to the Bank of Israel's forecast, the deficit for 2008 is expected to be higher than in 2007, mainly due to the reduction in taxes of some NIS 7 billion which will lower the share of taxes in GDP by one percentage point. Using the common international definitions the deficit is expected to reach 2.4 percent of GDP in 2008.

Increasing government expenditure in line with the ceiling set by law will allow the continued fall in government spending (net, including credit given) as a proportion of GDP. In 2008 this proportion is expected to reach 35 percent, 0.7 percentage points less than the proportion expected in 2007, and a cumulative drop of 6 percentage points since 2002. Total public expenditure is expected to fall to about 43.5 percent of GDP (44.6 percent according to common international definitions). According to the budget forecast of average price rises of 2.4 percent in 2008, the real growth allowed by the expenditure ceiling (total net expenditure, including credit and less the one-off expenditure that was approved) is only half a percent, significantly less than the 1.7 percent. The reason for this low increase is the need, in line with the law, to correct the level of expenditure to reflect the lower-than-assumed rise in prices compared to the 2007 budget projection. However as the actual level of expenditure in 2007 is expected to be lower than that budgeted, due to this over-estimation of prices, inter alia, then full implementation of the budget in 2008 will lead to an actual increase in expenditure of about 2 percent.

The slow increase in the expenditure aggregate used in the calculation of the budget ceiling does not reduce the deficit nor the total public expenditure to the extent derived from the direct calculation based on this rate. This is due to the heavy weight of the accounting adjustments adopted this year in order to meet the expenditure ceiling: 1) transfer of payments for desalinated water to the "conditional expenditure" item, which is not included in the deficit ceiling; 2) a considerable reduction in credit to housing, which was included in the expenditure ceiling from 2007, but is not included in the deficit calculations; 3) conversion of credit to local authority sewage plants that enjoy direct subsidies to a grant equivalent to the benefit latent in the credit, so that the sum registered in the budget is reduced by some 90 percent without changing the economic cost; 4) charging health tax from homemakers that will be registered in the budget as a reduction on subsidies of the health basket, because tax receipts will be transferred to the health maintenance organizations directly by the National Insurance Institute; from an economic point of view this is a tax increase and not a reduction in expenditure; and 5) cancellation of the employers' tax—a tax levied mostly on public sector bodies—allowing the simultaneous reduction of allocations to these bodies though this is not a reduction in the deficit. The government also proposes setting up a Balance Fund that will allow the transfer of monies (about NIS 1 billion a year) from the strong local authorities to the weaker ones, bypassing the budget. These many steps taken this year may point to the government's increasing difficulty in meeting the restriction of the expenditure ceiling.

Multi-year forecast for 2008 to 2012

a. Main analysis and assumptions

The forecast for the years 2008–2012 is based on a framework of a multi-year budget of the Bank of Israel's Research Department and estimates of budget performance for 2007. The forecast reflects the budgetary implications of specific decisions by the government in different fields of activity, and examines how these match the deficit and expenditure ceilings. The forecast relies on many assumptions, detailed below. In order to test the sensitivity of the conclusions to changes in the assumptions, the analysis is also presented with alternative assumptions.

The major assumptions used in this analysis are:

- Real GDP will grow in 2008 by 4.4 percent and in the years 2009–2012 by 3.2 percent each year on average. The expected rate of growth is based on a faster increase in employment than the increase in the labor force, so that unemployment will reach its natural level (of around 6.5 percent) in 2010, and an annual increase of 1.25 percent in labor productivity, similar to the average in the past thirty years.
- The government will apply the multi-year plans as detailed in Table 2.1.
- Expenditure on the disengagement from Gaza will be completed in 2008.
- Real wages in the economy will rise from 2009 at the same rate as the increase in labor productivity.

