

Recent Economic Developments

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Part 1: Review of Recent Economic Developments, January to June 2007

Main developments

Israel entered the period reviewed—the first half of 2007—with very strong economic fundamentals. Despite the Second Lebanon War in the summer of 2006, GDP grew rapidly in 2006, led by exports and fixed capital formation. Responsible fiscal policy and expansionary monetary policy had helped maintain the fast pace of growth; the current account surplus reflected the higher rate of saving, the boom in the capital market and stability in the financial markets, that attracted foreign investment on an unprecedented scale.

In the period reviewed the growth cycle became more firmly established, and various indicators showed that it was at an advanced stage. Domestic uses, mainly private consumption and investments, played a more significant role in spearheading growth. The sharp increase in private consumption was the result both of the marked improvement in the labor market, reflected in most indices—headed by the drop in the unemployment rate and the rise in wages—and of the increase in private wealth resulting from the increase in the value of the public's assets portfolio. The rise in consumption promotes expansion in the commerce and services industries, and is thus likely to boost the demand for workers with low levels of education, most of whom are employed in those industries. The steep increase in fixed capital formation, mainly investment in machinery and equipment, reflects the transition to the stage of expansion of the economy's productive capacity. In the early stage of growth, manufacturers expanded their output by increasing the utilization of the existing factors of production, which raised productivity and reduced unit labor costs, with no marked change in the rate of unemployment or wages. The flattening out of the rise in productivity, the considerable drop in the unemployment rate despite the rise in the participation rate in the labor force, and the rise in wages in all the principal industries, together with the stabilization of unit labor costs, all these point to high utilization of the factor inputs and the need to increase them. High investment in physical capital indicates expectations of continued expansion of manufacturing activity. In the period reviewed the current account surplus fell, for the first time in a long period. This reflected a rise in investment on the one hand, and a decline in savings, resulting from the increase in consumption and the low rate of interest, on the other.

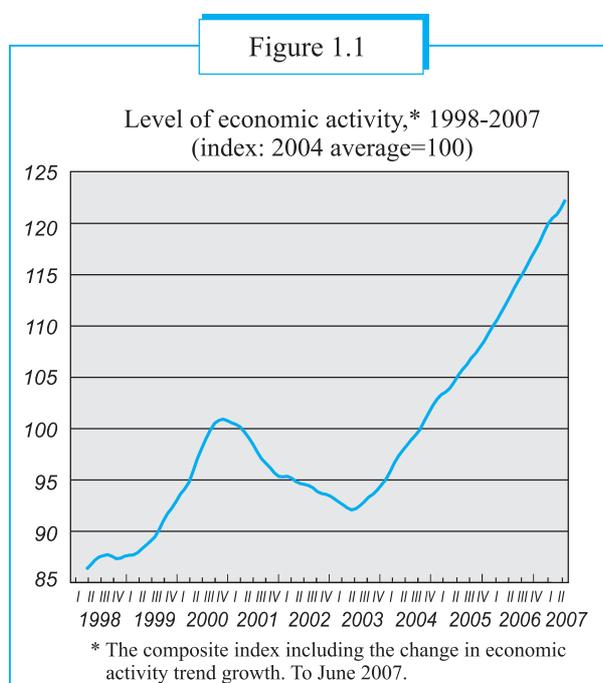
The CPI rose by one percent in the half-year under review, affected to a great extent by the movement in the NIS/\$ exchange rate. "Domestic" prices, i.e., those unaffected by changes in the exchange rate but affected by the contraction of the output gap, acted to push the CPI up, and those prices rose by more than 2 percent in the last twelve months. Acting in the opposite direction, the appreciation of the shekel at the beginning of the period held the rate of inflation back, via its downward effect on the index of housing prices and on tradable goods prices, but towards the end of the period this effect was offset as a result of the depreciation that was caused by the widening of the negative differential between interest rates in Israel and the US, among other things. Inflation expectations moved in parallel with changes in the exchange rate: the sharp appreciation that started towards the end of the first quarter and continued until mid-May brought expectations down to below the lower limit of the inflation target range, and depreciation at a similar rate in the middle of May pushed them back close to the middle of the range. The Bank of Israel's policy regarding cuts in the interest rate is to return inflation to the target range without undermining financial stability. This policy increased the probability that inflation would revert to the range in the course of 2007.

Aggregate and by-industry real activity

Preliminary National Accounts estimates for 2007:Q1 suggest that Israel's economy continued to expand rapidly: GDP rose at an annual rate of 6.3 percent, reflecting an increase of 6.5 percent in business sector product (Table 1).¹ The latter did not expand uniformly. While the output of the commerce, hotels and catering industries grew by 11 percent, and of the finance and business services industry by 9.8 percent, manufacturing output declined by 1.7 percent. The increase in GDP in 2007:Q1 rested mainly on the rapid rise in private consumption, in fixed capital formation, and in goods and services exports. The increase in the economy's sources derived not only from the rise in GDP, but also from the 13.8 percent rise in imports (excluding defense imports, ships, planes and diamonds).

¹ Although this rate of growth was below that in 2006:Q4, it is important to remember that the rapid growth in the last quarter of 2006 resulted from the recovery of economic activity following the slowdown in the previous quarter due to the Second Lebanon War.

The continuous rise in the composite state-of-the-economy index is a sign of the persistent rapid growth also in 2007: Q2 (Table 2 and Figure 1.1). Data from the Bank of Israel's Companies Survey for the second quarter of 2007 also indicate the continued expansion of economic activity, particularly in manufacturing, commerce, transport, communications and business services. Construction and tourism also recorded modest rises.



Expenditure per capita on private consumption rose at an annual rate of 10 percent, comprising a sharp increase in expenditure on durables, mainly cars and electrical goods. Although increased expenditure on durables reflects households' improved economic situation, it is highly volatile. The rise was affected by the strengthening of the shekel, tax changes and lower interest rates, and reflected the rise in private wealth due to the increased value of the public's asset portfolio. Current consumption rose at an annual rate of 5.5 percent.

Data on the sales revenue of the commerce and services industries showed continued growth, albeit slower than that in the second half of 2006 (Table 2). All the industries in this group, except for personal services, recorded increases, and in retail trade and education growth accelerated. The Companies Survey projects a similar picture—continued expansion in transport and communications² (excluding services to nonresidents) and business services, and an accelerated rise in sales of the commerce industry.

² This industry is not included in the Central Bureau of Statistics' (CBS) revenue index of the trade and services industry.

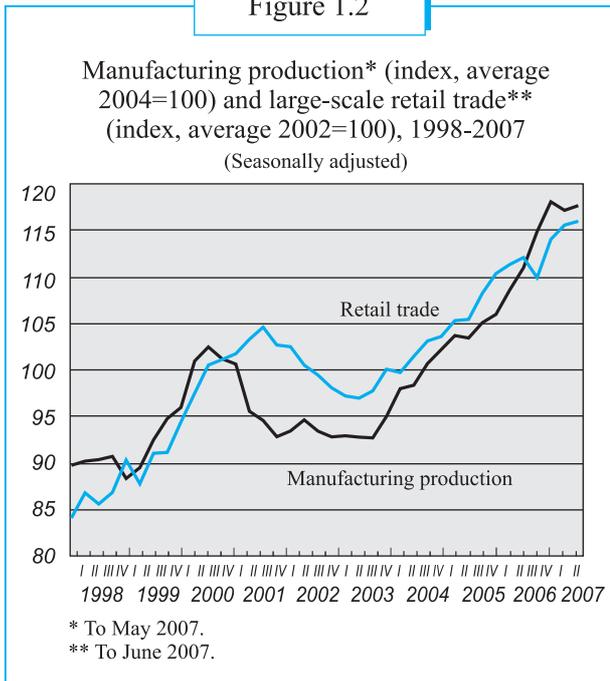
The steep rise in fixed capital formation encompassed an increase in investment in the principal industries (mainly in machinery and production equipment) and an increase in nonresidential construction, alongside a decline in housing investment. The increase in investment in the principal industries reflected expansion and renovation of the stock of physical capital, as the situation was approaching one of full utilization of existing capital, together with the expectation that activity would continue to increase. The relatively low interest rate and the capital market boom served to lower the cost of raising capital for investment. In the past few years GDP growth was based on increased utilization of existing capital and a rise in labor productivity, while improvements in the rate of unemployment and wage rises lagged behind. From the middle of 2006 most indicators suggest that this changed: the rate of unemployment fell markedly, the rise in productivity leveled off, wages rose in all the principal industries, and hence unit labor costs stopped falling.

In the goods and services exports category all types of exports posted impressive gains—manufacturing, agricultural and other. Public consumption (excluding defense imports) rose relatively fast, mostly due to labor costs. This item is expected to continue rising during the year because of the increase in the minimum wage and the teachers' pay increase as per the agreement signed by their union in April.

In January–May 2007 manufacturing output was 7.9 percent higher than in the equivalent period in 2006, according to CBS seasonally adjusted data (Figure 1.2). The data show that although the rate of increase in manufacturing output in the first quarter was significantly lower than that in 2006, in April and May it surged again. This general trend is consistent with the changes in the index of output of the high-tech industries—contraction in the January and February 2007, a continuation of the trend of slowing rate of expansion towards the end of 2006, with marked acceleration from March to May. Unlike the situation in the high-tech industries, in the industries with lower levels of technological intensity there was relatively quick growth at the beginning of the year, which eased back in the following months. The Companies Survey supports these data, showing that the rise in output and sales in the first quarter encompassed the low-tech and medium-high- and medium-low-tech companies, while the high-tech companies reported only modest increases, whereas in the second quarter it was the high-tech companies that reported increased output, sales and exports.

The Purchasing Managers Index published each month by Dun and Bradstreet, shows a rise for the twentieth consecutive month, and the trend is expected to continue. Other indicators, however, point to a slowdown in the rate of growth in the manufacturing industry: the rate of increase in the number of posts and in the number of hours

Figure 1.2



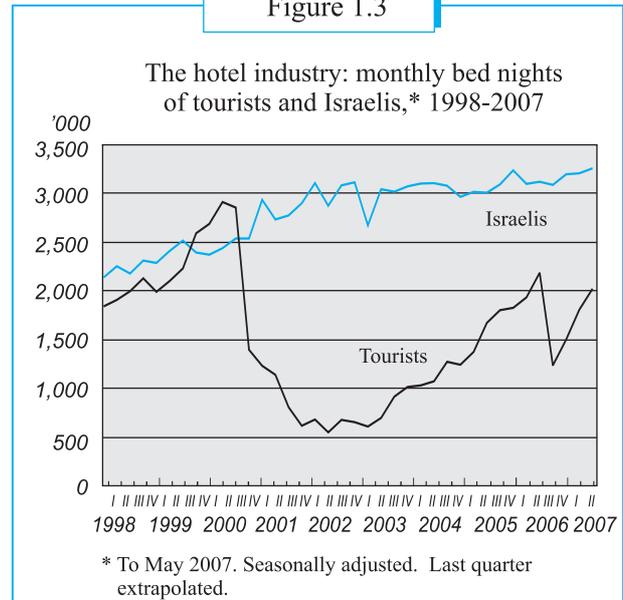
actually worked in manufacturing eased; the demand for high-tech staff, based on information from the Manpower employment agency, flattened out; and the rate of increase in the wage in high-tech industries was the lowest in the whole of the manufacturing industry, according to data from the Manufacturers Association Economics Division. Those data also indicate a slowdown in the rise of labor productivity and in the recruitment of new staff in manufacturing.

Several indicators show that the tourist industry is recovering gradually from the effects of the Second Lebanon War, but has not yet reached its pre-war level (Figure 1.3). In the first half of 2007 tourist entries to Israel were about 4 percent lower than in the first half of 2006, and the number of tourist bed nights showed a similar decline. The number of Israeli bed nights remained steady. The Companies Survey shows that the main demand constraint, i.e., the number of incoming tourists, eased, although it was still relatively severe. It should be noted that some visitors to Israel are businessmen, whose visits are not tourism related.³ As most business visitors tend to stay in the central part of the country, hotel occupancy in the Central and Tel Aviv Districts was even higher than in the equivalent period in 2006, while hotel occupancy in the other districts showed a decline. The data in the Companies Survey, categorized by region, back up this finding. Despite the reduction in the number of tourists and the number of

³ The Israel Hotel Association estimates that in 2007 businessmen constitute 17–20 percent of all visitors, compared with 7–10 percent in 2006.

bed nights in 2007:Q1 compared with 2006:Q1, the levels of tourist hotels revenue in the two periods were similar, as a result of the hike in prices in the industry.⁴ The total number of employee posts in tourist hotels (including those employed directly by the hotels and those employed via manpower companies) was more than 5 percent higher in 2007:Q1 than in 2006:Q1, and the average nominal wage per employee post was 4 percent higher.

Figure 1.3

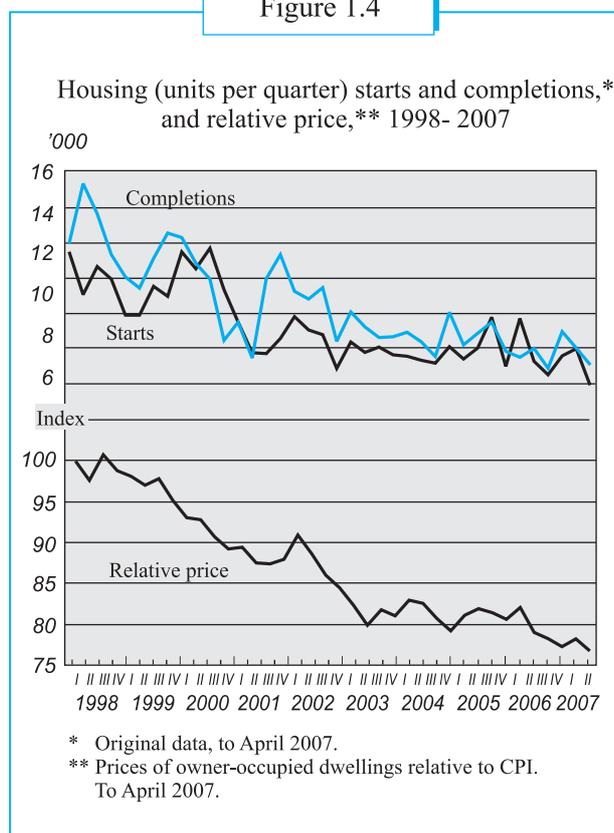


Despite the conditions that make the purchase of an apartment a more attractive proposition—the relatively low rate of interest on mortgages, the relatively weak dollar, the low rate of inflation, and the increase in the average wage—the construction industry is still not showing any buoyancy. Sales of new apartments in the first five months of 2007 were 6.4 percent lower than in the equivalent period in 2006. This was the result of a sharp drop in the sales of new apartments in the Tel Aviv and Central District, which outweighed a jump of 72 percent in the Northern District and of 9 percent in the Southern District. According to the monthly data, it appears that the improvement evident in the last quarter of 2006 will not continue in 2007. Although sales of new apartments are still rising, the rate of increase is slowing down month by month. The stock of apartments for sale is apparently an obstacle to undertaking new building projects, so that the number of building starts in 2007:Q1 was about 16 percent lower than in 2006:Q1 (Table 2 and Figure 1.4). This is reflected in the drop in housing investment in the National Accounts. The increased demand for mortgages

⁴ According to CBS data, revenue in 2007:Q1 from tourists and Israelis who purchased services that are not exempt from VAT was 4 percent higher, at current prices, than in 2006:Q1.

in the last few months⁵ is partly due to the refinancing of mortgages on owner-occupied apartments, which becomes more worthwhile the more the interest rate falls. Data for the first half of 2007 from the Companies Survey show a modest rise in the activity of large and medium-sized construction companies, mainly in infrastructure building.

