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# RECENT ECONOMIC DEVELOPMENTS\*

## Main developments

During April–September 2002 (the period reviewed) economic activity continued to contract, as it has since 2001. The decline in activity was expressed in most of the economic indices: the composite (State-of-the-Economy) and the manufacturing production indices went down, manufacturing exports plummeted, and imports declined. Employment figures indicate stagnation. The contraction of economic activity was affected by the decline in private consumption, while domestic public consumption rose sharply. Alongside the fall in activity, there was instability in the financial markets until mid-year. In 2002:III financial pressure eased, because the Bank of Israel raised its key interest rate in June and the budget was amended, signalling greater fiscal restraint.

The slowdown in economic activity in the period reviewed found expression in the decline in business-sector product, after it had risen in 2002:I; this reflected the marked fall in exports and decline in private consumption. The latter was influenced by the intensity and length of the recession as well as by the decline in the real wage. GDP fell more slowly than business-sector product because of the marked increase in domestic public consumption. Data for 2002:III—a fall in exports and in imports of factor inputs—raise apprehensions of a further contraction of economic activity. Indicators of expected economic activity in 2002:IV, drawn from the Survey of Companies, are also negative. Two factors impair the economy's ability to recover: a) The global economic recovery slowed considerably in 2002:II. The economic indicators and marked slump in global stock markets in 2002:III attest to further deceleration. Furthermore, the global recovery is concentrated in the traditional industries, while Israel specializes in high-tech industry. b) In the period reviewed Israel was affected by the security situation and the consequent uncertainty, which is further exacerbated by the possibility of war between Iraq and the US.

High-tech exports, which had led manufacturing exports in 2000, continued to fall steeply in the period reviewed, sustaining the trend evident since the end of 2000. Exports of less advanced industries remained stable in

this period, however, and rose in 2002:II. This increase may be due to the real depreciation and improvement in Israel's terms of trade that had begun in 2002:I. During the period reviewed direct foreign investment plummeted, apparently due to four main factors: the continued political-security uncertainty, investors' expectations that the recession would persist, the instability of financial markets abroad, and the global slowdown in investment in emerging markets, and in the high-tech industry in particular. Investment abroad by Israelis soared in 2002:II and fell in 2002:III.

Labor market developments were in line with the general picture of recession, expressed in the failure of employment to rise in 2002:II in either the public services or the business sector, thus halting for the moment the trend evident since 2001:III of a decline in business-sector employment and a rise in employment in the public services. The participation rate fell sharply in 2002:II, giving rise to a decline in the civilian labor force. The unemployment rate dipped slightly in 2002:II as a result of the fall in the participation rate, but the depth of unemployment rose. The real wage was down by 5.5 percent in April–July over the equivalent period in 2001 (by 4.8 percent in the business sector, and by 7.1 percent in the public services), after a marked rise in recent years. The sharp increase in employment in guarding and the contraction of the real wage in the business sector supported business-sector employment.

In fiscal policy, the domestic budget deficit stood at 2.8 percent of GDP in the period reviewed (Table 6), compared with 3.6 percent in the equivalent period in 2001. Cash data for the budget and its financing indicate tighter fiscal discipline in 2002:III than in 2002:II. Budget implementation figures for 2002:II show that the deficit was continuing to grow. The deviation of the deficit from the target in 2002 stemmed from the fall in tax receipts resulting from the lower level of economic activity than that—very optimistically—forecast in the original budget, as well as from the marked rise in defense expenditure due to the security situation. These factors led the government to conclude that it would not be able to attain the deficit target (which had been amended in December 2001 to stand at 3 percent of GDP). The breach in the budgetary framework, which was accompanied by local-currency depreciation,

\* For diagrams (bilingual) please turn to Hebrew section.

Table 1. Indicators of Business Activity, 2000–2002  
(seasonally adjusted)

	2000	2001	2001		2002			Apr–Sep*		***
			III	IV	I	II	III	2001	2002	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	6.5	-1.2	-9.4	-3.3	-2.1	-4.3	-1.1	-1.8	-2.7	9
Large-scale retail trade	10.3	4	4.9	-1.5	-5	-3.9	-9.2	4	-3.2	9
Manufacturing production (excl. diamonds)	9.9	-4.7	-8.0	-4.6	0.0	3.9	-3.1	-6.4	-1.8	8
Business-sector consumption of electricity	7.5	2.3	-0.8	-1.4	-0.9	9.6	6.8	1.5	2.8	8
Index of revenue in commerce	9.7	0.3	-2.5	-0.3	-7.4	-1.9	-4.8	-1.0	-3.5	8
Index of total revenue	11.1	1.9	-0.4	0.6	-3.5	-1.3	-9.6	1.3	-2.5	8
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	3.8	-50.3	-12.1	-18.5	0.1	-25.6	2.1	-51.8	-44.0	8
Immigrant arrivals	-21.6	-27.6	32.0	-11.8	-30.7	-1.7	27.6	-28.6	-20.0	8
Residential starts	16.0	-31.4	-2.2	8.4	7.9	-1.8		-36.2	15.1	7
of which:										
Government-initiated	52.2	-50.3	4.9	45.2	-7.3	1.4		-67.0	24.6	7
Residential completions	-4.0	-13.0	27.7	11.5	-2.6	-3.7		-24.6	17.0	7
of which:										
Government-initiated	-35.1	-18.3	10.4	23.7	11.4	-12.6		-34.1	17.2	7
Survey of companies (percent) <sup>a</sup>										
Output of manufacturing firms (not adjusted)	11	-15	-20	-18	-13	0**	-14			9
Output of manufacturing firms (adjusted)	11	-15	-23	-18	-4	-4	-15			9
Sales by commerce firms (not adjusted)	5	-24	-30	-23	-48	-40	-16			9
Sales by commerce firms (adjusted)	4 **	-24 **	-39	-15	-45	-40	-25			9

\* Compared with same period in preceding year.

\*\* Not significant at 5% level.

\*\*\* Last month for which data available.

<sup>a</sup> 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.

expectations of a rise in inflation and long-term yields, and the probability that Israel's credit rating would be lowered, increased Israel's risk rating. Israel's rating outlook by S&P's went down from stable to negative in April. In June fiscal policy was amended in order to stop the rise in the deficit, and a package of measures including tax hikes and spending cuts was approved. At the same time, a new deficit target of 3.9 percent of GDP was announced, and in July the Knesset passed a law restricting private legislation. Cash data indicate that the economic measures contributed to the sharp drop in the share of domestic government expenditure in GDP in

2002:III. At the beginning of 2002:III the Knesset adopted the recommendations of the Rabinowitz Committee on income tax reform, with a slight reduction in taxes on labor and rise in those on capital. These measures will reduce the discrimination between the taxation of labor income and capital gains in Israel, which is greater than is customary in other countries. Some of the changes will go into effect at the beginning of 2003, but most of the reduction in taxes on labor is expected to go into effect only later. However, the implementation of the committee's recommendations will lead to a deficit in financing the reform in the next few years,

Table 2. National Accounts, 2000–2002<sup>a</sup>  
(seasonally adjusted)<sup>b</sup>

	2000	2001	2001		2002			Apr-Sep*		**
			III	IV	I	II	III	2001	2002	
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	7.4	-0.9	-6.8	-4.0	2.5	-1.5		0.8	-2.5	6
Business-sector product	9.7	-2.4	-9.5	-6.9	0.0	-3.4		-0.6	-5.0	6
Business-sector product excl. start-ups	7.0	-1.1	-5.7	-3.6	-0.7	-6.8		-0.6	-4.3	6
Private consumption	7.2	2.5	-0.3	-1.4	-0.1	-6.4		3.3	-2.1	6
Gross domestic investment	-2.8	-2.6	5.6	-51.4	11.8	16.8		-4.1	-9.5	6
Gross domestic investment excl. start-ups	-6.6	-4.8	-11.9	-31.1	-4.5	34.0		-1.0	-6.1	6
Goods and services exports	25.3	-11.7	-19.8	0.8	-4.1	15.4		-9.1	-2.7	6
Goods and services exports excl. start-ups and diamonds	22.5	-6.9	-16.9	-8.8	-7.8	-16.5		-7.1	-12.6	6
Goods and services imports	12.3	-4.5	-14.9	-7.1	7.8	17.8		0.1	0.1	6
Goods and services imports excl. diamonds	15.1	-4.2	-9.1	-13.9	9.1	-3.7		-0.7	-4.8	6
Public-sector consumption	1.3	3.3	-16.5	38.5	17.6	-2.6		6.4	7.3	6

\* Compared with same period in preceding year.

