

## RECENT ECONOMIC DEVELOPMENTS, 109

October 2004–March 2005

### Part 1: Review of current developments

#### Main developments

The economy expanded rapidly in the last quarter of 2004, and a particularly large growth was recorded in private consumption. At the beginning of 2005 the expansion in the economy slowed and its composition changed. The share of exports in economic activity declined while the share of domestic consumption and tourism rose. Although unemployment continued to fall, the improvement in employment ceased at the end of 2004. In the area of macroeconomic policy, fiscal discipline was retained, the Bank of Israel made a further reduction in the interest rate, and the interest rate differential between Israel and abroad contracted to a particularly low level. The consumer price index remained unchanged in the last quarter of 2004, and fell quite heavily during the first quarter of 2005. In that quarter, inflation expectations rose but remained close to the middle of the inflation target, the expansion in the money supply and the liquidation of the public's asset portfolio continued, capital imports were extensive, while capital exports were relatively low despite the decrease in the interest rate differential and the reform in taxation applying to investments abroad.

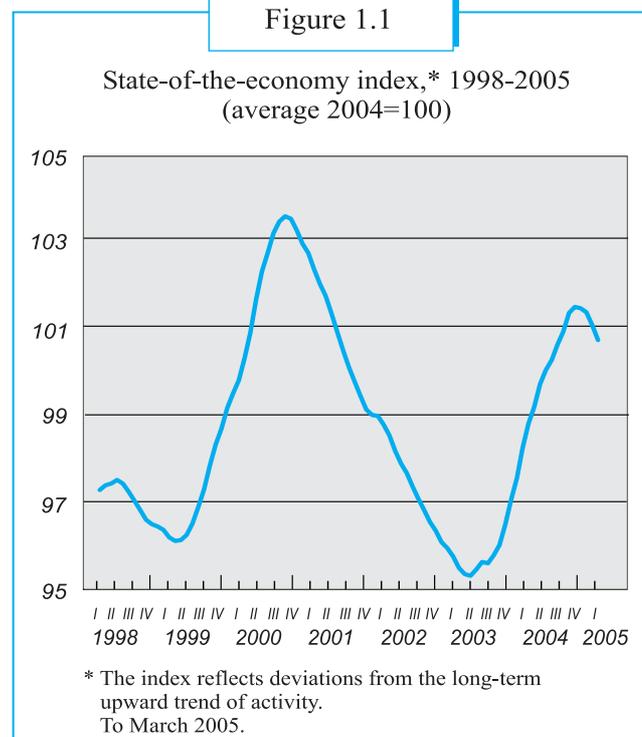
#### Aggregate real activity and industry-specific activity

In the period reviewed (October 2004 to March 2005) two changes were apparent in the trends that characterized the development of the economy during the previous quarters - a slowdown in the growth rate and a change in its composition from export-oriented growth to an expansion based on local activity. These changes were especially notable when comparing between the last quarter of 2004 and the first quarter of 2005, although certain signs of a slowdown had already emerged in 2004:IV.

**Changes in the rate of growth during the period reviewed:** In the last quarter of 2004 the growth in economic activity continued and actually accelerated, as reflected by the more rapid upturn in business-

sector product, private consumption and exports of goods (Table 1). The slower pace of expansion since the beginning of 2005 was reflected by a more moderate rise in the industrial production index during January-February and by a decrease in the composite state-of-the-economy index, and by slower growth in exports and imports of goods during the first quarter of 2005 (Tables 2 and 4).

Figure 1.1



Some of the signs of a slower pace of expansion in the economy were apparent before the beginning of 2005: a continued slowing in the rate of increase in the composite state-of-the-economy index had been recorded since the second quarter of 2004; the rate of increase in exports of goods and services excluding start-up companies and diamonds had fallen consistently since the second quarter of 2004 (Table 1); and the improvement in employment that lasted for several quarters ceased in the last quarter of 2004 (see below for details).