Figure 1.4



The labor market

The rate of unemployment dipped slightly in 2007:Q1 to 7.7 percent, from 7.8 percent in 2006:Q4 (Table 4 and Figure 1.5), and the trend data for April and May indicate that unemployment held steady. Although the drop in unemployment in the first quarter was modest in comparison with those in the previous two quarters, the reduction nevertheless reflected a rapid rise in employment, as the rate of participation in the labor market rose considerably, by half a percentage point, to reach 56.1 percent. The rate of employment, i.e., the percentage of employed persons in the working-age population, went up by half a percentage point, to 51.8 percent. It may be assumed that most of the new

⁵ In 2007:Q1 value of new mortgage loans from banks increased by 21.5 percent.

participants in the labor market found work immediately, since the depth of unemployment, i.e., the proportion of the unemployed who have been looking for jobs for a long time, increased.⁶

The boom in the labor market was reflected by several indicators. The Employers Survey of the Ministry of Industry, Trade and Labor shows that the demand for workers in the business sector continued rising in the first half of 2007, and in the second quarter reached its highest level in the last ten years. The number of vacancies, excluding construction and agriculture, was 40 percent higher than in 2006:Q2. Also, the number of posts filled was 20.7 percent higher than a year earlier; the balance of employment⁷ rose (to almost three times its level in 2006:Q2), which is consistent with the drop in the unemployment rate; the average time it took employers to fill vacancies lengthened (from 4.9 weeks in 2006:Q2 to 7.7 weeks in 2007:Q2); and the share of workers choosing to leave their jobs rose (two-thirds of those leaving jobs did so on their own initiative, compared with one-half in the equivalent period in 2006). Furthermore, expectations of an increase in activity and in staffing in the next quarter were positive. According to the Companies Surveys for the first and second quarters of 2007, the severity of the shortage-of-labor constraint rose in transport and communications, manufacturing, hotels and construction.

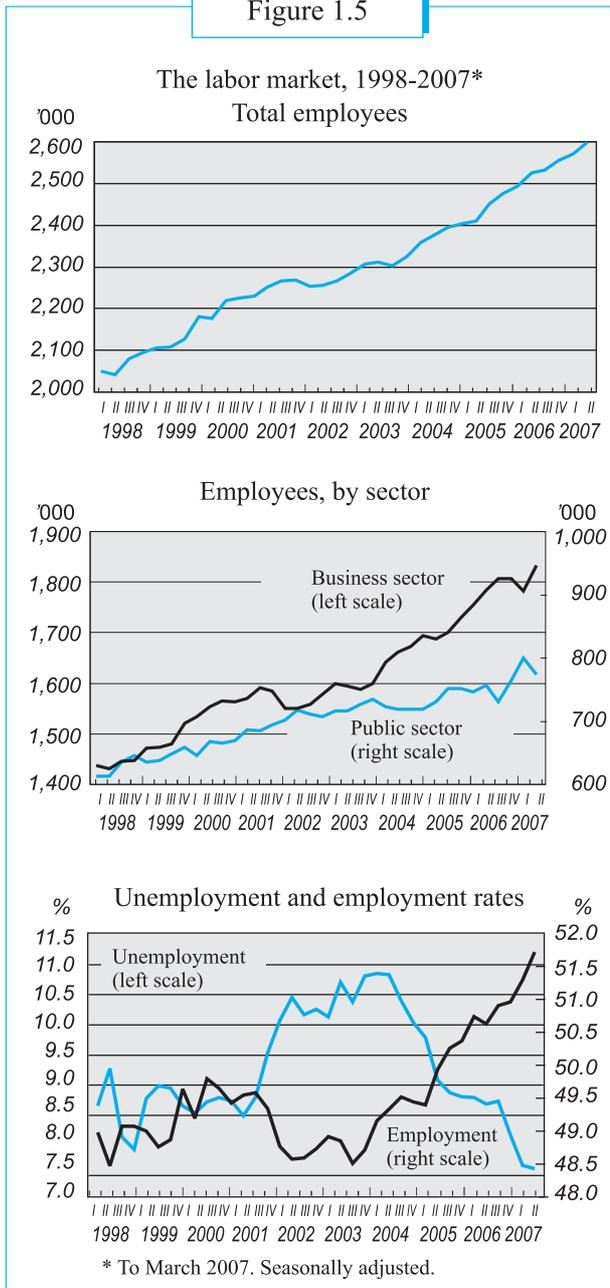
Based on the Manpower Surveys, the total number of employees increased in 2007:Q1 by 33,100, a rise of 1.3 percent from the previous quarter (Table 3). The rise in employment in the business sector was double the rise in the public sector (1.5 percent compared with 0.7 percent), and the share of the business sector in total employment continued to increase (Figure 1.5). The extent of the increase within the business sector varied from industry to industry: the largest increases were posted in commerce (4.3 percent), construction (3.7 percent), and financial services (2.4 percent), while in manufacturing and business services staffing rose more modestly, by 1.7 percent and 1.3 percent respectively. In contrast, the number of Israelis employed in agriculture fell by 5.1 percent, apparently due to the permission granted to employ an additional 3,000 foreign workers. Hotel and catering services recorded a small decline (1.2 percent),⁸ as did transport and communications (0.3 percent). In the public sector the 5.8 percent rise in the

⁶ According to original data, the proportion of the unemployed who have been looking for work for more than half a year rose from 38.4 percent in 2006:Q4 to 44.2 percent in 2007:Q1, and their number increased to 88,300.

⁷ The number of posts filled minus the number of employees who stop working.

⁸ Compared with the equivalent period in 2006, the number fell by 6.9 percent.

Figure 1.5



in agriculture (mostly in the outlying areas) and the raising of the maximum number of Palestinians permitted in the construction industry from 13,500 to 14,250, as agreed between the Association of Contractors and Builders in Israel and the Ministry of Defense at the beginning of June.

Despite all these positive developments, the rise in the labor market permeates less to the ranks of the poorly educated. As shown in the table below, the average level of education among new participants in the labor force in the first quarter of 2007 was relatively high: almost all had 13–15 years of education, while some of those with low education—0–10 years—left the labor market, even though the drop in their participation rates in recent years had come to a halt. Most of the increase in the number of employed was also among those with 13–15 years of education, while at the same time the number of those employed with 0–10 years of education fell. Still, among those with 11–12 years of education, both their participation and employment rates increased. Most of the increase in employment in the last quarter was concentrated among the free and technical professions, and managers, while among clerks, and sales and services workers there was a slight rise. In contrast, employment of professional and non-professional workers in the principal industries fell. The improvement in the unemployment rate encompassed all educational groups, except for those with 0–8 years of education, among whom the number of unemployed rose.⁹

Changes in Participation, Employment and Unemployment by Educational Level in 2007:Q1

Years of education	Share of working-age population (15+ years) (percent)	Participants in labor market ('000, change from previous quarter)	Started working (original data)	Number of unemployed
8–0	11.8	-4.9	-11.1	6.3
10–9	10.5	-13.0	-12.6	-0.4
12–11	34.9	3.0	8.6	-5.6
15–13	22.2	34.5	44.0	-9.5
16+	19.8	-0.3	8.3	-8.6

number of employees in public administration was notable, as was the decline of 4.8 percent in health, welfare and social work services.

The number of non-Israeli workers fell slightly in the first quarter of 2007 (Figure 3) as did the share of such workers out of the total employed in the business sector: to 11.4 percent, from 11.6 percent in the preceding quarter. However the number of non-Israeli workers is a volatile figure, which is likely to grow soon due to the employment permit mentioned above for a further 3,000 foreign workers

This is not surprising, as demand for workers in the business sector is directed mostly at those with relatively high levels of education. According to the Employers Survey of the Ministry of Industry, Trade and Labor covering the same period as the Labor Force Survey, the rise in the number of jobs available in the first quarter of 2007 compared to the number in the first quarter of 2006 was particularly

⁹ Note that the share of those with 0–8 years of education out of the total population aged 15 or more is less than 12 percent, and most are over age 45.

prominent in transport and communications and the financial services industries. The number of posts filled also grew at an impressive rate in these industries as well as in business services. In contrast, in hotels and catering services, though the numbers of jobs available rose compared to the previous quarter, the number of workers who left the industry increased sharply. In the second quarter of 2007 the number of posts available in the hotels and catering services rose sharply (by more than 50 percent compared to the previous quarter), though the number of places filled remained unchanged, due to dismissals, while in the commerce industry the numbers actually fell.

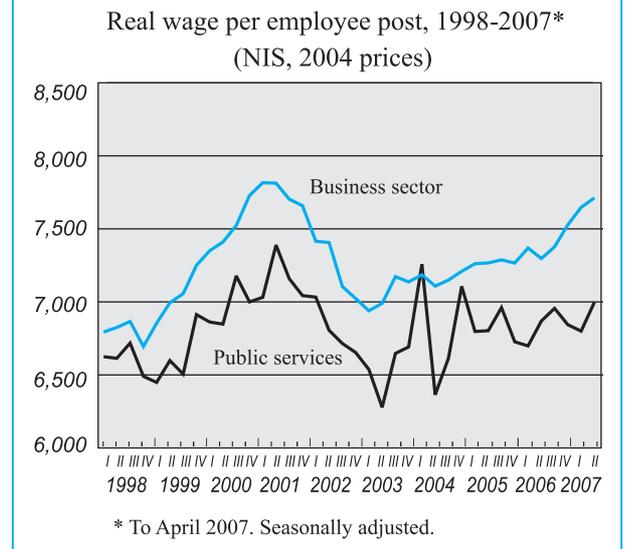
According to the survey by the Manpower company, the demand for workers in the economy in May returned to its level prior to the Second Lebanon War.¹⁰ Demand for workers through the Public Employment Service, which deals primarily with those without university education, was 1.7 percent lower, on a monthly average, in January to May 2007 than in 2006.

Real wages in the economy rose in January–April 2007 by 3.6 percent compared to their level in January–April 2006. Wages of Israelis in the business sector rose by 4.2 percent, while the increase in the public services was less than half that: only 2.1 percent.¹¹ The rise in wages in the business sector encompassed all principal industries, except for electricity and water. Particularly prominent was the increase in the wage in business services (6.7 percent), hotels and catering services (5.9 percent), construction (4.8 percent) and manufacturing (4.6 percent). These wage data point to growth partially penetrating the sector of the labor market where those with relatively low levels of education are employed: the hotels and catering services, commerce and construction. However it should be noted that in the weakest sectors of the population growth contributes far less to a rise in wages than in the higher deciles, as growth is mostly reflected in those industries that employ workers with relatively high levels of education.¹²

The increase in wages in most of the principal industries was consistent with the increase in income tax payments

of salaried workers and company managers of 4.5 percent in January–April 2007. The amount of tax collected rose in most principal industries in the first quarter of the year, with an outstanding increase of 12 percent in the business services industry, which constitutes about 17 percent of the total tax deductions.

Figure 1.6



An increase in labor productivity against a background of a more modest rise in wages allowed for a drop in unit labor costs in the first quarter of 2007, after rising for three consecutive quarters. In the long-term view, one can point to the stabilization of labor productivity at the highest level since the beginning of the decade and of unit labor costs at the lowest level (Figure 1.7). These indices point to relatively high profitability and a potential to expand manufacturing and employment, on condition that the rise in wages remains moderate. But data on employee posts and average monthly wage per employee post point to a deceleration in the rate of increase in the number of posts in the economy, and at the same time, an acceleration in the rise in the average wage per employee post, which could signal a slowing down in the rate of economic expansion in the future.

The rise in wages in public services was more uniform than in the business sector. After eight months of negotiations an agreement was signed in principle between the government and the teachers union, according to which teachers' pay will rise by an average of 26 percent, in return for increasing

¹⁰ A sharp rise in demand for workers in banking, insurance and finance was registered in May compared to April. In contrast, demand for workers in trade and hotels and catering services fell.

¹¹ It is important to take into account though that part of the increase in real wages stemmed from a drop in the inflation rate, so the rise in nominal wages was actually lower: 2.8 percent in the economy in general, 3.5 percent in the business sector and only 1.4 percent in the public services.

¹² "The Economic Policies for Continued Growth and Economic Recovery," Israel Democracy Institute, presented as part of the Caesarea Conference XIII.

their average hours of work by 20 percent.¹³ Negotiations are currently in progress over a collective agreement for the public sector; the last agreement was signed in 2001. In addition to a rise in wages, the Histadrut Labor Federation also demands a change in the public sector employment structure: the absorption of some contract workers into the rank and file of the permanent public sector staff, and an arrangement to cover the employment of workers hired through manpower agencies and non-profit organizations. At the same time it was agreed between the government, the employers and the Histadrut that several steps would be taken to enforce the labor laws. The agreement is meant to benefit first and foremost workers hired through manpower agencies, as this is the population of workers most exposed to infringements of the labor laws. The recommendations of the steering committee on labor law enforcement include, inter alia, the imposition of managerial and civic responsibility on whoever ordered the service, i.e., the actual employer, including monetary fines, and setting a minimum hourly wage in tenders for providing services, which will enable manpower agencies to pay their workers in accordance with the law, i.e., not below the minimum wage.