\*\* Last month for which data available.

<sup>a</sup> The data in the table incorporate the latest update of national accounts data published by the Central Bureau of Statistics on 16 October 2002.

<sup>b</sup> Each series is adjusted individually.

requiring a significant slowing of the increase in current expenditure to enable the reform to be implemented while attaining the government's deficit target.

During the period reviewed there were marked shifts in the development of prices, dictated by exchange-rate movements, and the Consumer Price Index (CPI) rose by 4.5 percent. In 2002:II prices rose steeply because of local-currency depreciation, while in 2002:III prices rose more slowly than in 2002:II because of local-currency appreciation.

The central bank's key interest rate and inflation expectations were higher in the period reviewed than in the previous six months, and notable changes were made in monetary policy. Developments differed in 2002:II and 2002:III. The interest-rate cut at the end of 2001 led to sharp local-currency depreciation and a rise in inflation expectations at the beginning of 2002. In view of the deterioration in the security situation, and the public's expectations that the budget approved in February would prevent attainment of the deficit target of 3 percent, inflation expectations and the demand for liquid assets rose, there was renewed sharp local-currency depreciation, and instability in the financial

markets increased. In response, the Bank of Israel raised its key interest rate to a steep 9.1 percent. At the end of 2002:II—in the wake of the sharp interest-rate hike and against the backdrop of the measures introduced by the government in June, which checked the expansion of the budget deficit—there was a shift in most of the indicators of the public's assessment of expected inflation and interest-rate changes. In 2002:III the depreciation of the dollar persisted, and short-term inflation expectations returned to the range of price stability. Concurrently, real interest rose and the demand for liquid assets fell. Local-currency depreciation returned in September, because the long-term credit rating of the three major banks was lowered and the likelihood of a war between the US and Iraq grew.

The objective of stabilizing the financial markets and reducing inflation expectations was attained, alongside a sharp interest-rate hike and tighter fiscal discipline. The 2003 budget, which embodied a deficit target of 3 percent and was approved by the government, has not yet been adopted by the Knesset. The budget is consistent with the policy line adopted in June 2002 regarding the necessity of preventing shocks to the capital market. The return to a declining deficit path will

enable real long-term interest to be reduced and price stability to be maintained at a lower interest rate. This process is expected to bring the real interest rate down, stimulate economic activity, and create the conditions for the revival of growth once the external conditions and security-political situation allow.

## The principal industries

National Accounts data (Table 2) indicate a decline in GDP in 2002:II, after a rise in 2002:I. The decline reflected mainly the steep fall in nondiamond exports and the reduction in private consumption, and was partly offset by the steep increase in domestic public consumption. Gross domestic investment went up after contracting in 2001, business-sector product fell again in 2002:II, by more than GDP. According to the monthly economic indicators, economic activity continued to contract in 2002:III.

Several factors impair the chances of business-sector product to recover: exports (excluding start-ups and diamonds), which dipped moderately in 2001:IV and 2002:I, plummeted in 2002:II. This trend encompassed both goods and services exports, mainly reflecting the decline in demand for high-tech products and advanced services, such as IT (information technology) and R&D (research and development) services. Excluding the security industry, business-sector product contracted even more. The expansion of employment in security in 2002:II does not constitute a sound basis for the growth of business-sector product.

Private consumption fell in 2002:II, after rising slightly in 2002:I. Consumption smoothing appears to be partial, as the public expects the recession—which stems from the security situation and the global high-tech crisis—to persist for a long time. The fall in consumption may also be explained by the protracted reduction of the real wage. The combination of the latter and the liquidity constraint (bank credit) may prevent individuals from smoothing consumption. The decline in durables consumption evident since 2001:I (with the exception of a slight rise in 2002:I) persisted. This decline reflects consumers' expectations regarding their future economic situation more than does current consumption, and is influenced to a greater extent by economic uncertainty.

Fixed investment rose slightly in 2002:II, after declining continuously since 2001:II, but remained far lower than in 1999, and of course than in 2000. According to data on imports of investment goods and figures from the

Survey of Companies on the utilization of equipment, this increase may be only temporary.

The Survey of Companies for 2002:III continues to indicate a decline in most principal industries (Table 1), with a decline in output. The downward trend in exports and export orders, which had moderated in 2002:I and 2002:II, revived in 2002:III. The decline in exports and export orders for 2002:IV encompassed all the principal industries. Domestic sales and orders for 2002:IV remained at low levels for all industries (except communications).

The composite index fell in April–September, after stabilizing in 2002:I. The decline in the period reviewed was evident in most of its constituent indices. The fall in manufacturing production expressed a decline in the demand for exports and in domestic demand. The contraction of receipts in commerce and the services as well as in imports except for investment goods expressed the decline in domestic demand.

The manufacturing production index was 1.8 percent lower in the period reviewed than in the equivalent period in 2001. In 2002:II production rallied slightly in all technological industries (high, low, and mixed), but in 2002:III (indices for July and August only) it dipped again. In the high-tech industry the index for 2002:II was 18 percent below its peak in 2000:IV. The decline in production reflects a quantitative fall in this industry's dollar exports.<sup>1</sup> Production in the less advanced technological industries, by contrast, did not decline as steeply. The dollar value of non-high-tech exports was slightly higher in 2002:II and 2002:III, possibly due to an improvement in the terms of trade in 2001:I and the stability of domestic demand, following the marked rise in public-sector domestic expenditure and the decline in private consumption.

The construction industry recovered to some extent on both the demand and supply sides, beginning at the end of 2001 and persisting in 2002. On the demand side, the recovery was evident in the 20 percent increase in privately-initiated new units sold in April–August over the equivalent period in 2001. The number of transactions involving new and second-hand apartments was also up in 2002:I and 2002:II over the equivalent period in 2001. According to purchase-tax and land-improvement-tax data, the number of transactions implemented in January–June was up by 10 percent over the equivalent period in 2001, despite the fact that sales

<sup>1</sup> Prices of high-tech exports were 4 percent lower than in 2000:IV.

## **Box 1**

### **Macroeconomic Forecast for 2003**

The security situation and global developments in the high-tech industry will have a crucial effect on economic activity in the coming year. Uncertainty regarding what these changes will be requires that attention be directed to a period rather than specific points in time.

The economic forecast for the entire period takes recent government decisions into account,<sup>1</sup> and assumes that the budget will be passed by the Knesset as it stands. In addition, the forecast takes into account the government decision to reduce the number of foreign workers and make the conditions of eligibility for unemployment benefit and income support more stringent. The forecast also incorporates the recent changes in taxation, with an increase in V.A.T., cancellation of the National Insurance payments ceiling, higher payroll taxes, additional indirect taxes (diesel and heating oil and cigarettes), and the tax reform which will go into effect gradually from next year.