- The real yield on bonds issued by the government from 2008 will be 4 percent, similar to the average in the past decade (6.5 percent on unindexed bonds).
- No real wage increase will be given to the education system beyond those additions included in the reform agreed between the government and the Teachers Union. The quantitative scale of education services will expand in line with the increase in the relevant populations and labor productivity. Recommendations from the Shochat Committee on Higher Education will be adopted and will reach full implementation in 2010.
- The application of several bills of private legislation, whose implementation was postponed in the past, and which are supposed to become effective in the coming years, will again be postponed.
- If defense aid from the US grows, the increase will be used to increase defense imports without a reduction in domestic expenditure.
- Income from taxes, less legislative changes, will rise with an elasticity of 1.08 to the increase in GDP in 2009 and thereafter, similar to the increase in the past 16 years. Income in 2008 was estimated on the basis of the Research Department's tax model, as described above.
- The tax reforms and the recent tax reductions decided upon by the government, including the reduction in National Insurance contributions from employers and the self-employed, will be implemented as planned.
- The exchange rate will be NIS 4.35 against the dollar at the end of 2008, similar to the budget assumption. The Consumer Price Index will rise by 2 percent a year.
- Funding of the health services basket will be conducted up till 2010 as recently agreed between the ministers of finance and health. The rest of the expenditure, and funding of the health basket after 2010, will increase in line with changes in the size and composition of the relevant populations. The quantitative increase in these services, for each beneficiary of the service, will be in line with the increase in labor productivity, with no change in manufacturing productivity. The rate of increase in wages per person employed in healthcare will be similar to that of the average wage in the economy.
- Indexation differentials on CPI-indexed government bonds issued from 2001 will be registered as expenditure in the budget at maturity.
- No further privatizations will be made in the coming years.

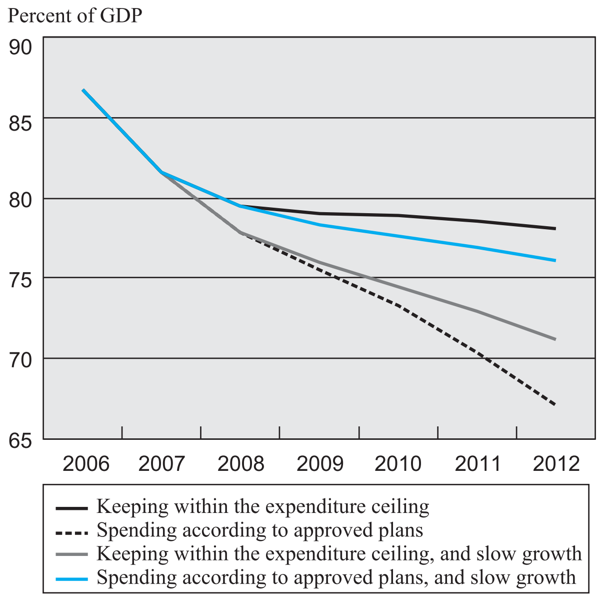
b. Basic scenario – meeting the expenditure ceiling

This scenario assumes that the government will increase its expenditure in real terms in the years 2009–2012 in line with the ceiling set: 1.7 percent a year, less one-off expenditures which have been decided upon for 2008. Meeting this ceiling will mean budget adaptations of considerable amounts because the government has adopted in recent years—and particularly this year—multi-year plans in many areas of considerable budget proportions. Table 2.1 summarizes the cost of these reforms, and hence we learn that the resulting budgetary outlay up till 2011 is higher than the total increase allowed by the expenditure ceiling; also in 2012 these plans utilize almost all the permitted increase. Though past experience teaches us that there is no surety that these plans will indeed come to fruition, particularly in line with the original schedule, one must remember that beyond these plans there is expected a considerable additional increase in expenditure due to the increase in population, the rise in real wages in the public sector (in particular with the end of the current collective wage agreements and tax reductions) and other plans that the government will surely want to adopt up till 2012. According to the assessment derived from the multi-year budget path—which also reflects government decisions on cutbacks and various freezes for the coming years—the scale of the additional steps required in order not to exceed the expenditure ceiling in 2009 is NIS 3.3 billion (Table 2.2). In 2010 a further expenditure reduction of about NIS 2.8 billion would be needed, and in 2011 some NIS 4.7 billion. Even in 2012, a significant reduction—of NIS 3 billion—would be required, although the size of the cut is dependent on exactly how the road and rail investment plans are spread out over the years.