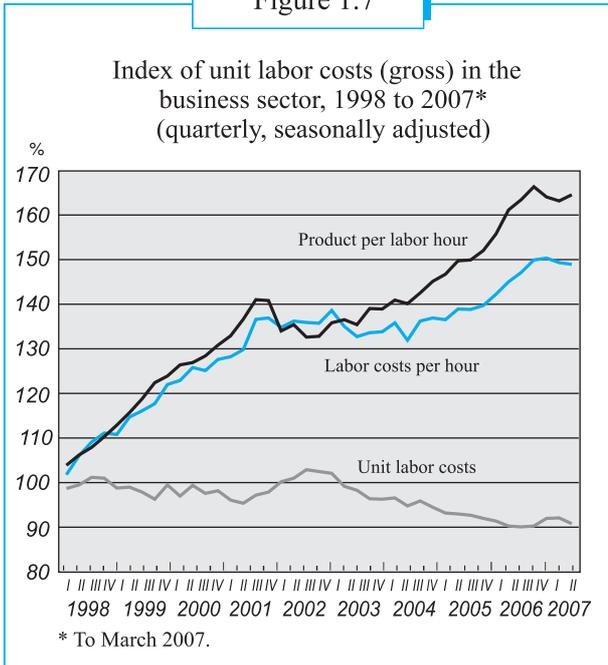
Many discussions on the continuation and improvement of the Mehalev program (the welfare-to-work plan) has led to a number of changes in the program, according to which those aged 45 or over will be taken out of the plan and transferred to the care of the Public Employment Service.¹⁴ This decision makes a great difference to the original program, as the over-45s make up about half of the participants. Moreover, according to new findings presented in a report by the National Insurance Institute and the Brookdale Institute,¹⁵ for the participants aged 45–54 the improvement in their employment condition was actually above the average, close to the achievements of the 35–44 age group and even higher than the improvement in situation of the younger participants. Among all participants in the program the rate of employment in full-time work rose from 21 percent to 36 percent (compared to a rise from 11 percent to 21 percent among similar individuals that did not take part in the plan), and the average monthly wage of those employed through the program grew by NIS 400 more than the increase in wages among peers that did not take part in the program.

The government

An analysis of budget developments during the first half of 2007 shows that the budget performance was consistent with a deficit substantially less than the government's limit for the year of 2.9 percent of GDP. During the period reviewed, a surplus of NIS 5.6 billion was accrued in the overall budget excluding credit extensions, NIS 12 billion more than the seasonal pattern that would have been consistent with adherence to the maximum deficit. This surplus reflects the effect of the amount of the positive deviation from the seasonal pattern in government revenue and the negative deviation in government expenditure (Table 4). According to initial growth data for the year, the annual deficit is also expected to be below the deficit ceiling and to amount to between 1 percent and 1.5 percent of GDP.

During the first half of 2007, the government's tax revenue, exclusive of the impact of legislative changes and non-recurring revenue, was 6.8 percent higher in real terms than in the same period last year. The growth reflects a real increase of 6 percent in revenue from direct taxes and a real increase of 8 percent in revenue from indirect taxes. The growth in tax receipts reflects the buoyant level of activity in the economy deriving from the expansion of business-sector activity, the increase in wages, the growth in consumption (via customs duty and purchase taxes) and increased earnings from the

Figure 1.7



¹³ The average wage of teachers in state education is currently around NIS 7,200 a month, and as a result of the reforms, this will reach a level of NIS 9,000–9,500 a month. The working week for a teacher will be defined as 36 hours, instead of the current 30-hour week.

¹⁴ Those aged 45 or over may continue participating in the Mehalev program if they choose to do so.

¹⁵ Assessment Research of the Mehalev Program, Report No. 4 (in Hebrew).

capital market. Non-tax revenue rose as the result of the transfer of income of NIS 700 million from the Israel Land Administration, NIS 400 million in dividends from Bezeq and Bank Leumi, and NIS 500 million in excess revenue from the National Insurance Institute.

On June 11 purchase taxes that had yielded some NIS 400 million a year were abolished on about a hundred consumer goods. As a result, these taxes are now only imposed on two groups of products—those that have a negative effect on public health and the quality of the environment (cigarettes, alcohol, cars and gasoline), and electronic equipment for entertainment (e.g., televisions, DVDs). The abolition of purchase taxes is part of the policy of reducing the tax burden and equating the purchase tax system in Israel with that practiced in the developed countries.

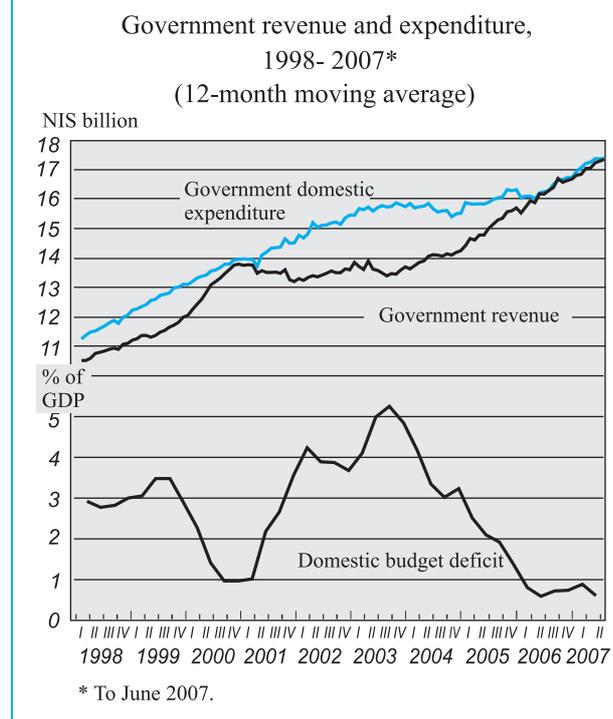
Government expenditure in the first half of the year was NIS 4.4 billion less than the level consistent with full implementation of the budget,¹⁶ even though there was no delay in approving the budget this year and despite the increase in civilian public consumption. The deviations from the seasonal pattern in the first two quarters of 2007 were similar. The expenditure at less than the seasonal pattern resulted from under-performance at the civilian ministries, while the defense budget was more than fully implemented. In addition, a transverse cut of NIS 600 million in the ministries' procurement item to the benefit of the Ministries of Defense and Education was approved. The cost of the reform in teachers' salaries, which will be implemented gradually over six years, is set to total NIS 3.3 billion. The rapid growth in the economy and the decline in the unemployment rate led to a drop in government spending due to a decrease in payments of unemployment benefit and guaranteed income supplement.

The development of an efficient tax system supportive of sustained growth, the accrual of a budget surplus and the retention of fiscal discipline are positive developments that can have the effect of reducing the public debt and the cost of financing the debt. A comparison of actual government borrowing with the budget framework shows that the government's domestic and overseas borrowing was considerably less than planned,¹⁷ while debt repayment exceeded its planned level. This resulted in negative net borrowing and deposits at the banks increased. The reduced borrowing requirements derived inter alia from the increase

¹⁶ Although a real increase of 6.6 percent was recorded in comparison with the same period last year, this resulted from the delay in approving the budget for 2006.

¹⁷ The government issued NIS 9.5 billion in the bond market in the first half of 2007 compared with the planned level of NIS 64 billion.

Figure 1.8



in privatization receipts. During the period reviewed, the first stage of the privatization of Haifa Oil Refineries was completed, producing receipts of NIS 6.43 billion (NIS 1.8 billion more than planned) and Pi Gllilot was privatized. The winning bidder for that privatization offering was Delek, which purchased the three Pi Gllilot terminals for NIS 800 million—twice the valuation assessment for the assets. The positive indicators for the Israeli economy contributed to a decline in Israel's risk premium in international financial markets, and prompted the Fitch and Standard & Poor's rating companies to increase their credit rating forecast for Israel from "stable" to "positive". This improvement could lead to a major reduction in the Israel Government's borrowing costs in international markets.

The balance of payments

The seasonally-adjusted current account surplus amounted to \$ 1.7 billion, 17 percent less than the four-quarter average for 2006 (Table 5). The \$ 130 million decrease in the current account surplus compared with the fourth quarter of 2006 derived from the large drop in the current transfer account and service account surplus, which was partly offset by a reduction in the goods account and the revenue account deficits. A current account surplus has been recorded consistently since 2003 at a continually growing amount over the years, which is indicative of the permanent nature of the phenomenon.

The current account surplus results from a variety of factors, including the decline in the proportion of immigrants in the population, the structural change in the economy, which has the effect of reducing physical investments in GDP and increasing investment in human capital, the contraction in the social security network and the reduction in the cyclically-adjusted general government balance. These developments were partly offset by the decrease in current transfers to the economy and the levying of tax on capital, which has the effect of reducing saving.¹⁸ The decrease in the current account surplus in the fourth quarter of 2006 and the first quarter of 2007 is attributed to the fall in saving that resulted from the growth in consumption and the low interest rate, coupled with the growth in investment for the purpose of expanding production capacity.

The seasonally-adjusted goods and services account was balanced in the first quarter of 2007. Nonresidents' investments in Israel continued to grow. Direct investments, conferring the investor with the right to participate in a company's management, rose by \$ 1.4 billion in the first quarter of 2007, and Israeli portfolio investments increased by \$ 1.2 billion, of which over 80 percent was for the purchase of shares and the remainder for the purchase of bonds. At the same time however, Israelis' investment abroad grew even more, resulting in a net capital outflow.

The terms of trade index (excluding ships, planes, diamonds and energy materials) showed a slight improvement of a tenth of a percent in the first quarter of 2007 after falling

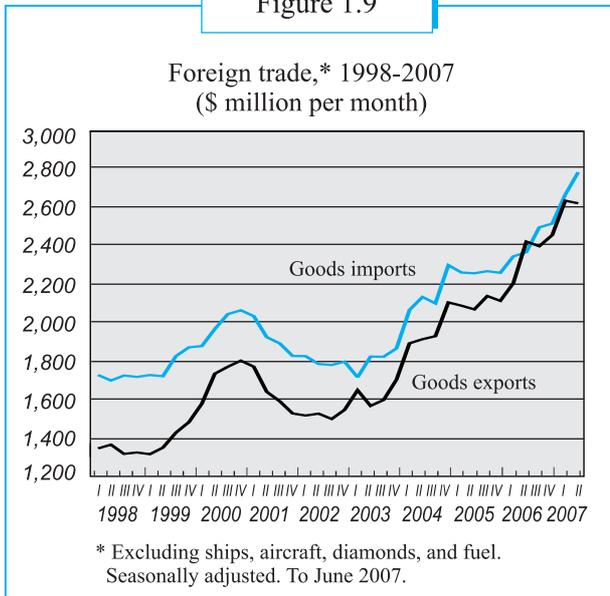
by 2.6 percent in the previous quarter. The improvement in the terms of trade derived from a slightly higher increase in export prices than in import prices.

In the first half of 2007 imports of goods (excluding ships, planes, diamonds and energy materials) rose by 14 percent compared with the same period last year and totaled \$ 17.3 billion, and exports of goods (excluding ships, planes and diamonds) increased by 13 percent to \$ 16.8 billion. The trade deficit (excluding ships, planes, diamonds and energy materials) reached an average of \$ 580 million a month or \$ 6.9 billion annualized.¹⁹ Imports of consumer goods surged by 36 percent compared with the first half of 2006. Imports of raw materials and capital goods also increased (Table 5).

Figure 1.10



Figure 1.9



Industrial exports (excluding polished diamonds) rose by 12.3 percent compared with the same period last year. The growth in exports encompassed all manufacturing industries except for textiles, clothing and leather, and electronics components and computers. From the aspect of technological level, the most rapid growth, 23 percent, was recorded in exports by mixed-high technology industries. High-tech industrial exports expanded by 10 percent, and exports by mixed-technology and traditional industries rose by 13 and 5 percent respectively. However, monthly trend data show a slower pace of increase in exports by mixed-technology and traditional industries. These data also show

¹⁸ See Chapter 7 of the Bank of Israel Report for 2006, The Balance of Payments, for further details.

¹⁹ For the sake of comparison, the trade deficit in 2006 amounted to \$ 7.6 billion.

a more moderate pace of increase in exports by high-tech industries, although it is too early to discern a slowdown, mainly because of the highly volatile nature of the export data of the pharmaceutical and aeronautic equipment industries. Excluding those industries, high-tech industrial exports remained stable.

Trend data show a slowdown in goods import and export trade with the European Union, an increase in the trade surplus with the USA due to higher exports and lower imports, stability in exports to Asian countries and reduced imports from those countries.

Global developments

In the present business cycle, especially in its initial stages, exports and most notably exports by the high-tech industries are leading the growth in the Israeli economy. As a result, the level of world demand, which is dependent on global growth, affects the economy's growth potential. It is feared that a slowdown in worldwide economic activity will depress local growth.

During the first quarter of 2007 the rapid growth in the eurozone countries continued, concurrent with an improvement in the labor market and a moderate pace of inflation. However, the growth rate in the USA and Japan slowed. In the Asian developing economies (principally China and India), rapid growth continued and actually exceeded initial forecasts. According to an IMF forecast, growth in the developing economies will amount to 7.5 percent in 2007, and the pace of growth in Asian countries will reach 8.8 percent. China's GDP growth data show that the Chinese economy will become the world's third largest after the USA and Japan. The rapid growth in the developing economies and their increased proportion in the global economy are making global growth less dependent on the American economy.

Updated growth data for the first quarter of 2007 show a considerably slower pace of growth in the USA, mainly due to the contraction of the construction industry.²⁰ The annualized GDP growth rate was downward adjusted from 1.3 percent to only 0.7 percent compared with the previous quarter. This is the lowest rate of growth for the past four years and according to an OECD assessment, is less than the potential growth pattern. As a result of the most recent data, the US administration's annual growth forecast has been adjusted from 2.9 percent to only 2.3 percent. The indexes show a mixed trend: Real-estate industry data, the retail trade index and the leading state of the economy index

²⁰ The decrease in investment in housing construction reduced GDP by one percent.

show a slowdown, while the industrial production index, the consumer confidence index, the Purchasing Managers Index and consumption of consumer durables are encouraging. The situation in the labor market is stable: the unemployment rate has fallen to 4.5 percent and despite the slowdown in the economy, no increase is expected in the near future. The weakening of the dollar in April made it possible to reduce the trade deficit by 6.2 percent. However, a slowdown in private consumption is expected because of the increase in fuel prices and the decrease in housing prices resulting from the difficulties in obtaining credit. Moreover, a rebound in the housing market is not expected in the near future: in the first quarter a record number of persons likely to lose their homes as the result of mortgage repayment problems was recorded. The increased amount of (mortgage default) attachments led to a growth in the supply of existing housing and a further decrease in prices. Concurrently, the contraction in the construction industry continued, as reflected by the drop in building starts. The Fed is adopting a policy of moderate restraint in view of the relatively high level of inflation:²¹ the interest rate set in May was left unchanged at a level of 5.25 percent.