At the lower end of the forecast estimate it is assumed that neither the security situation nor the backdrop to activity in the high-tech industry will improve in 2003. Given these conditions, exports will not rise in spite of real depreciation and the expected expansion of world trade, and hence as an annual average exports will decline in 2003, too.

At the lower end of the forecast estimate the assumption is that GDP will decline by another 1 percent for the third year in succession, alongside a marked increase in unemployment, bringing it up to 12 percent, due to the steep drop in business-sector product (as a share of GDP) and unchanged public services employment, in accordance with the government's decision. The current account deficit will continue to rise, expressing mainly the ongoing contraction of exports and the deterioration in the terms of trade. Given these conditions, unless additional steps not embodied in either policy or the forecast are taken, tax receipts will be 0.7 percent of GDP lower than forecast, and the deficit will exceed the target of 3 percent of GDP to stand at 3.7 percent.

At the positive end of the forecast estimate there is a moderate turnaround in economic activity. The principal assumption here is that the security situation and the background conditions will improve to some extent, with a rise in world trade and some recovery in the high-tech industry. The combination of these factors will cause the effective demand for Israel's exports to rise and investment to decline by less than at the lower end of the estimate—also as a result of the recovery of inward investment. Due to the trend shift, especially if the security situation improves, the foreign-currency market will be more stable, and hence real interest will be lower (a higher risk premium), also contributing to the recovery. The rise in the effective demand for Israel's exports will prevent the terms of trade from deteriorating.

Given these conditions, economic activity will pick up moderately, as expressed in GDP and business-sector product growth of 1.5 percent each, although this will not be sufficient to prevent the continued rise in unemployment. The current account deficit will improve by about \$ 0.5 billion as a result of the rise in exports. The stabilization of public expenditure and the rise in tax revenues due to both the expansion of economic activity and changes in tax rates, will enable a significant reduction of the public-sector deficit and rise in the national saving rate, alongside the attainment of the deficit target.

Measures that have a direct effect on the labor market are very important. Reducing the number of foreign workers while introducing measures designed to reduce the threshold wage (the wage above which workers are prepared to enter the labor force) will contribute significantly to increasing the number of Israelis in employment. If these measures are not introduced the unemployment rate will soon rise by another percentage point throughout the estimate. This means that at the lower end of the estimate the unemployment rate will be 13 percent.

<sup>1</sup> Since 1985–86, when civilian domestic expenditure was cut, this item has risen every year. The government's decision means that civilian domestic expenditure will not rise in 2003.

Uncertainty regarding the level of economic activity next year requires being prepared—and this also applies to the budget—for it to contract further. This should involve constantly monitoring the level of activity and making some current expenditure contingent on a level of revenues that will ensure that the deficit target is attained.

### Indicators of Economic Development, 2001–2003

	2001	Estimate for 2002	Forecast for 2003		
			Upper		Lower
<i>(quantitative change,<sup>a</sup> percent)<sup>b</sup></i>					
<b>Sources and Uses</b>					
1. GDP	-0.9	-0.9	1.5	-	-1.0
2. Business-sector product	-2.4	-2.9	1.5	-	-2.0
3. Per capita private consumption	0.1	-2.2	-0.3	-	-1.6
4. Public consumption excl. defense imports	2.5	6.0	0.1		
of which: Civilian consumption	2.9	3.6	0.2		
5. Fixed investment	-6.1	-6.3	-3.4	-	-7.1
6. Domestic uses (excl. defense imports)	1.5	-0.3	0.5	-	-0.8
7. Goods and services exports	-11.7	-5.0	5.2	-	-1.0
8. Civilian imports	-5.4	-2.8	1.9	-	-0.5
<i>(\$ million, current prices)</i>					
<b>Balance of Payments</b>					
9. Civilian import surplus: goods and services	1.7	3.5	2.6	-	3.6
10. Current account deficit	1.9	3.4	2.9	-	3.7
11. Current account deficit (share of GDP)	1.7	3.4	2.9	-	3.6
12. Current account deficit plus capital transfers	1.2	3.3	2.4	-	3.2
13. Foreign-exchange reserves (end-year) of Bank of Israel <sup>c</sup>	23.2	24.2	...		
<i>(rate of change, percent)</i>					
<b>Population, Employment, and Prices</b>					
14. Immigrants during year ('000s)	43.6	29.0	30.0		
15. Mean population	2.4	2.1	2.1		
16. Unemployment rate	9.4	10.5	11.7	-	12
17. Rise in CPI during year <sup>d</sup>	1.4	9.4	...		
18. Total Israelis employed	2.1	0.3	1.2	-	0.9
of which: In business sector	1.3	-1.3	1.4	-	0.9
<b>Public Sector</b>					
19. Government overall deficit, excl. credit to be extended	1.75	3.9	3.0	-	3.7 <sup>e</sup>
20. Government overall deficit on cash basis (% of GDP)	4.5	...	...		

\* The forecast for 2003 is based on preliminary estimates published by the CBS for 2002. The final figures may be very different.

<sup>a</sup> The calculation of the quantitative change is based on annual averages.

<sup>b</sup> At previous year's prices.

<sup>c</sup> In 2002, to end-September

<sup>d</sup> In 2002, to end September, annualized.

<sup>e</sup> If corrective measures are not taken.

of government-initiated apartments were down by 4 percent in January–July 2002 compared with the same period in 2001. The recovery of the construction industry in spite of the difficult economic situation is largely explained by the low level of mortgage interest in March–June, after its reduction at the beginning of 2002. The V.A.T. hike in mid-June and the rise in the index of rents may have served to bring purchases forward. Increasing uncertainty regarding financial assets and their taxation may also have encouraged investment in property.

The supply side rallied, too, to some extent. The 7 percent increase in building area for all purposes in January–June 2002 over the equivalent period in 2001 comprises a 9 percent expansion of residential building area and a 2 percent rise in nonresidential building area, though the level is still lower by 16 percent than in the equivalent period in 2000. The area of residential building starts was also greater in the first half of 2002 than in the first half of 2001. The level of building starts was significantly below the annual increment of households, which expresses long-term demand. This gap is indicated by the continued decline in housing stock and supply months (the number of months remaining until the stock of housing is used up based on the rate of sales at the time).

The increase in the number of building starts is also reflected in a slight rise in construction employment in January–June over the preceding six months, despite the moderate decline in the number of legal foreign workers, which continued to contract in 2002:III. According to the Survey of Companies, for the first time since 2000:III there were expectations of a rise in the number of construction projects in 2002:IV, the main constraint on activity in the industry being the supply of workers. The real wage in construction has declined by less than has that in the business sector. This moderate decline may be due to the relatively high demand for workers and/or to the large share of foreign workers whose wage is indexed to the dollar, which appreciated in the period reviewed.

Incoming tourism was badly hit by the security situation. Tourist bed-nights were 36 percent lower in the period reviewed than in the equivalent period in 2001, and 78 percent less than in 2000. Nevertheless, there was a slight improvement in 2002:III due to the easing of the security situation. According to the Survey of Companies, activity in the industry has rallied to some extent as a result of internal tourism. Currently tourism relies mainly on internal demand. In 2002:III (July–

August) tourist bed-nights accounted for only 20 percent of hotel bed-nights, compared with 25 percent in 2001 and 48 percent in 1999. The increase in bed-nights of Israelis only partly offset the effect of the decline in tourist bed-nights, Dollar revenues from tourists were 57 percent lower in 2002:II than in 2001:II, while revenues from Israelis fell by 3.4 percent in nominal terms, alongside a 2 percent rise in the number of bed-nights by Israelis due to the continued reduction in prices for Israelis. Because of the crisis in tourism, the government offered hotels concessions. In 2001 the hotels were granted a 66 percent reduction in municipal rates, and the government has approved a similar arrangement for 2002. In addition, the government has continued to fund marketing and loans for hotels

### The labor market

Developments in the labor market are in line with the overall picture of recession. The number of employed persons remained unchanged in 2002:II—a static situation that encompassed both business-sector and public-services employment. This checked the trend that had been in evidence since 2001:III—a decline in employment in the business sector and rise in that in the public services. The participation rate fell dramatically, so that the labor force also contracted. The unemployment rate dipped slightly in 2002:II due to the decline in the participation rate, but the depth of unemployment rose. In April–July the real wage was down by 5.5 percent from the equivalent period in 2001, after a notable increase in the previous years. Compared with last year, the nominal wage rose at a very low rate in these months.