Meeting the expenditure ceiling, assuming the rates of growth in the scenario, means a considerable drop in public

Figure 2.4

The Ratio of Public Debt to GDP with Alternative Policies, 2006-2012



expenditure as a share of GDP. In 2012 this rate is expected to reach less than 33 percent of GDP, 4 percentage points below its 2006 level and 8 points less than in 2003; and so Israel will reach a level of public expenditure lower than the average in developed countries, particularly in primary civilian expenditure. This considerable drop in public expenditure as a share of GDP will allow the reduction in deficit despite the considerable reduction in tax rates that the government and Knesset have decided upon, which will lower the share of tax payments as a proportion of GDP by about 2 percentage points by 2010. According to this scenario, the budget will balance in 2011, and in 2012 the government budget will be in surplus. The fall in the deficit will also allow a consistent reduction in the ratio of public debt to GDP (Figure 2.4) to about 75 percent at the end of 2009 and to 67 percent in 2012. However, as mentioned, realizing this scenario would require considerable fiscal effort to ensure that the expenditure ceiling is maintained

Table 2.2 The Expected Path of the Main Budget Aggregates under Different Scenarios, 2006–2012 (percent of GDP)

	Estimate		Budget	Forecast			
	2006	2007	2008	2009	2010	2011	2012
(1) Constant annual increase of 1.7 percent in expenditure ceiling[a]							
Expenditure (excluding credit granted)	36.7	35.7	35.0	34.0	33.5	33.0	32.6
Additional steps needed to adhere to expenditure ceiling	...	...	...	0.5	0.4	0.6	0.4
Real rate of change of net civilian expenditure excluding interest	4.9	3.9	5.0	-0.4	2.8	0.3	1.5
Income (excluding credit repaid)	35.7	35.2	34.0	33.4	32.9	33.0	33.0
Deficit excluding credit (–)	-1.0	-0.5	-1.0	-0.5	-0.6	-0.1	0.4
Public debt (gross)	86.7	81.5	77.9	75.5	73.3	70.4	67.1
(2) Increase in expenditure according to the specific government decisions[b]							
Expenditure (excluding credit granted)	36.7	35.7	35.0	34.4	34.3	34.4	34.3
Real rate of change of expenditure	4.4	2.7	2.3	1.6	2.9	3.6	2.9
of which net civilian expenditure excluding interest	4.9	3.9	5.0	1.7	4.5	3.2	3.0
Deficit excluding credit (–)	-1.0	-0.5	-1.0	-1.0	-1.4	-1.5	-1.4
Public debt (gross)	86.7	81.5	77.9	76.0	74.5	72.9	71.2
3) Increase of 1.7 percent in expenditure, 3 percent growth in 2008 and 2 percent annual growth thereafter							
Expenditure (excluding credit granted)	36.7	35.7	35.5	34.9	34.8	34.7	34.6
Deficit excluding credit (–)	-1.0	-0.5	-1.5	-1.5	-2.1	-1.9	-1.9
Public debt (gross)	86.7	81.5	79.4	79.0	78.9	78.6	78.1
(4) Increase in expenditure according to the specific government decisions,[b] and 3 percent annual growth from 2009							
Expenditure (excluding credit granted)	36.7	35.7	35.5	35.0	34.9	35.1	35.1
Deficit excluding credit (–)	-1.0	-0.5	-1.5	-1.6	-2.1	-2.3	-2.3
Public debt (gross)	86.7	81.5	79.4	78.3	77.6	76.9	76.1

[a] Assuming that expenditure in 2007 will be NIS 2.5 billion lower than the budget, and the cuts required in the years 2009–2012 will be in civilian expenditure.
[b] The decisions shown in Table 2.1.
SOURCE: Bank of Israel Research Department.

in 2009–2012. This difficulty is illustrated by the low rate of growth of civil expenditure without interest in the years 2009–2012: on average 1 percent.

c. Alternative scenarios

In order to estimate the sensitivity of the multi-year forecast to the assumptions of growth rates and policy paths, two alternative scenarios were examined. The first of these assumes that GDP growth in 2008 will be 3 percent and in each of the years 2009–2012 it will be only 2 percent. According to this scenario the budget deficit will reach 1.5 percent of GDP in 2008, close to the ceiling set for that year, and in the years after it will rise slightly, reaching 1.9 percent of GDP in 2012, even if the government does not exceed its expenditure targets. In this event the debt/GDP ratio is expected to get stuck at 78 percent (see Figure 2.4). This analysis stresses the sensitivity of expenditure policy to macroeconomic developments, though it also demonstrates that if the expenditure ceiling is maintained only a persistent recession will prevent the continuing fall of the debt/GDP ratio.