In the eurozone rapid growth continued, and GDP rose by 0.6 percent in the first quarter of the year compared with the previous quarter. The leading growth factors are exports and investment. According to a forecast by the eurozone central bureau of statistics, the GDP growth rate for 2007 will amount to 3.0 percent. Current indicators also support continued growth: the increase in retail sales (following a slowdown in the initial months of the year due to the VAT hike in Germany), increased orders from factories, a rise in the OECD's leading index and a rise in the consumer confidence index. Strong growth led to an improvement in the labor market: the unemployment rate fell to its lowest level since 1993, 7.1 percent, a development supportive of increased domestic demand and sustained growth. Inflation remained below the upper limit of the targeted range (2.0 percent). Despite this, the contraction in the GDP gap, the decrease in unemployment and the rapid expansion of the monetary and credit aggregates led to a quarter-percent interest rate hike in June, to a level of 4.0 percent. The ECB expects the inflation rate in the eurozone to reach 1.8 percent this year, and the market is expecting a further rise in the ECB's interest rate by the end of the year in view of the rapid growth and creation of inflationary pressures.

Although the Bank of England left the interest rate for June unchanged, at a level 5.5 percent, a rate hike is expected

²¹ In May the rate of increase in the consumer price index during the previous 12 months amounted to 2.7 percent, and the rate of increase in the core index (excluding energy and food prices) was 2.2 percent.

due to the high growth rate (which reached 2.9 percent annualized in the first quarter), high inflation at an annual rate of over 3.0 percent due to the increase in energy prices, and the 10 percent increase in housing prices during 2006.

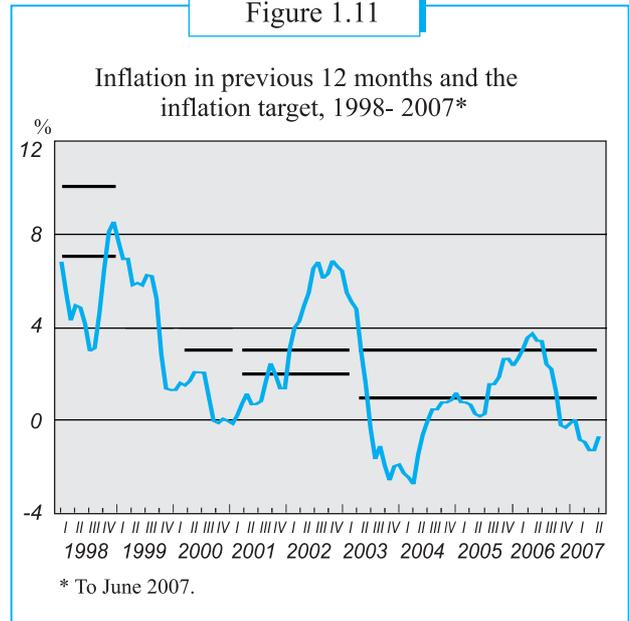
In Japan an annualized growth rate of 2.4 percent was recorded in the first quarter, indicating a slowdown compared with the first quarter of 2006 when the economy expanded by 5.0 percent in annual terms. Growth was based on a rise in exports and an increase in private consumption, which was higher than expected despite the stability in wages. The unemployment rate fell to 3.8 percent. The increased pressure in the labor market is likely to lead to wage increases, a growth in private consumption and higher inflation. To date however, as the result of low and even negative inflation—including core inflation—the central bank has not raised the interest rate, which has been left at a mere half percent.

Prices, monetary policy and the money and capital markets

The consumer price index rose by one percent during the period reviewed (Table 7). Since 2003, the Bank of Israel has operated within the framework of a continuous price target. Adherence to the inflation target is thereby examined monthly on the basis of cumulative inflation in the previous 12 months, Figure 1.11 shows that in each of the months from January to June 2007, actual inflation was below the lower limit of the inflation target (a development that began in the last quarter of 2006) and was even negative. However, the probability of inflation reverting to within the targeted range this very year is high. The main factor contributing to the slower pace of inflation in the middle of the period reviewed was the fall in the housing price index, which resulted from the appreciation of the shekel. The consumer price index excluding housing, fruit and vegetables, clothing and footwear, and price controlled items rose by 1.8 percent in the first half of 2007. The annual rate of increase in the prices of local goods and services that are not affected by changes in the dollar exchange rate as calculated by means of econometric models was 2 percent. The wholesale price index rose by the high rate of 4.1 percent during the first half of the year. The large depreciation of the shekel in the second half of May, which offset the effect of the appreciation, also pushed up inflation during the last two months.

12-month inflation expectations were close to the lower limit of the targeted range (Table 9 and Figure 1.12). This indicator fell in the middle of the second quarter due to the large appreciation of the shekel against the dollar. During June however, these inflation expectations rose to the middle of the targeted range. Average inflation expectations in the Companies Survey were higher, and close to the middle of the targeted range in both quarters.

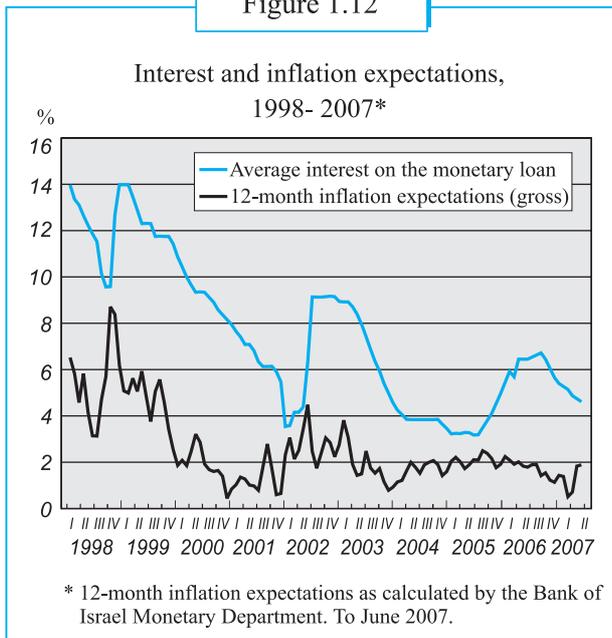
Figure 1.11



During the period reviewed the Bank of Israel cut the interest rate from 5 percent in December 2006 to 3.5 percent in June 2007. The stability of the shekel and the rapid growth in the economy made it possible to reduce the interest rate without fear of undermining financial stability, despite the unprecedented differential of 1.75 percentage points between the Fed’s interest rate and the Bank of Israel interest rate. The policy of cutting the interest rate was intended to increase the chances of inflation reverting to within the targeted range, and was based on an analysis of the forces affecting the rate of price increase. Contributing to the downturn in inflation was the strengthening of the shekel against the dollar, which reflected the weakness of the dollar as well as the accrual of a current account surplus and the flow of foreign investment to Israel. However, the closure of the GDP gap resulting from the rapid growth in the economy since 2003, the decline in the unemployment rate—especially among skilled workers, and households’ increased demand for consumption could create inflationary pressures. Other developments indicative of this possibility are the slow rate of growth in labor productivity and the decrease in the unit labor cost.

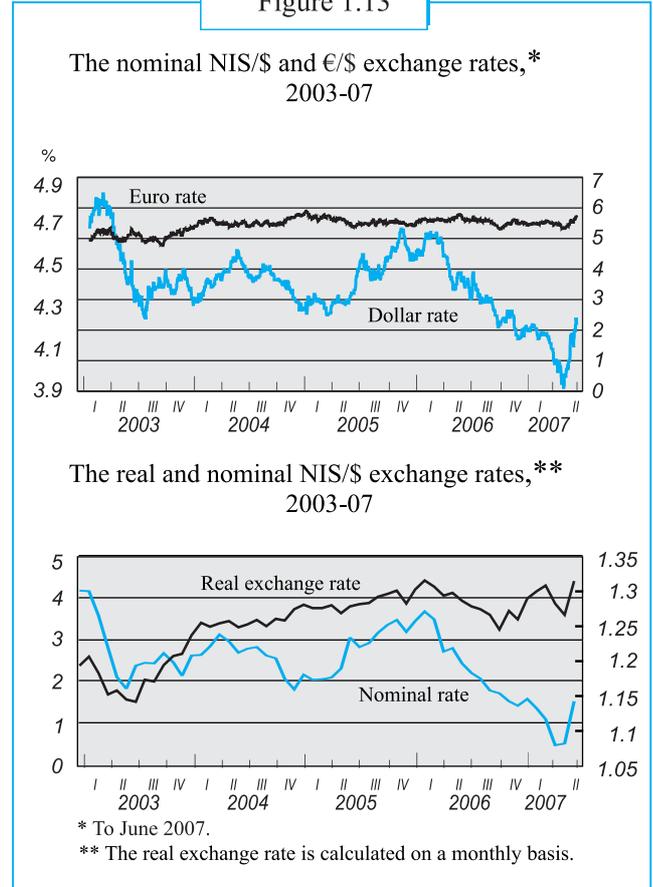
One of the most important factors affecting the development of prices and the level of inflation during the first half of the year was the exchange rate of the shekel against the dollar, via the changes in the prices of tradable goods and the shekel prices of dollar-price denominated goods and services. The exchange rate thereby has a major impact on the housing price index and via that index, on the consumer price index as a whole because of the housing item’s high weighting in the basket of goods and services. Developments in recent months show that the impact of this pass-through

Figure 1.12



mechanism is extensive, and exchange rate volatility can cause unexpected fluctuations in the inflation rate. The dollar exchange rate at the beginning of the year was NIS 4.225 and at the end of the first half reached a level of NIS 4.25—a depreciation of only half a percent (Table 7 and Figure 1.13). However, this apparent stability over the half-year period conceals extreme changes during recent months: Following a period of relative stability from the beginning of the year until almost the end of the first quarter, a large, cumulative 6.5 percent appreciation of the shekel began in a process that continued until the middle of May, during which the dollar exchange rate reached a low of only NIS 3.93. The large depreciation of the shekel resulted from the worldwide weakening of the dollar caused by the enormous current account deficit and the slowdown in the American economy, and the favorable performance of the Israeli economy, as reflected by the expansion in production and exports and the accrual of a current account surplus, despite the unstable security situation and the exposure of various episodes of corruption. In the second half of May however, the shekel began to depreciate heavily. The reduced expectations of an interest rate cut in the USA led to a rise in US government bond yields to a level above 5 percent. In addition, the central banks in Europe raised their interest rates because of concern over an upturn in inflation. Due to the rise in yield on risk-free investment, foreign investors shifted their funds from the emerging markets, including Israel, back to the USA and Europe, The outflow of money from the Israeli capital market reduced the supply of foreign currency and led to a depreciation of the shekel. The cut in the Bank of Israel interest rate for May also contributed to the weakening of the shekel.

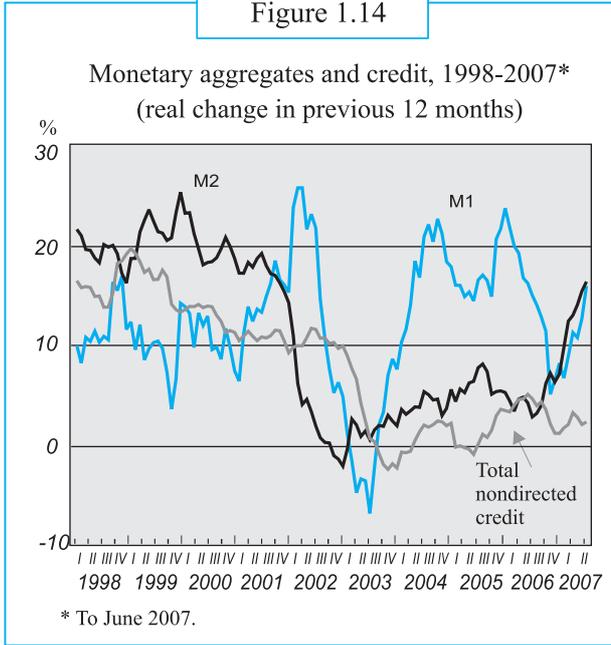
Figure 1.13



The rate of expansion in the means of payment (M1) increased to 16 percent during the last 12 months, compared with 13.7 percent in 2006 (22 percent during the period reviewed), and far exceeded the inflation rate plus the GDP growth rate (Table 1.8). It should however be noted that the effect of the money supply on the level of prices in an inflation targeting regime is marginal, because the policy instrument under this regime is the interest rate. The development of the aggregate in question is more important from the aspect of changes in demand, and its expansion at least partly reflects the rapid growth in non-financial activity in the economy, the increase in consumption resulting from the very low interest rates on low-risk and liquid investments, and the buoyant state of the stock market. The rate of expansion in M2 also increased, to 21 percent.

Unrestricted bank credit expanded rapidly during the period reviewed after contracting in the last quarter of 2006, apparently due to the uncertainty resulting from the Second Lebanon War. A change was apparent in the composition of bank credit, with a large increase in unindexed local currency credit and a decrease in foreign currency credit and CPI-indexed credit, developments that resulted from the development of the exchange rate and inflation. The

Figure 1.14

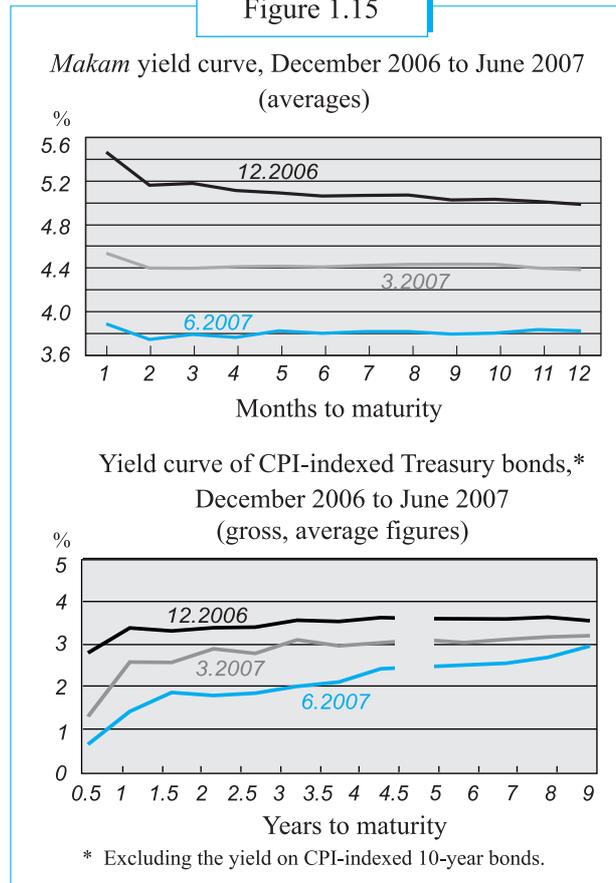


relatively low level of bank credit reflects the move to borrowing from non-bank sources. The volume of capital raising via bond issues increased considerably during the first half of 2007, when firms raised nearly NIS 45 billion in IPOs. The largest issue, amounting to a billion shekels, was that of Israel Aircraft Industries.