The counter-cyclical trend of a rise in the number of persons employed in the public sector was checked, apparently because of the last few budget cuts. One of the reasons for the stability in the number of persons employed in the business sector is the marked rise in the number of persons employed as guards.

The moderation of the decline in employment was supported by a marked reduction in the real wage, which has gone down continuously since 2001:III. It declined by 7.1 percent in the public services in April–July, and was 4.8 percent lower in the business sector than in the same period in 2001, after rising continuously since 1992. The decline stemmed mainly from the fall in the demand for workers, which served to reduce the wage per employee post. Another reason for the decline in the real wage was the greater share of industries in

Table 3. Indicators of Labor Market Developments, 2000–2002  
(seasonally adjusted)

	2000	2001	2001		2002			Apr–Sep*		**
			III	IV	I	II	III	2001	2002	
	('000s)									
Civilian labor force	2,433	2,499	2,512	2,518	2,538	2,530		2.2	1.6	6
Israelis employed	2,216	2,265	2,272	2,258	2,269	2,269		2.2	0.0	6
Business sector	1,554	1,574	1,581	1,556	1,552	1,554		2.3	-2.1	6
General government	662	691	694	701	714	716		2.6	4.3	6
Average hours worked per employee	38	37	37	37	37	37		-0.4	-1.3	6
Business sector	41	40	40	39	40	40		0.1	-1.5	6
General government	31	31	30	30	31	31		0.7	0.2	6
Labor input of Israelis employed	83,919	83,821	83,591	82,880	83,968	83,503		1.8	-1.3	6
Business sector	63,307	62,612	62,475	60,986	62,441	61,862		2.4	-3.6	6
General government	20,609	21,146	20,865	21,230	22,158	22,283		3.3	4.5	6
Claims for unemployment benefit	106	118	124	127	129	130	121	13.2	8.2	8
Work seekers	166	186	195	201	204	204	196	12.7	6.8	9
Real wage per employee post (NIS) <sup>a,b</sup>	4,558	4,678	4,667	4,612	4,550	4,475	4,432	4.7	-5.5	7
of which: Business sector	4,688	4,802	4,773	4,744	4,610	4,624	4,557	4.0	-4.8	7
General government	4,298	4,412	4,393	4,356	4,402	4,209	4,120	6.7	-7.1	7
Nominal wage per employee post (NIS) <sup>b</sup>	6,827	7,081	7,101	7,032	7,084	7,147	7,164	5.5	0.2	7
of which: Business sector	7,018	7,269	7,275	7,227	7,159	7,390	7,393	5.0	1.0	7
General government	6,435	6,679	6,696	6,632	6,848	6,719	6,670	7.5	-1.6	7
Unemployment rate (%)	8.8	9.3	9.6	10.3	10.6	10.3				6

\* Percent change compared with same period in preceding year.

\*\* Last month for which data available.

<sup>a</sup> At 1994 prices.

<sup>b</sup> Real and nominal wage per employee post relate to Israelis and to foreign workers with work permits, and does not include Palestinians.

which the average wage is low.<sup>2</sup> Unexpected inflation in January–July and the failure to adjust the nominal wage may also have played a part in the decline in the real wage. The decline in the real wage gave rise to a debate on the COLA (cost of living allowance). The last COLA agreement expired in 2000, and discussions between the Histadrut (Federation of Labor) and the Treasury about renewing it were held in the shadow of sanctions instituted by the Histadrut in mid-October.

The labor force participation rate fell by 0.5 percent in 2002:II, despite the long-term upward trend in the participation rate of women. The decline is explained by

<sup>2</sup> A significant factor explaining these developments is the decline in the number of persons employed in the high-tech industry, where wages are high, as well as the fact that their wages have fallen.

the recession, which makes it difficult for unemployed persons to find work (the discouraged worker effect).

The unemployment rate fell to 10.3 percent in 2002:II, reflecting stability in the number of persons employed, alongside a steep drop in both the labor force and the participation rate. Had it not been for the drop in the participation rate, the unemployment rate would have reached 11 percent. Since the labor force responds with a lag to the contraction of the business sector, the decline in the average number of hours per employee post in 2002:II may be a preliminary to dismissal. Furthermore, the future stabilization of the number of employed persons in the guarding industry, where employment rose markedly in 2002:II, will not continue to support the reduction of unemployment.

Concurrently, the trend of deepening unemployment, which had begun in 2001:III, persisted: the proportion of

unemployed persons seeking work for over 27 weeks rose, as did the proportion of those who had not worked in the last 12 months. The protracted difficulty in finding work may have led many unemployed persons to leave the labor force, thereby reducing the participation rate.

A by-industry analysis of the development of employment in 2002:II shows that its stability in the public services expresses the steadiness of all the two-digit industries, while in the business sector it expresses a significant change in composition. There were marked increases in employment in the electricity and water industries in June, apparently due to new desalination tenders, in construction as a result of a rally in building starts, and also in transport and communications. Business services recovered because of the addition of 10,000 employees in the guarding and cleaning industries, due to the marked rise in demand for guards. There was, however, a notable decline in employment in manufacturing—mainly in the high-tech industry. The number of persons employed in IT,<sup>3</sup> which was down by 2.5 percent in 2002:I from 2001:IV, fell by another 1 percent in 2002:II. The number of persons employed in the commerce and vehicles, hotels, and catering industries also fell, apparently as a result of the protracted slump in tourism, as was the case with community and personal services. A by-industry analysis of the labor market shows that the real wage declined in all industries in the period reviewed, especially in banking and business services, as well as in computer services—apparently because of the steep drop in demand for workers.

When the figures are analyzed by gender we see that the decline in the participation rate of men in 2002:II (from 60.6 to 60.0 percent) was steeper than it was for women (from 48.5 to 48.1 percent), that the male unemployment rate fell (from 10.6 to 10.1 percent) while that of women remained relatively stable (from 10.6 to 10.5 percent), and that both the male and female employment rates remained relatively steady (male employment rose by about 1,000, and female employment fell by about 1,000).

There were approximately 245,000 foreign workers in Israel in 2002, 82,000 of them legal. In contrast with the continuous rise in the number of foreign workers in the last few years (with the exception of a slight decline in 2002:I and 2002:II), the number of Palestinian workers continued to contract in 2002:II, too. After the reduction in the number of permits issued to foreign workers at the

<sup>3</sup> Computer services, communications, and scientific instruments.

beginning of the year, their number rose by 10,000 in 2002:II and by another 13,500 in 2002:III. The employment of foreign workers has far-reaching economic repercussions, especially for unskilled Israeli workers. Despite the particular importance of the subject, the government's decisions on reducing the number of foreign workers, making it more expensive to employ them, and utilizing only Israeli labor in national projects have scarcely been implemented.

A policy of deporting foreign workers was recently announced, and an authority was set up to deal with the problem. To date, however, the number of illegal foreign workers does not appear to have declined, because of logistical difficulties in housing the deportees. In October the prime minister decided not to allow foreign workers to enter the country, and to grant legal status for a limited period to those already here.