**Change in the composition of growth:** In 2004 exports had led economic growth. In the first quarter of 2005 growth was based on local activity, as apparent from several factors: Industrial exports fell following a long period of consistent expansion. The decline was particularly notable in high-tech exports, although it also encompassed medium-level technology industry and traditional industry. The slower rate of increase in the industrial production index during January-February resulted from a contraction in the export-oriented high-tech industries while in traditional industry, which is oriented towards the local market, a moderate expansion was recorded. This was after the high-tech industries had led the rise in the industrial production index during the previous quarters. The Companies Survey also shows a slower pace of expansion in the high-tech industries during the first quarter of 2005 while the rate of growth in the traditional industries was maintained. In addition, the Companies Survey (Table 2) indicates that the growth in manufacturing slowed while the rapid expansion like that recorded at the end of 2004 continued in the commerce industries. It should be noted however that industrial companies' reports on local as opposed to export sales did not match this picture: These companies reported a further growth in exports but stability in local sales.

In itself, the slower rate of growth should not come as a surprise in view of the very rapid expansion that was recorded in the last quarter of 2004. Accordingly,

the main question arising with respect to the period reviewed is **whether the findings are indicative of a substantial decrease in the rate of economic growth** or whether a mere adjustment for that quarter is involved. The answer to this question is not clear-cut, as will be explained below.

Figure 1.3

Foreign trade,\* 1998-2005  
(\$ million per month)

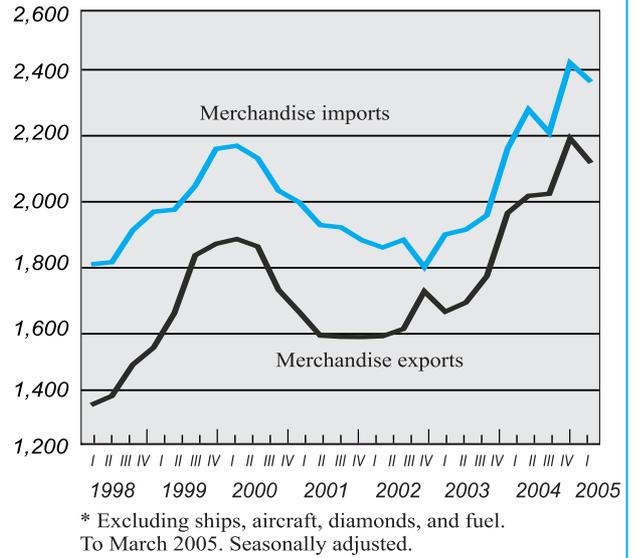


Figure 1.2

Manufacturing production\* (index, average 2004=100) and large-scale retail trade\*\* (index, average 2002=100), 1998-2005



Figure 1.4

Israel's exports of and US trade in electronic components, electronic communication equipment, and scientific and monitoring equipment,\* 1998-2005