The *makam* yield curve fell consistently along its entire length during the period reviewed by an average rate similar to the cumulative reduction in the interest rate (Figure 1.14). The curve remained flat, reflecting expectations that the interest rate would remain unchanged. The negative slope of the yield curve in the very short term of one to two months at the end of 2006 appears to have reflected the public's expectations of a continued reduction in the interest rate during 2007 as well, which actually materialized. The changes in the CPI-indexed bond yield reflect the fall in the real yield in the short run, which in the absence of any change in inflation expectations matches the decline in the nominal interest rate. The decline in the real yield derives from the decrease in the budget deficit, and with it the need to borrow in order to finance the deficit, and from the decline in Israel's risk premium even though interest rate hikes in the developed countries actually led to a rise in yields. The slope of the yield curve changed from almost completely flat to moderately positive, reflecting the absence of expectations of any major decrease in the real interest rate in the long term.

The performance of the Tel Aviv Stock Exchange during the last half year was rated in 13th place worldwide out of 50 countries. The stock market continued its upward climb in

Figure 1.15



the first half of 2007 after rising for four years, and ended the half year with a return of 20 percent on the Maof index. The impact of the positive trends in world markets and the rapid growth in the Israeli economy surpassed that of such local shocks as the resignation of the Finance Minister, the exposure of corruption scandals, the Hamas takeover of Gaza, the violent disturbances in the Palestinian Authority, the Katyusha rocket attacks in the north and the Kassam rocket attacks in the south. Apart from a spate of profit-taking at the end of February and the beginning of March, the markets moved upward concurrent with a decrease in volatility. The upturn in share prices in the stock market reflected the record profits recorded by publicly-traded companies and the decline in the P/E ratio. 45 companies floated shares in IPOs, more than in the whole of 2006. NIS 16 billion²² were raised from share issues. The proportion of Israeli equities in the public's asset portfolio rose at the expense of other assets.

The mutual fund industry raised a record amount of NIS 25 billion in the first half of 2007. This was a result of the cuts

²² A large part of this amount – NIS 6.4 billion – was raised in the Haifa Oil Refineries issue.

in the interest rate in Israel, which reduced the investment feasibility of shekel deposits, and the appreciation of the shekel, which made dollar assets unattractive. In June however, the pace of issues slowed considerably and extensive redemptions were recorded, mainly from shekel funds. The withdrawals from the mutual funds by households and by nonresidents derived from the strengthening of the dollar and the rise in yields on US government bonds. The end to the Bank of Israel's interest rate cuts are also likely to slow the pace of future issues.

Table 1. National Accounts,^a 2006-2007

	2006					2007	2007	Last month for which data available
	2006	I	II	III	IV	I	I ^b	
GDP	5.1	5.7	6.4	-0.8	7.3	6.3	4.7	Mar
Business-sector product	6.4	7.9	8.7	-4.1	10.0	6.5	5.1	Mar
Private consumption	4.8	7.7	4.6	4.8	4.9	11.8	6.4	Mar
Gross domestic investment	4.1	0.7	-16.9	-38.0	181.0	-41.9	-4.2	Mar
Fixed investment	6.4	5.5	0.3	20.6	-0.2	23.7	10.6	Mar
Goods and services exports ^c	4.9	-2.0	41.7	-14.4	9.3	11.1	10.2	Mar
Goods and services exports								
excl. diamonds	9.3	1.5	46.0	-13.5	6.8	14.9	11.6	Mar
Goods and services imports ^d	3.1	3.3	12.8	-12.5	44.1	-2.3	8.6	Mar
Goods and services imports								
excl. diamonds	5.0	6.3	14.2	-11.6	21.5	13.8	8.7	Mar
Public sector consumption	3.3	4.8	-0.1	17.9	4.9	-4.0	4.3	Mar
Public sector consumption								
excl. defense imports	2.7	3.5	-2.2	12.2	1.9	6.3	4.4	Mar
Domestic use of resources	3.8	6.4	-0.7	-1.6	21.1	-0.9	17.2	Mar

^a Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.

^b Compared with 2006:I

^c New calculation - excluding subsidies.

^d New calculation - excluding taxes.

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,^a 2006-2007

	2006	2006			2007		Jan 07- Jun 07 ^b	Last month for which data available
		II	III	IV	I	II		
Composite state-of-the-economy index	4.3	8.5	7.4	6.5	7.6	7.6	7.4	Jun
Large-scale retail trade	4.2	2.8	-7.7	15.5	6.2	5.0	4.1	Jun
Manufacturing production								
(excl. diamonds)	8.4	9.4	14.4	11.3	-2.7	5.4	7.9	May
Index of revenue in commerce	5.4	6.5	-2.0	11.9	12.2	6.0	6.8	May
Index of commerce and services revenue	8.2	9.3	1.7	11.5	16.8	1.6	8.9	May
Index of export - services	-2.1	10.8	-2.8	-11.3	101.4	18.4	18.8	Jun
Tourist arrivals	-3.9	9.5	-84.5	126.2	103.1	17.1	-5.2	Jun
Residential construction ^b								
Starts	-3.0	-8.1	-29.8	7.3	-15.8		-16.6	Apr
Completions	-7.8	-8.5	-24.5	12.4	6.0		1.1	Apr
Nonresidential construction ^b								
Area of starts	3.0	8.4	1.7	-10.6	-64.2		-64.2	Mar
Survey of companies (net balance, percent) ^c								
Weighted balance of the business sector	28	28	14**	34	24	27		Jun
Output of manufacturing firms	29	33	22	26	28	21		Jun
Sales by trading firms	33	29	24**	39	30	30		Jun

^a Percentage change from previous period, in annual terms, 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 3. Indicators of Labor Market Developments,^a 2006-2007

	2007		2006		2007		Jan 07- Jun 07 ^b	Last month for which data avail- able	
	I	II	II	III	IV	I			II
	('000s)		percent change from previous quarter						
Civilian labor force	2,864		1.1	0.0	0.6	1.2	3.0	Mar	
Israeli employees	2,643		1.0	0.6	1.2	1.3	4.2	Mar	
<i>Of which:</i> in general government	780		4.8	4.4	-3.1	0.7	6.7	Mar	
in business sector	1,859		0.2	-1.2	2.6	1.5	3.1	Mar	
Foreign workers and Palestinians (unadjusted)	372		-1.0	4.3	2.7	-0.9	5.0	Mar	
Average hours worked weekly per employee	36.9		-0.6	-0.3	2.2	0.3	1.3	Mar	
Labor input in business sector (incl. foreign workers and Palestinians)	88,124		-0.6	1.1	3.5	0.8	4.8	Mar	
<i>Of which:</i> Israelis	77,252		-0.5	0.2	4.0	0.9	4.2	Mar	
Labor input in general government (Israelis)	19,911		4.1	3.2	-2.2	3.7	10.7	Mar	
Unemployed	221		1.6	-6.3	-5.5	0.5	-9.7	Mar	
Work seekers	205	202	-0.4	-3.1	-2.6	-1.4	-1.3	May	
Claims for unemployment benefit	65	65	-2.1	-1.3	-3.7	-2.6	0.2	Jun	
	Nominal NIS (unadjusted) ^c								
Real wage per employee post ^c	7,438		0.7	0.9	1.0	0.7	1.3	3.6	Apr
In general government	6,734		2.5	1.3	-1.6	-0.6	2.9	1.9	Apr
In business sector	7,773		-1.0	1.1	2.0	1.6	0.9	4.2	Apr
Nominal wage per employee post ^c	7,610		1.2	0.6	0.1	0.8	1.2	2.8	Apr
In general government	6,890		3.5	0.6	-2.7	-0.4	3.4	1.2	Apr
In business sector	7,953		-0.5	0.9	1.1	1.7	1.0	3.5	Apr
	percent								
Participation rate			55.8	55.5	55.6	56.1	1.1	Mar	
Employment rate			50.9	51.0	51.3	51.8	2.3	Mar	
Unemployment rate			8.8	8.3	7.8	7.7	-12.1	Mar	
Depth of unemployment ^d			44.7	38.9	36.7	42.1	6.0	Mar	

^a Seasonally adjusted.

^b Compared with January 2006 - June 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 4. Government Budget Performance, 2006-2007

	2006		2006		2007		Jan 07- Jun 07	Last month for which data available
		II	III	IV	I	II		
Domestic deficit as percent of GDP	0.2	-0.2	-1.2	-3.7	5.2		5.2	Mar
Deviation from domestic budget path, excl. credit extended ^a							NIS billion ^b	
	NIS billion, nominal prices							
Revenue	10.0	2.7	3.0	0.7	4.1	3.5	1.3	Jun
Expenditure	0.3	-0.1	4.1	-0.1	-2.2	-2.2	-0.7	Jun
Deficit	-9.6	-2.8	1.1	-0.8	-6.3	-5.7	-2.0	Jun
Total deficit excluding credit	-5.5	-3.2	-2.0	-8.1	6.4	-0.8	1.0	Jun
	Real percentage change from respective period, previous year							
Government tax revenue	6.9	4.4	7.2	7.4	7.3	7.4	5.2	May
<i>of which:</i> income tax, net	12.3	10.1	19.4	7.8	10.6	5.8	6.0	May
VAT, gross	4.7	6.1	-1.9	6.5	0.4	2.3	1.3	Jun
Government expenditure	3.4	3.8	7.1	6.5	9.0	2.1	7.7	May
National insurance allowances	3.2	0.5	2.3	8.8	4.8	3.4	4.7	May
<i>of which:</i> Unemployment benefit	-3.8	-5.9	-4.9	-0.9	-7.4	-8.3	-7.5	May
Income support	-7.1	-9.0	-6.7	-5.9	-6.6	-4.8	-6.1	May
National insurance contributions received from the public	2.3	0.3	3.4	6.3	2.9	6.6	4.2	May

^a The path was determined on the basis of a deficit of 3.0 percent of GDP.

^b Compared with Jan-Jun 06, without reference to seasonal budget path.

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

Table 5. Foreign Trade, Balance of Payments, and the Reserves,^a 2006-2007

	2006	2006			2007		Jan 07- Jun 07 ^b	Last month for which data avail- able
		II	III	IV	I	II		
	percent change from previous period ^c							
Trade in goods ^d								
Goods imports	7.9	1.0	5.8	0.8	6.3	4.6	14.3	Jun
Of which: Consumer goods	10.5	1.0	4.7	0.3	28.2	1.2	35.8	Jun
Capital goods	4.5	-4.3	8.6	-0.5	0.5	4.1	5.8	Jun
Intermediates	8.4	3.0	5.2	1.4	1.4	6.1	10.4	Jun
Goods exports	13.5	10.4	-1.1	2.6	7.7	-0.5	13.3	Jun
<i>Of which: Manufacturing</i>	14.0	10.8	-1.3	2.6	6.7	0.1	12.3	Jun
<i>Of which: High-tech</i>	20.3	18.1	-3.5	1.8	3.0	1.4	9.6	Jun
Balance of payments								
		\$ million						
Goods and services exports	62,992	16,363	15,571	16,297	16,645			Mar
Goods and services imports	61,892	15,616	15,212	16,479	16,668			Mar
Balance of trade in goods and services	1,100	747	359	-182	-24			Mar
Current account	7,990	2,080	2,336	1,830	1,697			Mar
Financial account (excl. foreign exchange reserves) ^e	-2,092	-1,602	-1,133	-1,799	-724			Mar
<i>Of which: Nonresidents' direct investme</i>	3,575	1,971	5,787	4,168	2,196			Mar
Nonresidents' portfolio investme	2,023	-1,547	-381	1,561	1,111			Mar
Residents' direct and portfolio investment abroad	5,509	1,695	2,451	3,699.0	3,286.0			Mar
Net foreign debt (percent of GDP) ^e	-23.3	-16.1	-19.7	-23.4	-24.8			Mar
Bank of Israel reserves, end-period ^e	29,055	27,349	27,627	29,055	30,503	29,112		Jun

^a Seasonally adjusted.

^b Compared with January 2006 - June 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 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	4.9	5.4	4.9	4.9
Advanced countries	1.9	3.3	2.5	3.1	2.5	2.7
Developing countries	6.7	7.7	7.5	7.9	7.5	7.1
World trade	5.4	10.6	7.4	9.2	7.0	7.4
Advanced countries						
Imports	4.1	9.1	6.1	7.4	4.7	5.7
Exports	3.3	8.9	5.6	8.4	5.5	5.8
Developing countries						
Imports	10.3	16.4	12.1	15.0	12.5	12.2
Exports	10.8	14.6	11.2	10.6	10.4	9.9
Commodity prices (US\$)						
Oil ^c	15.8	30.7	41.3	20.5	-5.5	6.6
Nonfuel	6.9	18.5	10.3	28.4	4.2	-8.8
Inflation (CPI) in advanced countries	1.8	2.0	2.3	2.3	1.8	2.1
Short-term interest ^d (%)						
Dollar deposits	1.0	1.4	3.2	4.8	5.2	5.1
Euro deposits	2.3	2.1	2.2	3.1	3.8	3.7
Unemployment rate in advanced countries	6.5	6.3	6.0	5.5	5.4	5.4

^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), April 2007.