The plan to establish employment centers (known as the Wisconsin Program), as recommended by the Tamir Committee, is supposed to deal with the return to work of persons receiving income support. Their number was 8.9 percent higher in April–June 2002 than the average in 2001, possibly because of the decline in the participation rate. In general, the program will require each unemployed person to work in accordance with the following priorities: independent integration into the labor force, temporary training work, public works. The experiment, within which framework four employment centers were supposed to be established, should have begun in August, but disagreement between the Treasury, the Ministry of Labor, and the Employment Service has prevented this.

### The balance of payments

The current-account deficit in 2002:II was \$ 1.2 billion, up from \$ 0.9 billion in 2001:II. The rise resulted mainly from the increased deficit in the goods and services account somewhat offset by the reduced deficit in the factor-inputs income account. The surplus in current transfers rose above its level in 2001:II.

Israel's trade deficit (Table 4) was higher in the period reviewed than in the equivalent period in 2001. The geographical composition of trade changed slightly, with a small decline in the share of trade with the European Union and a modest increase in trade with the US and other countries.

Goods exports were considerably lower than in 2001:II. Most of the fall was in high-tech industrial exports, in which the downward trend that had started at the

Table 4. Balance of Payments, Foreign Trade,<sup>a</sup> and the Reserves, 2000–2002  
(\$ million, current prices)

	2000	2001	2001		2002			Apr–Sep		*
			III	IV	I	II	III	2001	2002	
<b>Monthly averages</b>										
Trade deficit	306	316	334	340	343	291	373	315	332	9
Goods imports	2,093	1,986	1,941	1,878	1,903	1,881	1,867	1,971	1,874	9
Consumer goods	376	388	387	382	395	355	356	378	356	9
Capital goods	494	500	495	464	442	463	432	506	447	9
Intermediates	1,221	1,097	1,057	1,030	1,064	1,062	1,076	1,086	1,069	9
Goods exports	1,787	1,670	1,607	1,538	1,560	1,590	1,493	1,656	1,542	9
Manufacturing	1,726	1,614	1,553	1,490	1,513	1,533	1,437	1,597	1,485	9
High-tech	921	834	819	722	765	740	668	818	704	9
<b>Quarterly averages</b>										
Net current account	-494	-463	-1,383	690	-677	-1,248		-1,164		6
Financial account (excl. foreign-currency balances)	927	-119	473	-583	464	759		249		6
Nonresidents' direct and portfolio investment	1,131	806	670	581	-213	798		772		6
Nonresidents' portfolio investment	1,271	72	-424	-560	728	43		88		6
Residents' direct and portfolio investment	1,150	671	669	840	1,587	1,025		737		6
Net foreign debt (% of GDP)	5.27	2.86	2.54	2.92	1.77	1.68		2.78		6
End-period Bank of Israel reserves	23,164	23,181	24,478	23,181	23,945	24,790	24,221	24,478	24,221	9

\* Last month for which data available.

<sup>a</sup> Foreign trade data are seasonally adjusted and do not include ships, aircraft, diamonds, and fuel.

beginning of 2001 persisted. Exports of the high-tech industries were affected by the slowdown in world trade, in which the crisis in these industries was a major factor, as was the security situation which deters some foreign agents from doing business in Israel. Exports of the mixed and traditional industries in April–September remained at the same level as in April–September 2001 due to the real depreciation of the NIS in the first two quarters of 2002, as they are more price-sensitive than exports of high-tech industries. Real depreciation in export terms was 4.3 percent in 2002:I and 4.5 percent in 2002:II.<sup>4</sup> Exports of the traditional and mixed industries were supported also by the slight increase in the price of exports (excluding ships, aircraft and diamonds) in 2002:I.

Goods imports (excluding diamonds, fuel, ships and aircraft) in the period reviewed remained at the same low level as in the previous two quarters. In the six

months reviewed imports of intermediates edged up above their level in the previous six months, and this was reflected by only a small reduction in the index of manufacturing output. Capital-goods imports remained at the low level of the previous six months, an expression of expectations that the recession would continue. According to the Bank of Israel Companies Survey, the reduction in the rate of utilization of machinery helps explain the low level of imports of capital goods. Another indication of the severity of the recession is the sharp drop in the imports of consumer goods compared with the level in the previous six months. Diamond exports rose by 32 percent in April–September from their level in April–September 2001. The marked rise in activity in the diamond industry resulted from the international recovery from the depression of 2001, and from the need to hold larger inventories abroad, as some customers are staying away from Israel because of the security situation.

After improving in 2002:I, the terms of trade (excluding ships, aircraft and diamonds) deteriorated again in the second quarter, by 2.4 percent; of this, 1.4 percent was

<sup>4</sup> Based on the ratio of the price of exports excluding diamonds to the price of business-sector product including housing services.

due to the rise in fuel prices. As the terms of trade deteriorated, prices of both imports and exports (excluding ships, aircraft and diamonds) rose.

The decline in the services account which followed the large surplus in 2000 continued, due to the drop in exports of software and R&D services<sup>5</sup> and of incoming tourist services. Exports of software and R&D services in 2002:II were considerably below their level in 2001:II, as were exports of tourist services due to the security situation in Israel and the events of 11 September 2001 which reduced outgoing tourism world wide. Imports of services also went down in the same period, mainly due to the sizable reduction in the import of tourist services. The latter resulted from the fall in prices of internal tourist services and the recession, and helped to cut the deficit in the services account.

Nonresidents' direct investment in Israel, which showed a marked recovery in 2002:II, remained at a quarterly level of about \$ 0.5 billion in the period reviewed compared with a level of \$ 0.8 billion a quarter in 2001. The drop in nonresidents' investment was a product of a worldwide fall in investment, particularly in emerging markets (Table 4 and Figure 9), but the decline in investment in Israel far exceed the average drop in investment in the emerging markets, due to the high share of investments in high-tech companies whose value had fallen as a result of the crisis in high-tech industries.

Investments abroad of the nonbanking private sector rose steeply in 2002:I from the average level in 2001, and declined again in 2002:II, although they stayed at a high level. The reasons for the rise in this investment were concern regarding a financial crisis due to the strengthening of the dollar, the desire to spread risks, and possibly also the recommendations of the Rabinowitch Committee for Tax Reform, which raise taxation on income from capital and which come into effect at the beginning of 2003. At the same time receipts of gifts and contributions from abroad also declined in the period reviewed, possibly because Israelis preferred to leave a greater part of their money abroad. In 2002:III, due to the sharp rise in local-currency interest, there was a significant reduction in investments abroad by the nonbanking private sector.

<sup>5</sup> No detailed information is available regarding these items, which are included under 'other services.' It is the Bank of Israel's assessment that most of the decline in exports of other services derives from the reduction in exports of software and R&D services.

The foreign-exchange reserves stood at \$ 24.2 billion at the end of the period reviewed, a rise of one percent from the level at the beginning of the period. The external debt fell to 1.7 percent of GDP, continuing the downward trend of the last few quarters.

## Global developments

Following positive trends evident in the first quarter of 2002 indicating recovery from the economic slowdown of 2001, the developments in the second and third quarters came as an unpleasant surprise, with the data attesting to slower recovery than expected.