In the second scenario, the implications were examined of carrying out the multi-year plans that appear in Table 1 but without additional cutbacks to those that have already been decide upon. Such a policy will lead to a real average increase in expenditure of 3.1 percent a year, which is an increase of 1.4 percent per capita, between the years 2009 and 2012. With such an expenditure path, public spending as a proportion of GDP will stabilize after 2009 and the budget deficit will grow to 1.4 percent of GDP, stabilizing at this level until 2012. The debt/GDP ratio will fall more moderately than in the basic scenario and will reach 71 percent in 2012. Moreover, if this expenditure path will be accompanied by a deceleration in growth to 3 percent a year throughout the period, the budget deficit will reach 2.3 percent of GDP in 2012 and the public debt/GDP ratio will contract by only three percentage points after 2008. This expenditure path will also not allow a rapid fall in the debt/GDP ratio if the government reduces the tax rates significantly beyond the reduction already decided upon. On the other hand, average growth of 4 percent a year in the period 2009–2012 will allow a significant reduction in the debt/GDP ratio even if expenditure expands in line with this scenario.

These scenarios show that meeting the expenditure ceiling in the years 2008–2012 allows the government a considerable reduction in the public debt/GDP ratio and of government expenditure as a share of GDP, with the debt converging, particularly at the end of the period, to levels commonly found in developed countries. Moreover, the reductions in taxes that have already been approved are expected to lower the burden of taxation consistently and reliably, thanks to meeting the expenditure ceiling, and hence will support sustainable growth in GDP in the coming years. However the meaning of this path is that primary civilian expenditure will increase on average in the years 2009–2012 by only 1 percent a year, a rate lower than population growth; it is not clear if such a path is sustainable in an environment of growth and in light of the current level of primary civilian expenditure. In contrast, an increase in government expenditure according to the multi-year plans and without extra cutbacks provides an answer to many problems in the areas of society and infrastructure, but will lead to a slower drop in the deficit and the debt/GDP ratio, while exposing the downward path of the debt to real risks, even if per capita growth is only slightly slower than the average in recent decades. A clarification by the government of how it intends to settle this inconsistency will establish the contribution of fiscal policy to sustainable growth, reduce the public sector's funding costs, and will strengthen the credibility of its commitments regarding its social and infrastructure objectives.

Diary of Events from April 2007 to September 2007

Month	Date	Event	Details
April	1	Committee charged with exploring necessary actions to increase institutional players' involvement in the Israeli capital market presents the Commissioner of the Capital Market with its interim report.	The committee recommends focusing the duty of participation of institutional players on matters that have conflict of interests with corporate principals and to encourage them to resort to professionals when phrasing voting recommendations.
	19	A Finance Ministry request for a cutback in Government expenditure is approved.	The Knesset Finance Committee approved an NIS 1 billion across-the-board cut in ministries' expenditures.
	22	The Bank of Israel cuts its key rate for May by 0.25 percentage points, to 3.75%.	
		Minister of Finance Hirschson suspends himself.	Minister of Finance Avraham Hirschson announces that he is suspending himself from his post for 3 months due to the investigation in which he is involved.
	23	PM Ehud Olmert becomes acting Minister of Finance.	
May	16	The Director of Wages at the Ministry of Finance, the Director General of the Ministry of Education, and the Chair of the Teachers' Union sign an outline of principles for reform and comprehensive restructuring of the education system.	The education-system reform will begin in the coming school year (5768 - 2007/8) and will be implemented gradually over six years on a countrywide basis that will be determined in accordance with progress. Cost of the reform is estimated at NIS 5 billion.
	20	Government approves the process of Israel's joining the OECD.	
	27	PM Ehud Olmert signs an order authorizing indirect compensation for Sderot and other communities bordering the Gaza Strip.	The order compensates business owners for indirect damage incurred due to hostile actions. The order is retroactive and, once approved, will allow compensation from May 16, 2007, when the escalation began.
	27	Outline for cooperation between the Supervisor of Banks and banking corporations for implementation of the Basel II recommendations.	The Supervisor of Banks, Rony Hizkiyahu, informed the banks that to promote the adoption of the Basel II Committee resolutions, the Banking Supervision Department will act at two levels—upgrading the system of bank risk-management, auditing, and corporate governance; and adapting banking-supervision practices to a risk-oriented supervision format.
	28	The Bank of Israel cuts its key rate for June by 0.25 percentage points, to 3.5%.	