Table 7. Selected Price Indices,^a 2006-2007

	2006	2006			2007		Jan 07- Jun 07 ^b	Last month for which data avail- able
		II	III	IV	I	II		
CPI	-0.1	1.0	-0.8	-0.9	-0.2	1.2	1.0	Jun
CPI excl. housing, fruit and vegetables	0.9	2.0	-0.8	-0.7	-0.1	1.7	1.6	Jun
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	1.4	1.7	-0.5	-1.4	0.6	1.2	1.8	Jun
Index of housing prices	-6.1	-3.2	-0.3	-2.9	-0.3	-0.1	-0.4	Jun
Wholesale price index	2.1	2.3	-0.6	-2.8	1.6	2.5	4.1	Jun
NIS/\$ exchange rate	-8.9	-4.6	-2.7	-3.5	0.0	-0.4	-0.5	Jun
NIS/currency-basket rate	-5.8	-3.0	-2.5	-2.4	0.0	-7.5	-3.9	Apr

^a Rates of change during period, percent.

^b Change in last six months. In semiannual terms.

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2006-2007
(annual terms, percent)

	2006	2006			2007		Cumulative in previous 12 months	Jan 07- Jun 07	Last month for which data available
		II	III	IV	I	II			
Rates of change		Change from preceding period					During period		
M1 ^a	13.7	6.6	11.0	-1.3	21.0	23.9	16.0	21.7	Jun
M2 ^b	4.9	5.5	10.0	9.5	22.8	19.7	16.5	21.0	Jun
M3 ^c	7.4	6.1	6.4	6.9	19.8	14.1	13.4	17.3	Jun
Nondirected bank credit	3.6	4.0	2.4	-0.5	3.8	4.2	2.4	5.3	Jun
Unindexed local-currency credit	12.3	16.8	13.9	18.0	20.0	11.8	13.9	11.8	Jun
CPI-indexed credit	1.1	-0.9	-0.3	-7.1	-6.3	0.5	-3.2	-0.2	Jun
Credit in and indexed to foreign currency	-7.6	-10.0	-14.2	-23.7	-13.0	-7.7	-11.8	-0.5	Jun

^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 9. Interest Rates, Yields, and the Share-Price Index, 2006-2007
(quarterly average, percent)

	2006	2006			2007		Jan 07- Jun 07 ^a	Last month for which data avail- able
		II	III	IV	I	II		
Nominal interest								
SRO deposits	4.1	4.1	4.3	4.1	3.4		3.4	Feb
Nondirected local-currency credit	8.4	8.4	8.7	8.3	7.8	7.2	7.6	May
Effective local-currency credit	5.3	5.3	5.6	5.5				Nov
LIBID 3-month dollar interest	5.1	5.1	5.3	5.2	5.2	5.2	5.2	Jun
Yield to maturity on:								
12-month <i>makam</i>	5.5	5.8	5.8	5.1	4.5	3.8	4.2	Jun
5-year bonds	3.7	3.8	3.9	3.6	3.2	2.9	3.1	Jun
Risk premium ^b	0.3	0.3	0.3	0.3	0.2	0.2	0.2	
Expected inflation ^c	1.8	1.9	1.8	1.4	1.3	1.0	1.1	Jun
General Share-Price Index (change)	5.4	-8.4	5.2	7.5	10.1	13.6	21.9	May

^a Compared with January 2006 - June 2006.

^b As measured by the 5-year credit-default-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

Vocational training in Israel and recommendations for its improvement

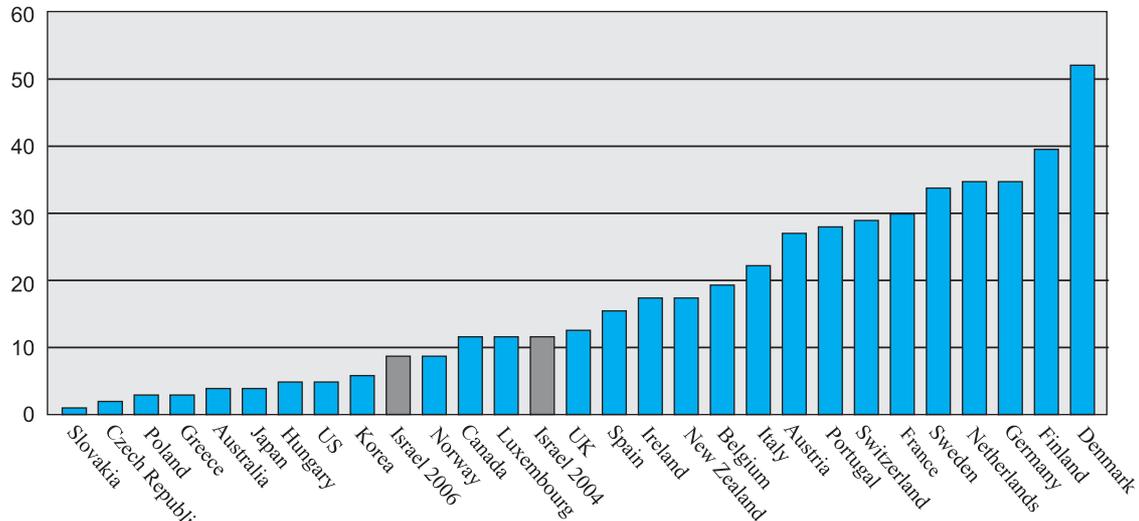
Active labor market policy (ALMP) is designed to prevent the erosion of the human capital of the unemployed and to improve their chances of being re-employed, through public employment services, employment subsidies and a system of training. Vocational training is designed to improve the participants' skills or to provide them with new ones. Vocational training is an important tool to bring the unemployed back into the labor cycle, though one should not underrate its importance to the employed too, particularly in the modern labor market, which is characterized by frequent changes in the work and occupational environment. Vocational training raises labor productivity, and those that receive training benefit from more assured employment and from more rapid pay rises.²³ However those workers

in most need of training—low-salaried workers, the young, temporary workers etc.—are mostly unable to finance such training, and also cannot borrow for this purpose due to market failures: since human capital, being an intangible asset, cannot serve as collateral for a loan, private banks refuse to lend money to finance training. This emphasizes the importance of public policy on vocational training.

The rise of unemployment in the last three decades of the 20th century in the western countries led to more government investment in training systems, with wide variations between countries. Despite this, Israel in recent years has seen legislative changes that caused a reduction in the scope of training,²⁴ in spite of the high unemployment figures. Figure 1, which shows public expenditure on training as a share of GDP in Israel and the OECD countries, shows that we are in the bottom part of the distribution.

Figure 2.1

Public expenditure on training as a share of GDP in Israel and the OECD countries, 2004^a
(percent)



^a US and UK, 2003; Israel also 2006.

SOURCE: Israel—budget data (item 3617, Training Division in the Ministry of Industry, Trade and Labor); other countries—OECD Employment Outlook 2006.

²³ OECD Employment Outlook, Boosting Jobs and Incomes, 2006.

²⁴ For further discussion, see Government-Initiated Vocational Training for Adults in Israel – a Disappearing World, Recent Economic Developments No. 113, p.24.

Empirical findings in Israel and abroad

After earlier research had found it difficult to identify and quantify the positive contribution of vocational training near to the end of training,²⁵ recent research has monitored the performance of those participating in training programs over a period of time. This research showed that the effect of the programs becomes significantly positive only after a relatively long time.²⁶ It was also found that the training programs' effect on different populations was heterogeneous: they benefited particular target populations—mainly mature women from the weaker segments of the population—while the rates of return for other populations—men, and the young—were low, or even negative.²⁷ It was found that the training was effective in bringing the unemployed back to work mainly among those with high motivation. In this context, it is claimed that extending vocational training widely could actually harm the effectiveness of the program, as it would bring in the unemployed with relatively low chances of success.²⁸

²⁵ For example, see A. Forslund and A. Krueger (1994). "An evaluation of the Swedish active labor market policy: new and received wisdom", NBER Working Paper No. 4802; N. Park, B. Power, W.C. Riddell and G. Wong (1996), "An assessment of the impact of government-sponsored training", *Canadian Journal of Economics*, vol. 29 (Special issue), Part I, pp. S93-S98.

²⁶ For example, see D. Friedlander and G. Burtless (1995). *Five Years After: the Long-Term Effects of Welfare-to-Work Programs*, Russel Sage Foundation, New York; V. Hotz, G. Imbens and J. Klerman (2000), "The long-term gains from GAIN: a re-analysis of the impacts of the California GAIN program", NBER Working Paper No. 8007; A. Dyke, C.J. Heinrich, P.R. Mueser and K.R. Troske (2005), "The effects of welfare-to-work program activities on labor market outcomes", IZA Discussion Paper No. 1520.

²⁷ J. Gueron and E. Pauly (1991). *From Welfare to Work*, New York: Russel Sage; C. Eberwein, J.C. Ham and R.J. Lalonde (1997). "The impact of being offered and receiving classroom training on the employment histories of disadvantaged women: Evidence from experimental data", *The Review of Economic Studies*, 64(4), Special Issue: Evaluation of Training and Other Social Programmes, pp. 655-682; R. LaLonde, (1995). "The promise of public sector-sponsored training programs", *Journal of Economic Perspectives*, 9, 149-168; H.S. Bloom, L.L. Orr, G. Cave, S.H. Bell and F. Doolittle (1993). *The National JTPA Study: Title II – An Impact on Earnings and Employment at 18 Months*, Bethesda: Abt Associates; J.P. Martin and D. Grubb (2001). "What works and for whom: a review of OECD countries' experiences with active labour market policies", *Swedish Economic Policy Review*, 8(2), 9-56.

²⁸ B. Cockx (2003). "Vocational Training of Unemployed Workers in Belgium", IZA Discussion Paper No. 683.

From comprehensive surveys of targeted vocational training programs in the US²⁹ three fundamental points for success stood out: 1) focusing on target populations who would benefit most from such programs; 2) a reduced scope of the program; and 3) bestowing recognized certification on completion of the course, and integrating some employment element, through strong links with local employers.

The main disadvantage of this type of intervention is the weakness of effort that the program participants put into job searching, due to a reduction in their free time—what is known as the 'locking-in effect'; taking part in the program is expected, in the first stage, to reduce the probability of finding employment, and only after the course is completed does the probability rise of the participants finding work. The period of unemployment may also be extended due to the narrowness of the field of job searching—after a particular training program, especially for the participant who had no prior skills—as well as due to the rise in the threshold wage. Therefore the benefit of continuous vocational training programs can only be assessed several years after their completion.

Analyses on the impact of such training programs in Israel are still limited, though it has been found that graduates of such training manage to find work sooner than those who did not undergo training,³⁰ and that the vocational training is more effective for new female immigrants with high levels of education.³¹ A survey that tracked vocational graduates³² showed that one third of them were not employed six months after completing the training, that out of those employed only half of them were working in the profession in which they were trained, and that the average wage of a graduate of the course was lower than the wage of his last job before the period of unemployment. However it was found that the vocational training programs were more beneficial to new

²⁹ Based on the surveys prepared by D. Friedlander, D.H. Greenberg and P.K. Robins (1997), "Evaluating government training programmes for the economically disadvantaged", *Journal of Economic Literature*, 35(4), 1809-1855; M. Stanley, L. Katz and A. Krueger (1998), "Developing skills: what we know about impacts of American employment and training programs on employment, earnings and educational outcomes", Malcolm Weiner Center for Social Policy Working Paper H-98-02, John F. Kennedy School of Government, Harvard University, October.

³⁰ M. Beenstock (1996), "Training and the time to find a job in Israel", *Applied Economics*, 28, 935-946.

³¹ S. Cohen (2000). "Training and work experience effects on labor market absorption of female immigrants", Tel Aviv University, The Eitan Berglas School of Economics.

³² A. Achitov, Y. Eyal, L. Cohen (2001), "Analysis of Changes in Employment and Wages of the Unemployed in Israel following Vocational Training," Ministry of Labor and Welfare, Authority of Labor Force Planning (in Hebrew).

immigrants than to the veteran population, to women more than men, and to singles more than marrieds. A survey that tracked participants in an education completion program³³ showed that two thirds of graduates did not work at all after completing their studies. This group was heavily represented by older people, Arabs, the ultra-Orthodox and those with low education (having completed only elementary school or junior high school). A large number of those in the group noted that they were forced to participate in the studies due to "lack of better activity." Therefore it should be stressed that the positive returns from running the program are obtained when participation is through choice, and the participants are motivated to succeed.

Vocational training in Europe

Vocational training is the most important component of Active Labor Market Policy, both in terms of the size of expenditure and in terms of the number of participants. However in recent years total expenditure on active steps has consistently fallen, while the importance of other types of involvement, such as employment incentives and special plans to bring the handicapped into the labor market, has continually risen. According to Eurostat figures for 2003, spending on training in EU countries—including class training, on-the-job training and support for participants—amounted to 39 percent of total expenditure on ALMP, compared to 44 percent in 1998. The maximum expenditure on training was registered in Britain (more than 80 percent out of total ALMP spending); Austria, Portugal, Finland and Germany had higher than average spending (from 47 percent to 65 percent out of total ALMP expenditure), while Belgium, Spain, Netherlands and Norway spent the lowest amounts, proportionately, on training (18, 20, 21 and 13 percent out of total ALMP expenditure, respectively). In Israel, spending by the vocational training department in 2006 stood at about 35 percent of the total ALMP budget.

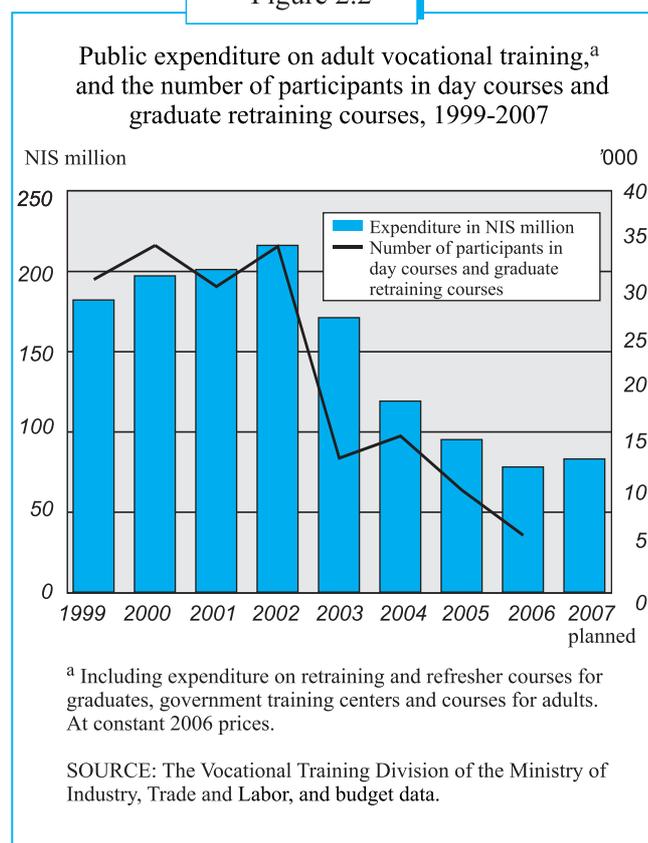
The latest situation in vocational training in Israel

In recent years there has been a drastic reduction in the scope of vocational training for the unemployed (Figure 2). Spending on vocational training was reduced sharply in 2003, and the allowances paid during the period of training have also been cut, which caused a drop in the number of participants in such courses by more than half. In 2006 the numbers registering for training courses fell by a further 40 percent.