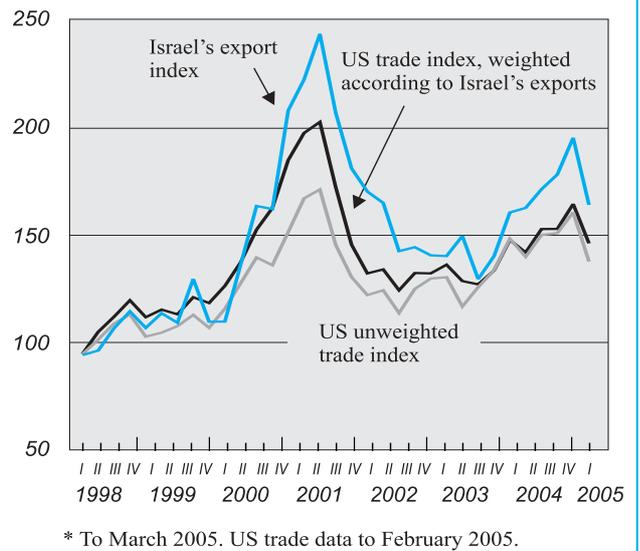
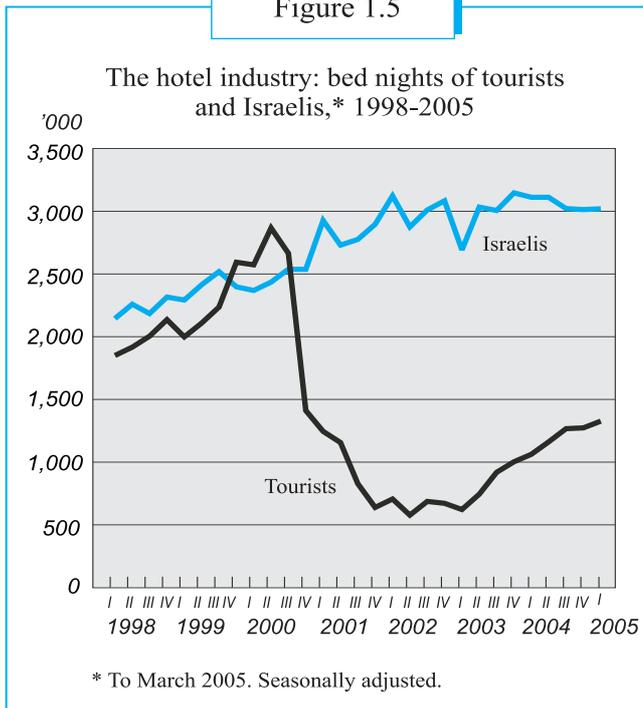


Figure 1.5



**A number of factors support further growth in the economy:** the continued calm on the security front, forecasts of further global growth and an expansion in world trade (Table 5), the low interest rate, the approval of the budget, and a policy of maintaining fiscal discipline that is committed to the expenditure and deficit targets, and of reducing taxes. The upturn in tourism continued during the first quarter of 2005 and there is evidence of optimism in the economy: among consumers - the consumer confidence indexes rose in the first quarter of 2005 after remaining stable or falling slightly at the end of 2004; among firms - the Companies Survey for the first quarter of 2005 reveals expectations of a further growth in industrial and business service companies' exports and an increase in the sales of commercial companies; and among investors - the share index rose sharply during recent months, nonresidents' investments in Israel increased at the end of 2004 and their activity in the stock market increased in the first quarter of 2005 as well.

**A number of factors are clouding the prospects of further rapid growth:** As stated, some of the signs of a slower rate of growth already appeared in 2004. Although global demand is expected to rise, forecasts regarding the rate of increase in this demand during 2005 were recently lowered as the result *inter alia* of high oil prices. Although it is too early to draw conclusions on the basis of a drop in exports during one quarter alone, the fall in high-tech exports was accompanied by a decrease

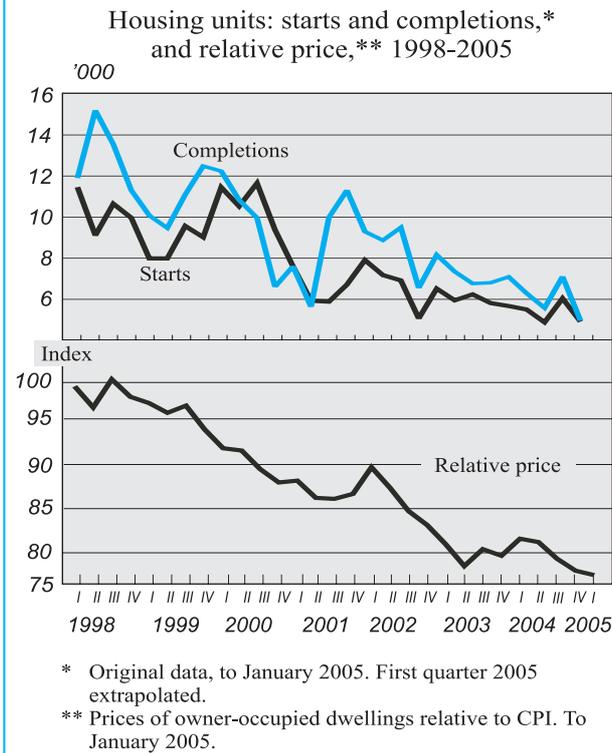
in high-tech imports in the USA and as stated, medium-level technology and traditional exports fell as well. While no signs of a slowdown are apparent among most sectors of the economy whose activity is based on the local market (such as commerce), imports of consumer goods fell in the first quarter of the year. If consumption slows as well, the economy will lose an important part of the local substitute for exports as a source of growth. Although domestic investment in fixed assets rose in the last quarter of 2004, this should not be taken as indicative of an upturn, since that quarter was preceded by two quarters of decline or stability in investment. Imports of capital goods remained static during the first quarter of 2005. The continued appreciation in the NIS will hinder a further growth in exports. Returns in the capital market reveal expectations of a moderate rise in the interest rate in the course of the year.