Basing itself on expectations of a slowdown in the global rate of recovery, the IMF revised its forecast of world growth in 2003 from 4 percent to 3.7 percent, and of growth in the advanced countries from 3 percent to only 2.5 percent (Table 5). According to the forecast, unemployment in the advanced countries will rise from 5.9 percent in 2001 to 6.4 percent in 2002. The consumer confidence index in the US fell by a cumulative 15 percent in May–September 2002. Concurrently consumer confidence in the euro zone fell too, continuing the decline which started at the beginning of 2002.<sup>6</sup>

Share prices in the US and in the other industrialized countries fell steeply in the first two quarters of 2002, due to revisions of over-optimistic assessments of rapid recovery, the accounting scandals in the US, and in 2002:III also the probability of a war with Iraq. All markets fell, unlike in 2001 when the decline was mainly in the high-tech sphere. Reductions in share markets reduce consumption due to the 'wealth erosion' effect. The volatility of the markets and the feeling of uncertainty raised demand for government bonds and corporate bonds of companies with a high credit rating, and sharply reduced their long-term yields. The expectation that the change to tight monetary policy in the US would be postponed also contributed to the reduction in interest on long bonds. This expectation encouraged investment. At the same time interest on credit to relatively risky borrowers increased, reducing investors' inclination to invest in risky ventures, for example in start-ups. This was one of the reasons for the steep decline in nonresidents' direct investment in Israel.

<sup>6</sup> The index is based on the European Commission Business and Consumer Surveys, published in Supplement B of *Euro-pean Economy* by the Directorate-General for Economic and Financial Affairs.

Table 5. Indicators of Economic Development in Advanced Countries,<sup>a</sup>  
Estimate for 2002 and Forecast for 2003

	2000	2001	Estimate 2002	Forecast 2003
Annual rate of change <sup>b</sup>				
World GDP				
Total	4.7	2.2	2.8	3.7
Advanced countries	3.8	0.8	1.7	2.5
World trade				
Total	12.6	-0.1	2.1	6.1
Advanced countries				
Imports	11.8	-1.3	1.7	6.2
Exports	12	-1.1	1.2	5.4
Investment in emerging markets <sup>c</sup>	-3.5	8.9	-12	6.3
Inflation (CPI)				
Advanced countries	2.3	2.2	1.4	1.7
Prices of unprocessed goods (US\$)				
Oil	57	-14	0.5	-0.8
Other	1.8	-5.4	4.2	5.7
Short-term interest <sup>d</sup> (%)				
Dollar deposits	6	3.5	1.8	2.7
Yen deposits	0.2	0	0	0
Euro deposits	4.5	4.2	3.3	3.7
Long-term interest <sup>e</sup> (%)				
Dollar deposits	6	5	4.3	
Yen deposits	1.7	1.3	1.2	
Euro deposits	5.4	4.9	4.8	
Unemployment rate in advanced countries	5.9	5.9	6.4	6.5

<sup>a</sup> According to "World Economic Outlook," Israel is classified as an advanced country.

<sup>b</sup> Apart from interest and unemployment rates, which are shown as percentages.

<sup>c</sup> Israel is classified as an emerging market.

<sup>d</sup> Annual average. For the US and Japan, 3-month government bonds; for the euro zone, 3-month euro bonds.

<sup>e</sup> Annual average. For the US and Japan, 10-year government bonds; for the euro zone, 10-year euro bonds.

SOURCE: "World Economic Outlook" (IMF), August 2002.

The dollar depreciated considerably against the Yen and the euro. This may have been due to the reduced attraction of investment in assets in the US, the purchase of euro by European institutions, and concern over the deficit on the US current account. The strengthening of the euro made it more worthwhile to import from the US than from the euro zone, and to export to the euro zone rather than to the US. The strengthening of the euro also had an adverse effect on Israel's terms of trade, as Israel's trade deficit vis-à-vis Europe is greater than that vis-à-vis the US.

In the emerging markets there are signs of a trend towards greater risk aversion and increased concern regarding debt. This is not a clear-cut situation, as there are marked differences between the various markets: in

Latin America the position deteriorated, and the estimate for 2002 reflects a drop in GDP. On the other hand in South East Asia there was a high rate of growth, due to the rise in world trade and in domestic demand.

Global growth depends on oil prices, which are determined by the security situation in the Middle East, among other things. Oil prices shot up in the second half of August, and stayed high through September. Signs of growth in the first quarter in the semi-conductor market, on which Israel is dependent, weakened in the last few months as a result of the difficulties experienced by the large telecommunications companies. Retail demand for electronic goods remained low, and shipments of semi-conductors were only slightly above their low level in 2001. The overall picture is a mixed one: demand for

Table 5a. Stock Market Indices,<sup>a</sup>  
(annual rates of change during period, percent)

	2001:IV	2002:I	2002:II	2002:III
Nasdaq	-2	3.1	-12.6	-20
Dow Jones	-3.9	5	-1.7	-14.4

<sup>a</sup> Rates of change of quarterly averages of the indices.

security consumption and of the IT industries in Taiwan and China rose, but total demand stayed low, and the large telecommunications companies faced particularly weak demand due to their over-capacity.

### The general government sector

In April–September the government's domestic deficit was 2.8 percent of GDP (Table 6), down from 3.6 percent in the equivalent period in 2001. Cash-basis data on the budget and its financing show a tightening of fiscal discipline from the second quarter to the third. In 2002:II the budget performance deteriorated, because despite the adjustments introduced as part of the Economic Arrangements Law (Supplementary to the Budget Law) passed in February 2002, the deficit continued to increase. The increase derived from lower tax revenues and higher defense expenditure than in the original budget. The government therefore concluded that it was unable to meet the target deficit of 3 percent of GDP. This breach of the budget raised the risk assessment of Israel's economy, and was accompanied

by a rise in the exchange rate and signs that financial stability was being undermined. In April the rating agency S&P reduced Israel's rating outlook from 'stable' to 'negative.'

The target deficit for 2002 was raised to 3.9 percent of GDP, and for 2003 to 3 percent of GDP, and the target of 1 percent was deferred from 2005 to 2007. The indications that financial stability was being undermined brought about the realization that the rise in the deficit had to be stopped, and in June the Knesset passed an 'Economic Defensive Shield' plan that included tax increases and cuts in expenses in approximately equal measure (in monetary terms). The following table shows the economic measures introduced under the Economic Arrangements Law and Operation Economic Defensive Shield.

As a result of the rise in the statutory tax rates, tax revenues in 2002:III were stable. Without this rise the gradual downward trend in tax revenues would have persisted. VAT revenues rose above their previous year's level due to the rise in prices, the depreciation of the NIS, and the increase in the VAT rate in June. These

Table 6. The Budget and its Financing, 2000–2002  
(cash flows, as percent of GDP)

	2000	2001	2001		2002			Apr–Sep		*
			III	IV	I	II	III	2001	2002	
1. Government domestic expenditure	35.9	37.5	37.7	39.7	37.1	38.3	36.6	38.6	37.4	9
2. Government receipts	35.4	33.7	35.8	30.8	34.9	34.7	34.6	35.0	34.7	9
3. Domestic budget deficit (1)–(2)	0.5	3.7	2.0	9.0	2.2	3.6	2.0	3.6	2.8	9
4. Government and Jewish Agency domestic deficit <sup>a</sup> (5)+(6)	-0.4	3.1	2.0	9.0	0.7	4.2	2.7	2.9	3.4	9
5. Government net borrowing from the public	0.2	3.7	1.4	7.4	8.6	3.9	3.9	3.1	3.9	9
6. Public-sector injection <sup>b</sup>	-0.6	-0.6	0.6	1.6	-7.9	0.3	-1.2	-0.2	-0.4	9
7. Bank of Israel injection	0.6	1.6	-2.1	1.4	9.5	0.0	-0.1	0.0	0.0	9
8. Change in monetary base	0.1	0.9	-1.6	2.4	1.2	0.0	-1.6	-0.3	-0.8	9

\* Last month for which data available.

<sup>a</sup> Including non-budgetary injection.

<sup>b</sup> The public-sector injection is recorded as a change in the monetary base minus the Bank of Israel injection and adjustments. The adjustments are small and are not presented in the table.