³³ M. Sofer (2006), "Education Completion for the Unemployed as a Tool to Improve Integration into the Labor Market," Research and Economics Administration, Ministry of Industry, Trade and Employment (in Hebrew).

The cutback in training programs stemmed not only from considerations of cutting costs, but also from an understanding that the training system that had operated in the past was not efficient enough to meet requirements.³⁴ Therefore the emphasis was placed on small programs, which were coordinated with the special needs of the targeted population—ultra-Orthodox, immigrants from the Caucasus and Ethiopia, and the minorities—and combined training for professions in demand with practical experience. Among the programs that were operated under this new regime was the 'New Horizon' course for technical training under cooperation with Intel; training programs for ultra-Orthodox women in real estate back office work from the US, in Modi'in Ilit, jointly run with Citybook Services; the 'Class in the Factory' program for training young Bedouin as plant operatives in the Kitan plant in Dimona, a joint project with Kitan and the Etgar College; and a training course in pharmaceutical mechanization with guaranteed employment, in cooperation with Teva. In addition to these,

Figure 2.2



³⁴ In October 2006 a committee was appointed to examine the vocational training system and changes in its perception, in order to give a satisfactory response to the needs of the economy and the labor market.

other courses arranged by the vocational training unit at the Ministry of Industry, Trade and Employment were added in the construction field in order to encourage the substitution of foreign workers with Israelis.

Vocational training is supposed to be an important component of the Welfare-to-Work program (known in Israel by its acronym Mehalev), though in its first year of operation only 1,035 course participants (4 percent of the total participants in the instruction) received vocational training from the operators of the employment centers.

Training programs for special populations in Israel

As the rate of participation in the labor force is the lowest among ultra-Orthodox men and Arab women, there is great importance attached to proposed vocational training programs for these populations in an attempt to bring them into the labor cycle. As their labor force participation rate is very low so far, any change in it would be significant in relative terms. One of the basic obstacles to these populations' involvement in the labor cycle is the absence of skills that match the modern labor force needs; therefore the potential inherent in vocational training is all the greater.

a. Training programs for the ultra-Orthodox community

The ultra-Orthodox education system centers its attention on religious studies, at the expense of more practical subjects of study: mathematics, computers, science and languages. Lacking knowledge in these subjects prevents the ultra-Orthodox from pursuing further education or from joining the labor force. Therefore improving their involvement in the labor force would require supplementing their basic education and vocational training in fields sought after by the market.

Since 1996 a number of institutions of vocational and academic training for the ultra-Orthodox population has been established, such as the Haredi Center for Technological Studies, Touro College and the Academic College in Or Yehuda. For the past decade the Joint Distribution Committee (JDC)-Israel and the Ministry of Industry, Trade and Employment have run a joint project called 'An Honorable Living' whose aim is to encourage the integration of the ultra-Orthodox into the labor force. The project operates in two fields: providing subsidized supplementary studies and vocational training for yeshiva students, and the establishment of employment advisory centers in four overwhelmingly ultra-Orthodox population centers. A study

that tracked one intake of the project³⁵ showed that 38 percent of the course graduates who were not employed prior to the course (the target population) were in employment in the follow-up stage (not necessarily in the field in which they trained), while a further 25 percent were seeking work. However the drop-out rate was relatively steep: 36 percent of the students that began the course dropped out at some time.

Recently significant efforts have been made to create places of work for the ultra-Orthodox public, including by investors from abroad, and as a result hundreds of jobs have been created. One must note in this context the call centers, the training for back office services and the opening of the Citybook Services branch, the establishment of plants by Matrix, Talpiot Technologies, ImageStore Systems and others in the ultra-Orthodox town of Modi'in Ilit, and the Matrix-Talpiot plant in Bet Shemesh, after relevant training courses. One must add to these activities the Encouragement of Capital Investment Law (to be discussed below), which is aimed at subsidizing plants that create new work places in ultra-Orthodox communities, as part of the employment track.

b. Training programs for the Arab community

In contrast to the efforts invested in recent years in encouraging the integration of the ultra-Orthodox population into the labor market, no such similar steps have been taken for the minority populations. In August 2006, several multiyear plans for encouraging industry and employment in the Druze, Circassian and Bedouin communities of the north, for which some NIS 8 million was allocated in 2006-2009 for vocational training of some 1,000 students, and a further NIS 12 million was allocated for encouraging the creation of new jobs. The 'Class in the Factory' program was also established, designed for young Bedouin in the south, with the aim of training some 30 students in the operation of machinery and absorbing them into the Kitan plant. The program is a joint project with the vocational training unit of the Ministry of Industry, Trade and Employment, Etgar College and the Kitan plant in Dimona.

Recommendations

1. The proposal of a training program catering to the populations that may derive the greatest returns from it should be continued and broadened, and to do so, the

³⁵ J. King, N. Gazit (2005), "An Honorable Living" (Course I): A Vocational Training Program for ultra-Orthodox Jews: An Evaluation Study, August, JDC-Israel (in Hebrew).

- system of training should be made more efficient.³⁶ For these groups the training should be begun as early as possible, and entitlement to unemployment benefit should be extended to throughout the period of the course. The vocational training system should be extended to specific populations which have lower participation rates in the labor market, but which show high potential: the minorities and ultra-Orthodox. These plans should include classes that complete high school education, as well as vocational training. The social and cultural characteristics, and special needs of these populations should be taken into account.
2. Training should be concentrated on those professions in demand by the labor market.
 3. The training itself should be conducted by the private sector, and financed by the government, and on completion recognized certification should be awarded.
 4. It is important that the link with the labor market is established early on in the course, through visits to appropriate places of work, familiarization with potential employers, practical experience and the acquisition of work practices. Training should be planned in conjunction with local employers, so that the theoretical studies can be combined with hands-on experience in plants and companies in the private sector, and the link between the training and the work placement can be strengthened. Incentives should also be offered to factories to take on graduates from the courses.
 5. The program should concentrate on groups of unemployed with the highest chances of success. Given the relative lack of success of supplementary education courses for adults, the vocational training courses should be offered only to those who wish to participate of their own free choice. This will ensure that those participating in the courses will be motivated, and this will raise the chances of success.
 6. Training courses should be planned for those professions which attract large numbers of foreign workers. In recent years, vocational training courses in construction have been established, and indeed Israelis have begun to replace foreign workers in this field. In the same vein, courses in agriculture should be offered.
 7. Emphasis should be placed on short and medium-length courses, such that on the one hand they provide training on the specific profession but on the other hand avoid the locking-in effect. Offering courses that are too long should be avoided, both because of this effect and because of the high cost.
 8. Participation in the courses should be open to employed individuals with low levels of education, and not only to the unemployed.

³⁶ From the survey presented above we see that the major groups that should benefit from the training are new immigrants and mature women.

9. Private sector employers should be encouraged to offer their workers vocational training through subsidizing the cost of the training. However the method of encouragement should be carefully planned to prevent waste, arising from subsidizing an investment that would anyway have been made. A form of subsidy that lowers the marginal cost of training is preferable to awarding a grant of a fixed size.³⁷ Lowering the marginal cost of the vocational training is likely to affect the decisions of the employers regarding their investment in human capital.

Encouragement of Capital Investments Law: local and international experience and recommended changes

The grant track of the Encouragement of Capital Investments Law (henceforth, the Law) will finish at the end of 2007, and therefore some new thought is required on this subject. We need to evaluate the success of the Law so far, and to find the best way to continue using fiscal instruments to encourage economic entrepreneurship in general and increased employment in particular. We will do this by looking at the state of the economy and taking into consideration international experience and knowledge accumulated so far.

The aid granted in the framework of the Encouragement of Capital Investments Law concentrates on manufacturing companies, with preference given to exporting companies,³⁸ and foreign investors. The aid is directed mainly to national priority development areas, which were categorized into two levels of priority by economic, geographic or political criteria. In 2003, an alternative employment track was added to the Law: direct participation at a rate of about 15 percent of wage costs for companies in outlying areas that have won employment tenders.

Objectives of the Law

The objectives of the current law are defined as follows: 1) development of the economy's manufacturing ability, efficient use of its resources and its economic potential and full use of existing factories' manufacturing capacity; 2) an improvement in the current account of the balance of payments, the reduction of imports and increase in exports; 3) regional development, absorption of immigrants, the planned spread of the population across the country and the

³⁷ For example, in Australia 120 percent of the cost of training can be recognized for tax purposes, that is, the marginal cost of the training falls by 20 percent.

³⁸ Exporting companies are defined as those that export at least one quarter of their output.

creation of new places of employment. We will now examine to what extent these goals were achieved.

1. *Efficiency and the development of productive capacity:* economic theory states that maximum economic efficiency is obtained by the independent allocation of sources by market forces, except in cases of market failure such as natural monopolies and external forces. The need to deal with such market failures is not in general a factor in the Israel Investment Center's³⁹ considerations in its granting the status of approved enterprise to factories.

As early as in the 1980s studies in Israel found that the Encouragement of Capital Investments Law reduced economic efficiency, as it distorts the allocation of resources. Litvin and Meridor (1983)⁴⁰ found that capital subsidization created surplus capital stock in approved enterprises, which caused direct damage of about half a percent of GDP in each year covered by their study (1974–79). Bergman (1986)⁴¹ presented similar findings for the years 1972–84. He found that subsidizing investments reduced capital utilization and raised the ratio of capital per hour of labor in those years. According to his study, this low utilization of capital explains part of the modest rise in total productivity in that period. Shefer and Frenkel⁴² conducted a survey of manufacturing firms in development areas that were receiving support by virtue of the Law, and found that the majority of employees were working in factories in non-growth industries, and that 80 percent of those working in manufacturing in the sample area were unskilled and low paid.

2. *Improving the current account of the balance of payments:* the current account is meant to reflect the economy's long-run (smoothed) consumption. A deficit or surplus in the current account will therefore express the optimal consumption and investment consistent with the economy's permanent income. Hence intervention that attempts to regulate the current account in opposition to market forces should be avoided. Moreover, since 2003 Israel's economy has registered a rising surplus in the current account, and since 2004 the goods and services account has also shown a surplus. The current account in 2006 ended with a surplus of \$ 8 billion, 5.7 percent of GDP a high surplus both historically

for Israel and also by international comparison. Thus there is no apparent justification for exports to constitute a criterion for entitlement to receive a benefit.

3. *Development areas:* The Bank of Israel Annual Report for 2006⁴³ gives the results of an empirical study to see whether the Law helps to improve the employment situation in development areas. Several equations were estimated, using different methods, and yielded the result that it was difficult to point to any improvement in employment in high-unemployment areas. The main finding is the low level of success of the grants track, which constituted a greater share of total expenditure under the Law than that of tax benefits in most of the period of the study (1987–2003).

These results come as no surprise. Moav and Reingvertz (2006)⁴⁴ present similar findings. A study by Bergman, Fuss and Regev (1992),⁴⁵ shows that the Law creates overuse of capital relative to labor, and suggests that the demand for labor does not rise at the desired rate because of the subsidy on capital. Lavi (1994)⁴⁶ shows that the survival rate of companies that received grants was lower than that of companies established with full private finance, so that subsidized investments provided temporary, unstable, employment. Reports of the State Comptrollers in past years described defects in the implementation of the Law, and in particular companies' failure to meet their employment targets. Even if investments carried out with the encouragement of the Law had some positive effect, those investments might have been undertaken in any event, or they may have crowded out other investments.

Experience in other countries

In the EU a process of reducing expenditure on encouragement and support of companies has been underway since 1997, and in 2005 the issue was formalized: a binding decision was made that incorporated laws limiting governments' support of companies, in order to increase competition in the EU and to reduce the distortions caused by discrimination between firms. Implementation of the reform started in 2005, and will be completed in 2009.

³⁹ The Israel Investment Center is responsible for the implementation of the Law and for determining factories' eligibility for grants and/or tax benefits.

⁴⁰ U. Litvin and L. Meridor, The Grant Equivalent of Subsidized Investment in Israel, Bank of Israel Economic Review No. 54, April.

⁴¹ A. Bergman, Industry and Industrial Policy in Israel, Bank of Israel Research Department (in Hebrew).

⁴² D. Shefer and A. Frenkel, Creating Jobs in Development Areas, the Center for Urban and Regional Studies, Technion, Israel Institute of Technology (in Hebrew).