Month	Date	Event	Details
	28	Knesset Finance Committee approves an NIS 8.2 billion allocation for the Tel Aviv light-rail project.	
June	5	Pi Glilot is privatized.	It is the first time that a dynamic on-line method is used in a privatization tender. The price obtained at the end of the process was twice as large as forecast. The winning bidder was Delek Israel Oil Co., Ltd., which acquired the three terminals en bloc for NIS 800m.
	10	Purchase tax on some 100 consumer goods is abolished.	The tax cut adds up to NIS 400m per year.
	17	Privatization of Industrial Development Bank begins.	According to the proposed outline, the buyer will acquire all controlling and share equity in the bank.
	25	The Bank of Israel leaves its key rate for June unchanged at 3.5%.	
	26	Knesset approves control of bank charges.	The control legislation, approved by the Knesset on third reading, allows the Bank of Israel to establish a list of services for which banks may charge fees and permits the Bank to intervene in the level of said charges.
	26	Knesset Finance Committee decides to apply an earned income tax credit plan for the self employed.	According to this decision, self-employed who do not reach the tax threshold as they earn too low an income will receive supplementary income through a tax credit.
	27	Government, employers, and Histadrut conclude an agreement to toughen enforcement of labor laws.	
July	1	Underwriting form comes into force.	The main aim of the reform is to ease the process of making a public offer of shares easier and to encourage foreign institutional investors and underwriters to participate more.
		Minister of Finance Hirschson resigns from the government.	
		The government approves a proposal by Prime Minister Ehud Olmert, called “Lighting the Path to Employment” to encourage those on welfare to return to work.	At the current stage the plan aims to cover individuals under 45 and implements the recommendations of the second Dinur Committee.
	16	Summary report from the Shochat Committee and its recommendations are presented to the prime minister.	The report covers all aspects of higher education. Among other things, the report recommends spending NIS 800m on research and an extra 600 posts to promote younger staff.
		The Capital Markets Commissioner and management of Bank Hapoalim agree on the gradual entry of the bank into the field of financial advice.	The agreement means that Bank Hapoalim can give financial advice to salaried workers in three years, and can advise the self-employed, minors and customers aged 55+ who are not salaried workers, after the bank has sold its provident funds.

Month	Date	Event	Details
	19	Employers and the Histadrut sign an agreement on compulsory pensions to be applied for all salaried workers in the economy.	As part of the agreement, employers will be obliged to set aside pension fees for their employees for five years of up to 15 percent of the average national wage. The agreement will cover some 500,000 workers who have no pension arrangements.
	23	The Bank of Israel raised its key interest rate for August by 0.25 percentage points to 3.75%.	
	26	The Ministry of Finance and the Histadrut reached an agreement in principle on wage rises for the public sector.	The agreement includes a wage rise of 5 percent. A sum will be allocated to correct distortions in the local government wage mechanism.
	29	The government adopted the main recommendation of the Brodet Committee, to add an extra budget of NIS 46 billion to the defense establishment in the years 2008–2017.	The extra budget will be funded from three sources: the state budget, foreign aid, and an efficiency drive in the defense establishment.
		Knesset approves amendments to the law on employment of women.	The main amendments are: 1) reducing maternity leave for a worker who has agreed to give her child up for adoption or for a surrogate mother (as defined by the law); 2) full rights of maternity leave for a worker; 3) absence due to pregnancy that does not qualify for high-risk-pregnancy benefit; 4) rights of a nursing worker to be absent from dangerous work; 5) protection from harm to the number of hours worked or income.
	30	Special allowance to Holocaust survivors living in Israel was approved.	According to the decision the state will allocate hundreds of millions of shekels each year in grants to Holocaust survivors.
August	1	Heftziba declares bankruptcy.	The Heftziba group, controlled by Boaz Yona, which includes three public companies, declares bankruptcy.
	5	The government of Israel adopts for the first time quantitative objectives in the fields of poverty and employment.	Two objectives approved are for employment and the reduction in poverty including the improvement in standard of living for the poorest sectors of society. These aims will be added to the existing two macro objectives (of budget deficit and inflation).
	27	The Bank of Israel raises its key interest rate for September 2007 by 0.25 percentage points to 4%.	
September	5	Minister of Finance Ronni Bar-On signs an order to extend the law of assistance to Sderot and Western Negev communities.	Minister of Finance determines that the communities of Dorot, Barur-Hayl, Mavki'im, Zohar, Ohad, Talmei Elyahu, and Sde Nitzan will also be included in the emergency instructions setting down various benefits for those living up to 7 km from the Gaza Strip border fence.

Month	Date	Event	Details
	23	Minister of Finance brings the proposal to cancel the Law of Inflation Adjustment up for debate, given the low levels of inflation in recent years.	
	24	The Bank of Israel leaves its key interest rate for October unchanged.	