## Budgetary Policy Steps Authorized in 2002

EA = Economic Arrangements Law  
 EDS = Operation Economic Defensive Shield  
 RC = Rabinowitch Committee Tax Proposals

Tax changes		Effective	Income	
			2002	2003
EA	Tax on use of employers' mobile phones	May 2002	150	250
EA	Tax on high earners; 0.5% in 2002 only	2002	150	
EA	Income tax cut for low wage earners	2002	Cost: 80	
EDS	Rise in tax on diesel fuel and cigarettes	May 2002	650	1,000
EDS	Removal of the ceiling on liability for National Insurance contributions (of 5 times the average wage for the employee, and 4 times the average wage for the employer) and that on Health Tax	July 2002 to end-2003	550	1,100
EDS	Rise of 1% net in National Insurance contributions by employers and the self-employed, by cutting employers' reduction by 1%.	June 2002	650	1,300
EDS	1% rise in VAT (Vat for non-profit organizations by 0.5%)	Mid-June 2002 to end-2003	1,200	2,300
EDS	Rise in compulsory vehicle insurance	To 1.4.04	40	80
RC	Tax cut on real estate transactions	Retroactive to 7.11.01	Cost: 600	
RC	Cut in tax burden on labor; increase on tax on capital. Gradual introduction from January 2003		Reduction of 1,000 in income	
EDS	Cuts in tax benefits for development regions to January 2002. Effective to end-2003	Retroactive 150	400	
Cuts in government expenses				
EA	Across-the-board 3% cut, including transfer payments, excluding wages and expenses covered by primary legislation	2002	1,400	
EA	Cuts in reduction of university tuition fees	September 2002	130	
EA	12% cut in child allowances	March 2002	700	
EA	Cancellation of the higher income support payment for those in receipt of support for more than 2 years	February 2002	110	
EA	Reduced support for Talmudical colleges	2002	55	
EA	Religious councils	2002	15	
EA	Allowances (except for invalidity) frozen at their nominal level	March 2002 to end-2003		
EA	Postponement of expenditure on the 'Ofek' project and on the planned assistance to the Arab sector	2002	140	
EA	Cancellation of rent reductions for those newly entitled to income support	January 2002		
EDS	4% cut in all National Insurance allowances except for invalidity, child allowance, and some old-age pensions	June 2002 to end-2003	440	
EDS	Freeze on pensions, allowances and other transfer payments in 2003, covered by various laws. No update in 2003 of child allowance or pensions indexed to the average wage	To end-2003		
EDS	Stricter criteria for receipt of unemployment benefit, and preference given to demobilized soldiers	July 2002		

## Budgetary Policy Steps Authorized in 2002 cont.

		Effective	Income	
			2002	2003
EDS	Across-the-board cut in purchasing budgets	July 2002	1,500	
EDS	Cuts in grants for housing aid	June 2002	80	160
EDS	Postponement of purchases of buses	To end-2003	20	30
EDS	Preference for demobilized soldiers. Child allowances to be paid to demobilized soldiers only (passed but not yet implemented). Appeal currently in High Court		400	800
EDS	Law to limit private legislation	July 2002		
	Accounting transfers of money			
EA	200 transferred from the Postal Authority and 350 from the Ports Authority	2002	550	
EDS	Withdrawal of surpluses from Amidar housing association	2002	150	
EDS	Transfer from Ports and Rail Authority	2002-03	300	300

increases offset the real decline in imports of durables and in activity that resulted from the recession. Income tax revenues, on the other hand, fell because of the considerable drop in the real wage and in company profits and the slump in the capital market. Despite the rise in tax rates, the share of taxes in GDP went down, mainly due to the decline in income tax revenues.

Although increases in tax rates can be expected to boost tax revenues and reduce the deficit in the short term, they are likely to have a negative effect on the economy's chances of returning to a path of sustainable growth, especially in the light of the continual tax reductions in the advanced countries with which Israel competes in international markets. At the beginning of 2002:III the tax reforms proposed by the Rabinowitch Committee—intended to reduce the discrimination in Israel between taxation on capital and that on labor—were confirmed. This discrimination goes beyond what is generally accepted worldwide.<sup>7</sup> Some of the recommendations will be implemented at the beginning of 2003.

Items which promote growth such as infrastructure investment were not cut, in fact they increased above their 2001 levels, due to investment in transport. For the first time in many years, National Insurance payments did not rise, and are expected to decrease in 2003 if the proposed budget is passed without major changes. An important component in the real erosion of transfer payments and wages was the unexpected spurt in

inflation while the transfer payments were frozen in nominal terms and the fact that agreements regarding cost-of-living increments or wages were not signed in most of the general government sector.

The share in GDP of the government's domestic expenses, which rose in the second quarter, declined steeply in the third as a result of the budget cuts. Over the whole of the period reviewed this share was well below the share in the equivalent period in 2001.

The budget cuts indicate the government's desire to tighten up fiscal discipline in order to restore its credibility, in the light of the concern over the adverse effect of fiscal expansion on financial stability. The budget for 2003, confirmed by the government but not yet passed by the Knesset, is consistent with the approach adopted in June 2002 that it is essential to avoid shocks in the capital market and to create conditions for a return to growth. The budget includes additional infrastructure investment, and several initial steps towards important structural reforms regarding welfare, including the encouragement of employment of those in receipt of transfer payments.

### Prices, and the money and capital markets

The Consumer Price Index (CPI) rose by 4.5 percent in the period reviewed, compared with a rise of 2.5 percent in the equivalent period in 2001 (Table 7). This is a higher level of inflation than that defined as price stability and continues the significant rise in the inflation rate in the first quarter.

<sup>7</sup> See *Recent Economic Developments*, No. 98.

Table 7. Selected Price Indices, 2000–2002  
(annual rates of change during period, percent)

	2000	2001	2001		2002			Apr–Sep		*
			III	IV	I	II	III	2001	2002	
CPI	0.0	1.4	3.6	-2.3	9.8	16.3	2.6	5.1	9.2	9
CPI excl. housing, fruit and vegetables	0.9	0.2	0.4	-2.4	3.2	16.3	5.8	3.5	11.0	9
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	0.6	0.2	1.1	-4.4	6.3	15.9	6.3	3.5	11.0	9
Index of housing prices	-2.4	5.2	12.6	-0.4	36.7	21.9	-12.7	7.0	3.2	9
Wholesale price index	2.0	-1.9	-5.5	-2.7	7.6	15.9	3.9	-0.4	9.8	9
NIS/\$ exchange rate	-2.7	4.8	16.3	-4.3	41.6	25.7	-12.7	7.7	4.8	9
NIS/currency-basket rate	-6.3	3.7	24.6	-7.4	38.2	39.2	-8.9	8.1	12.6	9

\* Last month for which data available.

Prices were affected by the depreciation of the NIS. Despite the severe recession, the rise in the dollar rate in the first quarter rolled over into a 2.4 percent rise in prices in that quarter. Nevertheless, most of the rise in the index in 2002:I reflected an increase in the housing index, while the prices index of tradable goods hardly rose. The continued strengthening of the dollar resulted in a price rise of 3.8 percent in 2002:II, but unlike in the previous quarter, this rise included the index excluding housing and the other adjusted indices, and the rise in the index of tradable goods was similar to that of the dollar rate. Among the factors contributing to the high indices in 2002:II were the one percent rise in the VAT rate, the rise of 2.7 percent in the dollar prices of imports, and possibly also a delayed reaction to the depreciation of the previous quarter. In 2002:III the rate of price increases went down to 0.6 percent during the quarter. The decline in the dollar rate, which led to a 3.3 percent decline in the housing index, contributed to the low rise in the CPI. The price index of tradable goods rose moderately, however, despite the weakening of the dollar.