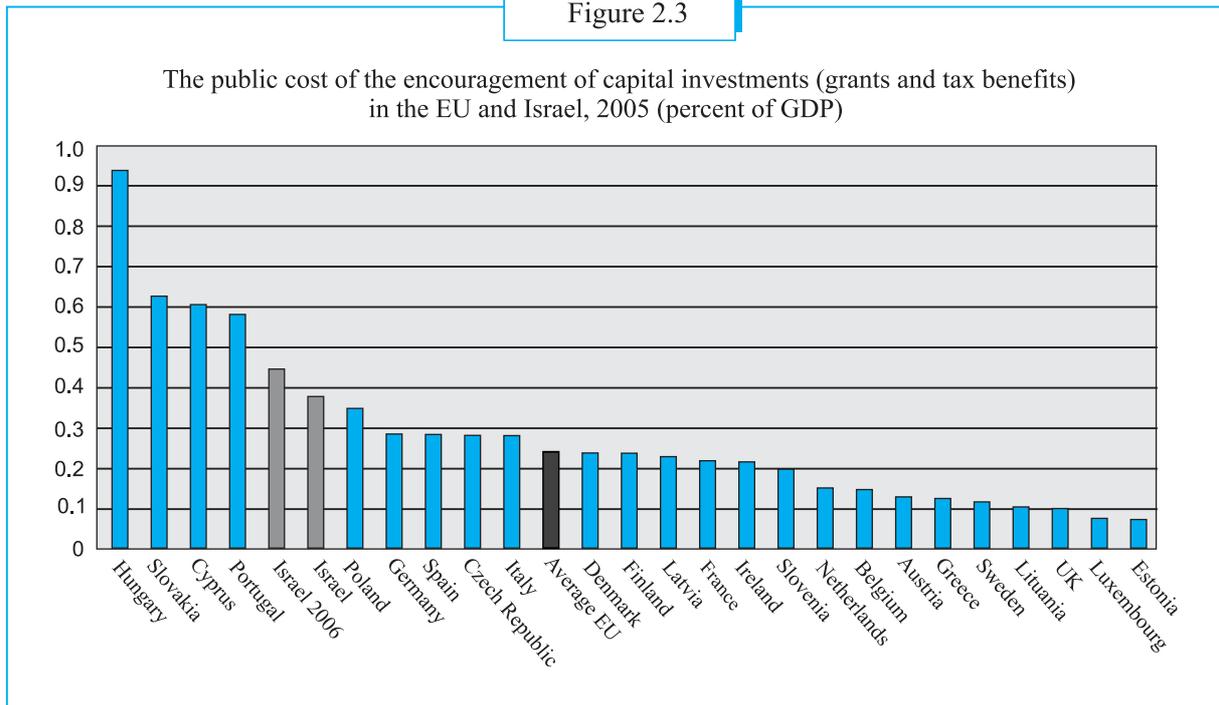
⁴³ Box 2.3, pp. 73–76.

⁴⁴ Moav and Reingvertz, Israel's Encouragement of Capital Investment Law: Employment in Development Areas 1984–2004, Shalem Center (in Hebrew).

⁴⁵ Bergman, Fuss and Regev (1992), The Production and Cost Structure of Israeli Industry: Evidence from Individual Firm Data, Bank of Israel Research Department, Discussion Paper Series, No. 92.06.

⁴⁶ Lavi (1994), The Effect of Investment Subsidies on the Survival of Firms in Israel, The Maurice Falk Institute for Economic Research in Israel, Discussion Paper no. 94.04.

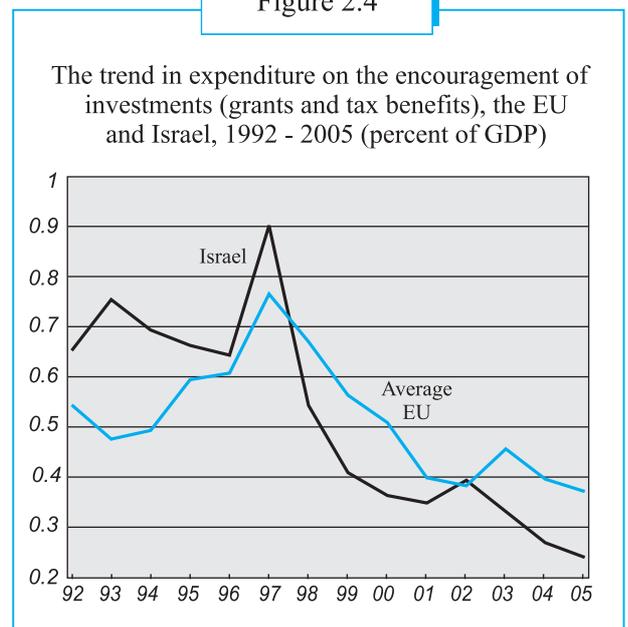
Figure 2.3



Underlying the decision is a certain measure of agreement regarding support for development areas: every country must obtain approval for its map of development areas. These areas must be especially weak, relative to the rest of that country and also relative to the average in the other EU member countries. The decision also defines certain goals that may and even should be supported. A supervisory committee was appointed to oversee these goals, with the authority to approve or reject support. The goals are such that attempts to achieve them do not adversely affect competition or efficiency but actually enhance them and create sustainable employment, i.e., investments in R&D, innovation and small companies.

Figures 2.3 and 2.4 compare Israel with the EU countries. Although Israel is showing the same trend as that in the EU of reducing the public cost of the encouragement of investments, it can be seen that the cost of grants and tax benefits in 2005 was higher in Israel than the average in the EU.

Figure 2.4



The recommended path to be followed to encourage investments and employment

The findings presented above suggest that the objectives of the support for investments and employment should be redefined, such that those objectives are consistent with actual experience gained in Israel and other countries. Furthermore, new methods and criteria should be adopted

that will help towards the achievement of the goals, while reducing any harmful effect on competition. The comparison with other countries indicates that the public costs of support for investment should be brought into line with the levels prevailing abroad.

Subsidies should be aimed at boosting employment and improving the standard of living in low socioeconomic regions. The selection procedure should be by tender, giving preference to initiatives incorporating specialized knowledge and technological innovation, and thus requiring skilled labor, as well as those that entail widespread training of staff. Setting priorities according to these criteria will probably help firms eligible to a subsidy under the Law to survive, and will contribute to the creation of stable employment. Studies abroad⁴⁷ found that adding the element of vocational training to the wage subsidy of new workers raises the chances that granting the subsidy will prove successful. Such preferences are the norm in the advanced economies—they encourage initiatives with positive external effects, and also help to reduce the incidence of market failures. On the other hand, it appears that there is no justification for giving priority to manufacturing or exporting companies or to foreign investors.

The map of priority areas should be redrawn so that the aid should be focused on outlying areas where employment is an acute problem. It is therefore proposed that the main regions included should satisfy two conditions: (1) they should be counted among the lower socioeconomic localities or regional councils, based on the socioeconomic index published by the CBS from time to time, and (2) they should be further than a certain distance from Tel Aviv and Haifa. The reasoning underlying the second condition is that residents of low socioeconomic areas close to the main conurbation or metropolitan area can overcome the local problem of lack of jobs by traveling to nearby areas where employment is available. This population requires a different approach, essentially via the educational system. The encouragement of investments in these areas is likely to crowd out others in the same or nearby areas, unlike the situation in outlying areas where there are fewer projects.

Projects in the outlying areas should be subsidized by a grant based on both the employment of labor and the investment in physical capital. To minimize the distortion that results from subsidizing factors of production, the grants should be allocated one-third to capital and two-thirds to labor, in accordance with the distribution of income in the business sector. The grants on employment will be geared to encouraging projects based on skilled, highly paid labor, and therefore the grants should be graded, rising with the level of wages. It is proposed that the grant on investment in physical

capital—machinery, equipment and new buildings—should be 20 percent of the total investment (the current norm in Israel).

Projects in the designated areas may also be eligible for tax benefits, and such benefits should be considered also for other regions low on the socioeconomic scale. Tax benefits should be granted on condition that the investment and employment targets—defined when the project was submitted—have been met. Some of the tax benefits could be granted via exemptions or reductions in the employer's and employee's National Insurance payments.⁴⁸ Such benefits would validate the employment targets, and would help to preserve the mix of support for physical capital and labor.

As can be seen from the Figure 2, the average public cost of the encouragement of capital investments in the EU is 0.24 percent of GDP, and in Israel, 0.36 percent of GDP. It would be advisable to set a downward path that would gradually reduce the budget cost of the Law to the normal EU level, particularly in the light of Israel's candidacy for membership of the OECD.

In the light of the worldwide trend of switching from grants to tax benefits, it is recommended that most of the benefits be granted via the tax system; such benefits, as they depend on companies' profitable activity, encourage high quality initiatives. Nevertheless, a policy that does not restrict the maximum amount of tax benefits lacks an element of planning, and is likely to run counter to the aim of meeting the deficit target. Therefore it is recommended that the limitation on the total amount of the tax benefits, which was removed in 2005, be reinstated.

⁴⁷ J.C. Van Ours (2000), *Subsidized Jobs for Unemployed Workers in Slovakia*, Working Paper No. 311, May. J.C. Van Ours and M. Vodopivec (2004), *How Changes in Benefits Entitlement Affect Job-Finding: Lessons from the Slovenian Experiment*, IZA DP No. 1181.

⁴⁸ National Insurance payments include payments of 4.14 percent by the employer and 0.4 percent by the employee on up to 60 percent of the average wage, and on the part of the wage above 60 percent of the average wage the employer pays 5.68 percent, and the employee, 7 percent.

Diary of Events from January to June

Month	Date	Event	Details
January	17	Ministers of Finance and Industry, Trade and Labor ease conditions significantly for participants in Project Mehalev (the Israeli “Wisconsin plan”).	Regulations sent to the Knesset for approval include significant easing of terms for those participating in project.
	22	First issue of 2–4-month bonds	In 2007, the units at the Finance Ministry Division of the Accountant General that manage government debt began to issue 3-month bonds. This is part of the Accountant General’s reform of government debt management, meant to make the management of the government’s cash flow more efficient.
	30	BOI draws up a proposal for the regulation of bank charges.	Pursuant to BOI’s decision to reexamine the matter in view of public debate and private members’ bills that were submitted about two months earlier, the proposal, including draft legislation, will be forwarded to the Finance Ministry for further legislative action.
February	14	Knesset Finance Committee approves a request by the Minister of Finance, Avraham Hirschson, to add 23 Jewish and Arab localities in the north to those eligible for compensation for indirect damage caused them by the Second Lebanon War.	The 23 localities join 200 localities that have been permanently eligible for compensation for the past 15 years.
	19	Government Companies Authority completes privatization of Israel Oil Refineries.	The total consideration is NIS 6.43 billion—making this the largest privatization in Israel’s history.
	27	Telbor market is formally established.	The Bank of Israel established the Telbor Interest Committee in conjunction with the stock exchange and a representative of the banks, in view of the widespread belief among market players that the Telbor rate quoted today is not a reliable indicator of interest in actual interbank transactions.
	28	BOI will use <i>makam</i> as an active monetary tool.	After more than a decade of gradual expansion of <i>makam</i> issues to absorb excess liquidity, BOI will begin to use <i>makam</i> as an official monetary tool in order to affect the level of liquidity in the economy depending on circumstances.
	28	Knesset passes Electricity System Bill into law.	Thus, Public Utilities Authority–Electricity will establish a special committee to exempt consumers who cannot afford to pay their electric bills or to offer them relief in repaying their debts.

Month	Date	Event	Details
March	12	Knesset Constitution, Law, and Justice Committee approves Compulsory Tenders (Compulsory Industrial Cooperation) Regulations	Compulsory industrial cooperation will apply to procurements by government and government-owned companies in sums exceeding \$5m instead of \$0.5m as before. The new threshold was patterned after the norm in other countries in order to make the buy-back mechanism more efficient.
	21	Agreement to solve the problem of delayed municipal wages is concluded.	The Director Generals of the Prime Minister's Office, the Ministry of Finance, and the Ministry of the Interior (Ra'anun Dinur, Yaron Ariav, and Ram Belinkov) concluded the outline agreement with the Chair of the Histadrut. The outline, endorsed by National Labor Court President Steve Adler and Judge Nili Arad, resembles a Government proposal that had been forwarded to the Chair of the Histadrut by the Ministers of Finance and the Interior and the Director General of the Prime Minister's Office. The accord was concluded on the basis, among other things, of authorizations for transfers of funds and/or credit approval to 19 municipal authorities. The Histadrut will receive additional authorizations soon.
	26	BOI leaves its key rate for April unchanged at 4%.	
April	01	Committee charged with exploring necessary actions to increase institutional players' involvement in the domestic 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, mainly for defense, reinforcement of the north, and other uses. Also, NIS 142m in expenditure was approved for a coalition agreement with the Yisrael Beitenu faction, in order to exempt pensioners from the Broadcast Authority fee, conduct the war on drugs, and make an allocation to the Rural Settlement Division, and allot NIS 75m for Religious Zionist projects such as national service and pre-induction preparatory programs.
	22	BOI cuts its key rate for May by 0.25 percentage point, to 3.75%.	
		Minister of Finance Hirschson suspends himself.	Minister of Finance Avraham Hirschson informs PM Ehud Olmert that he is suspending himself from his post for 3 months due to the investigation in which he is involved.

Month	Date	Event	Details
	23	PM Ehud Olmert becomes acting Minister of Finance.	PM will hold the Finance portfolio until a suitable candidate can be found.
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 (2007/2008) and will be implemented gradually over six years on a countrywide basis that will be determined in accordance with progress. The main provisions of the NIS 5 billion reform are extra classroom hours and personal teacher–student meetings, restructuring of teachers' working day, and enhancement of teachers' pay and working conditions.
	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, which requires approval by the Knesset Finance Committee, 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. The list of qualifying localities will be unchanged until August 2007, depending on circumstances in the field.
	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. The Supervisor added that Israel would apply the Basel II recommendations by the end of 2009.
	28	BOI cuts its key rate for June by 0.25 percentage point, to 3.5%.	
	28	Knesset Finance Committee approves an NIS 8.2 billion allocation for the Tel Aviv light-rail project by majority vote.	
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 the independent estimates that had been presented to the joint committee—Prof. Arania and Co. and Ducas Planning and Economic Consulting, Ltd. The winning bidder was Delek Israel Oil Co., Ltd., which acquired the three terminals en bloc for NIS 800m plus VAT.

Month	Date	Event	Details
	10	Purchase tax on some 100 consumer goods is abolished.	This evening, PM and acting Finance Minister Ehud Olmert signed an order abolishing purchase tax on most consumer goods that had been liable to this tax (cosmetics, "white appliances," air-conditioners, telephones, and batteries). 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. The State will sell its holdings in the bank and the public's holdings will be sold to the buyer under an arrangement to be worked out between the bank and its shareholders, provided that the court approves. At the end of the process, the buyer will hold all shares in the bank. Once sold, the bank will cease to be a public corporation and its banking license will be cancelled.
	25	BOI 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 BOI to establish a list of services for which banks may charge fees and permits BOI to intervene in the level of said charges.
	27	Government, employers, and Histadrut conclude an agreement to toughen enforcement of labor laws.	The improvement in enforcement will affect the employment terms of all workers countrywide but will be most influential vis-à-vis contractors' employees whose status makes them more susceptible to infringements of rights. The three main sections of the accord prescribe fines for employers who violate "expansion orders." Those who order cleaning, guarding, and catering services will be held responsible, under some conditions, for infringements of workers' rights. Binding minimum prices for winning bids in tenders will be set, allowing personnel companies to pay their workers lawful wages.