## Construction

The construction industry (Table 2) is a source of particular interest because its development during the period reviewed, as in the last two years, appears to be detached from developments in the rest of the economy. No real change in the industry was apparent in the last quarter of 2004 either. Activity in the industry remained sluggish despite the general upturn in the economy and the low level of interest rates. This is especially apparent in housing construction. All the indexes show a further downturn in this area of construction or at the very most, stability at a low level. This is reflected by the number of housing starts, the area under active construction and investment in housing construction during the last quarter of 2004 as based on National Accounts data. The slight increase in sales of new apartments during 2004:IV is not indicative of a recovery; the opposite in fact, since it followed a large decrease in the third quarter and the number of apartments sold in 2004:IV was almost the lowest since mid-2003 (only in the third quarter was it even lower). The shrinking size of the market was also apparent from the contraction in the stock of new apartments that were still available for sale. National Accounts investment data show that non-housing construction remained stable at the end of 2004.

The figures continue to show that the weakness in the industry mainly derives from low demand. Prices of second-hand apartments fell almost consistently in the second half of 2004 after rising at the beginning of the year. During the second half of 2004, apartment rental fees fell again after remaining stable during the previous three quarters. This may indicate that the weakness in demand was not only the result of households' fear of taking on the long-term liabilities involved in purchasing

Figure 1.6



an apartment, although the uptake of mortgages decreased in the last quarter of 2004 after falling in the previous two quarters as well.

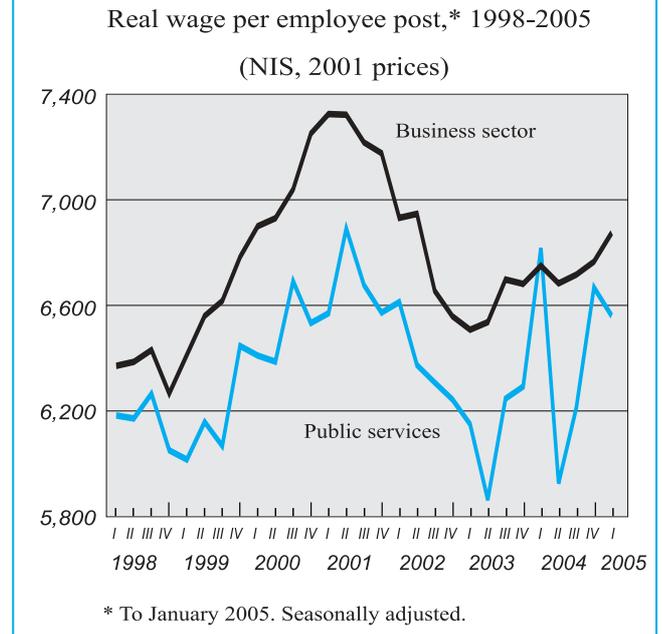
The low level of housing starts shows that construction companies do not expect a growth in demand in the near future. But according to the Companies Survey for the first quarter of 2005, their expectations regarding the industry's activity in the next quarter stabilized for the first time after a long period of decline.