Monetary interest and inflation expectations were higher in the period reviewed than in the previous six months, but the situation was not the same in the two quarters. The reduction of the interest rate in December 2001 resulted in a sharp rise in the dollar rate in 2002:I. Following the rise of 0.6 percentage points in the interest rate in March, the exchange rate against the dollar remained stable until the end of that month. It rose again in 2002:II due to the difficult security situation and the deviation from the deficit target that resulted from the marked fall in tax revenues and the problems encountered in trying to get the budget cuts passed.

Inflation expectations for the next twelve months rose above the 3 percent upper limit of the price-stability target range. The 0.2 percentage point rise in the interest rate at the end of May and the passing by the Knesset of the budget cuts at the beginning of June did not prevent the pronounced strengthening of the dollar during June and the rise of inflation expectations for the short term (twelve months) to far above the upper limit of the price-stability target range. This led to a reduction in real short-term interest and to a rise in nominal yields. The Treasury bills yield curve reflected the public's expectations of a rise in the interest rate. In response to these developments the Bank of Israel raised its key interest rate sharply, to 9.1 percent, thereby lowering short-term inflation expectations.

At the beginning of the third quarter the dollar went down, and short-term inflation expectations returned to within the price-stability range. The Treasury bills yield curve reflected the public's expectations that the key interest rate would not rise in the next twelve months, and indeed the monetary interest rate was kept unchanged at its high level in the third quarter. Against the background of the reduced long-term credit ratings of the banks in Israel by international rating agencies, uncertainty regarding the passage of the 2003 budget through the Knesset, uncertainty regarding the possibility of war between the US and Iraq, and the difficulties confronting Israel's exporters, the dollar rate rose again in September, and short-term inflation expectations went up to 3.9 percent.

Inflation expectations for the medium term (between two and three years) were above the price-stability range during the period reviewed. Expectations for the long term, i.e., six years to ten years, which are affected

Table 8. Monetary Indicators and Nondirected Bank Credit, 2000–2002  
(annual terms, percent)

	2000	2001	2001		2002			Apr–Sep		*	
			III	IV	I	II	III	2001	2002		
Rates of change	Average		Compared with preceding quarter						During period		
M1 <sup>a</sup>	11.0	14.2	28.3	4.6	50.7	10.5	-12.0	23.6	-8.2	9	
M2 <sup>b</sup>	20.0	17.2	14.9	14.2	-11.2	-2.2	2.7	13.5	5.5	9	
M3 <sup>c</sup>	16.9	15.5	13.3	13.1	-0.6	7.3	0.5	13.2	6.6	9	
Nondirected bank credit	13.1	10.8	12.7	8.1	9.6	15.4	9.3	12.2	12.5	9	
Unindexed local-currency credit	25.2	15.0	7.8	6.3	0.3	2.0	18.6	6.5	15.4	9	
CPI-indexed credit	6.9	4.7	13.8	9.6	1.0	12.4	9.9	13.0	8.5	9	
Foreign-currency-indexed and denominated credit	9.5	15.7	17.9	8.2	39.2	38.8	-1.5	19.1	15.0	9	

\* Last month for which data available. Data for the last quarter are preliminary.

<sup>a</sup> Narrow money supply (cash in the hands of the public and demand deposits).

<sup>b</sup> M1 plus unindexed time deposits (up to one year) plus self-renewing overnight deposits.

<sup>c</sup> M2 plus deposits in and indexed to foreign-currency, and deposits indexed to the CPI (up to one year).

by long-term fiscal policy, rose throughout the period reviewed, and at the end of September, after the dollar had started rising again, were above the price-stability level. This may be due to the public's view that the political situation in Israel would prevent the government from cutting the deficit, and that the slowdown in exports caused by the crisis in high-tech industries would persist for a long time. If the 2003 budget is passed unchanged by the Knesset, it will send a message to the markets that fiscal policy is more responsible, and this is likely to reduce long-term inflation expectations.

Other changes in the assets portfolio in the period reviewed were the reduction of the share of relatively long deposits (more than three months) in the M2 aggregate (excluding Treasury bills) which includes the narrow money supply M1 and local-currency interest-bearing deposits of up to one year, and positive accumulation in savings schemes. The share of relatively long deposits in M2 continued to shrink in 2002:II due to the persistent demand for liquidity, and the positive accumulation in savings schemes continued, against the background of the acceleration in the rate of price rises and the resulting increase in uncertainty. The accumulation in savings schemes ran counter to the very large-scale net withdrawals in 2000 and 2001. In 2002:III demand for liquidity fell, the share of long-term deposits in M2 (excluding Treasury bills) rose, and accumulation in CPI-indexed savings schemes dropped sharply due to the slowdown in the rate of price increases and the fall in related uncertainty.

The rate of expansion of credit continued to slow down, and in the period reviewed it was only 12 percent (nominal rate, in annual terms). In real terms, i.e., deducting the rise in the CPI, credit remained virtually unchanged in the period. Most of its nominal increase derived from the rise in local-currency terms of foreign-currency credit resulting from the rapid depreciation and from the rise in unindexed credit. The moderation of credit expansion is consistent with the slowdown in activity, the persistence of which makes it difficult for households and businesses to increase their financial commitments.

The high rate of interest and the large differential between interest in Israel and abroad lower the probability of a financial crisis, as they act to slow down the depreciation of the NIS and to support a return to price stability. On the other hand, however, high interest hampers business activity. The Companies Survey shows clearly that financing difficulties in the implementation of planned activities worsened due to the high short- and long-term real interest rates in 2002:III and the contraction of bank credit. The rate of increase of this credit slowed in the period reviewed, against the background of the serious increase in doubtful debts, the lowering of the banks' long-term credit rating, the closure of the Trade Bank, and the liquidity problems of the Industrial Development Bank—making it difficult for households and businesses to expand their activities. Nonetheless, all industries reported that the main constraint was on the demand side.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2000–2002

	2000	2001	2001		2002			Apr–Sep		*
			III	IV	I	II	III	2001	2002	
Nominal interest										
Nondirected										
local-currency credit	12.9	10.0	9.6	9.2	7.4	8.5	11.8	10.0	9.8	8
Average monetary loan	9.3	6.7	6.2	5.8	3.7	4.9	9.1	6.6	7.0	9
SRO deposits	8.0	5.6	5.2	4.7	3.1	4.3	8.0	5.6	5.7	8
3-month Eurodollar	6.4	3.7	3.3	2.0	1.8	1.8	1.7	3.7	1.7	9
Yield to maturity on										
Treasury bills	8.8	6.5	6.4	5.7	4.8	7.2	8.9	6.5	8.0	9
10-year bonds	5.5	4.9	4.6	4.6	4.1	5.3	5.6	4.8	5.4	9
5-year bonds	6.0	4.9	4.3	4.5	3.2	4.4	5.8	4.6	5.1	9
General Share-Price										
Index (points)	248.6	197.5	194.7	196.1	199.6	183.4	177.8	195.6	180.6	9
Expected inflation (gross)	2.5	1.9	2.8	1.7	2.8	4.3	2.6	2.1	3.4	9
Interest derived from										
expected inflation (gross)	6.0	4.3	3.6	3.6	2.2	3.3	6.1	4.2	4.7	9

\* Last month for which data available

The general share-price index went down by 11 percent in the period reviewed from its mean level in the first quarter, while the Dow Jones index declined by 16 percent. In 2002:II the share-price index fell by a further 8 percent, and in 2002:III by 3 percent. The decline in the index is consistent with the sharp falls in stock

markets abroad and with the lowering of the banks' long-term credit rating. The low levels of the share-price index expresses the public's pessimistic assessment of the economic situation. The low level of turnover continued in the period reviewed.