Apart from the continuing weakness in demand, a relatively large rise in the construction inputs price index was recorded in the first half of 2004, after which prices fell slightly. In the period reviewed the rise in this index resumed, but for different reasons: The rise in the index during 2004 derived from the prices of materials and equipment; the rise at the end of 2004 and the beginning of 2005 derived from an increase in wages while prices of materials fell.

### The labor market

A number of changes were recorded in the labor market during the last quarter of 2004 compared with the trends in the previous quarters (Table 3). The unemployment

Figure 1.7



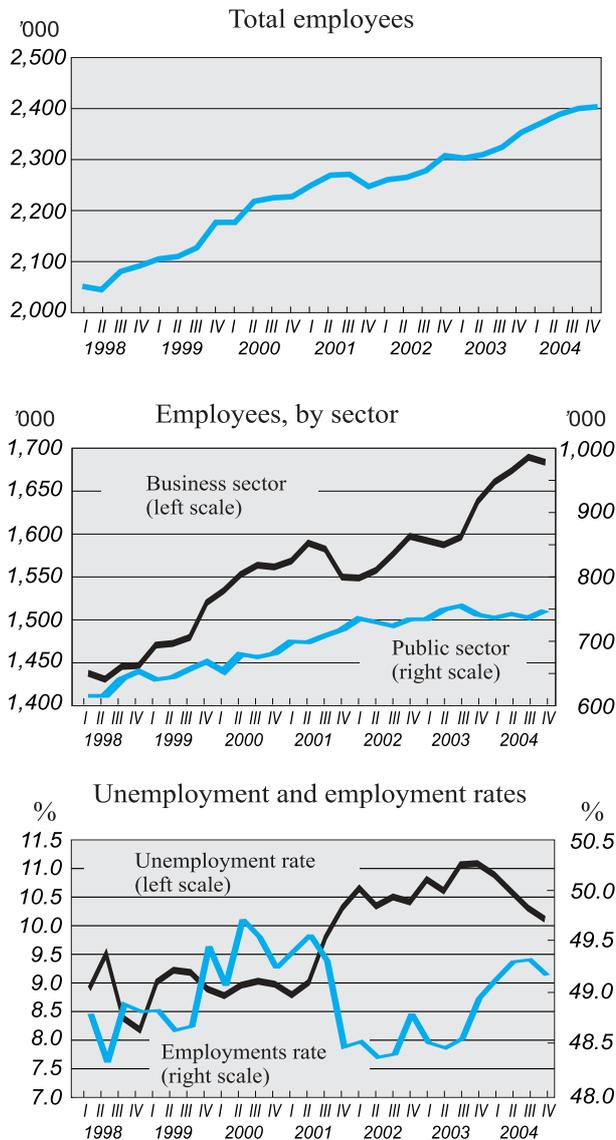
rate continued to fall in that quarter but did not reflect an improvement in employment. The opposite in fact, for the improvement that was recorded in the previous quarters ceased at the end of 2004. The number of Israeli employed persons remained unchanged in the fourth quarter after increasing for several quarters. The decline in the unemployment rate resulted from a drop in the participation rate (a decrease that characterized the third quarter as well). The number of persons employed in full-time posts fell in the last quarter of 2004, continuing the decrease recorded in the previous two quarters, and for the first time since the end of 2002 the number of persons employed in part-time posts fell as well.

The sources of the change in the number of Israeli employed persons also differed. During the previous quarters the business sector led the expansion in employment, while in the public sector the number of employees fell. This situation changed in the last quarter of 2004. The number of Israelis employed in the business sector dropped for the first time since the third quarter of 2003, while the number of persons employed in the public sector rose quite considerably. The employment of Israelis fell despite some decrease in the number of non-Israeli employed persons (foreign workers and workers from the territories).

The decrease in the number of non-Israeli employed persons reflected opposite developments among foreign workers and workers from the territories. The number

Figure 1.8

The labor market,\* 1998-2004



\* Seasonally adjusted.

of legal and illegal foreign workers rose during the fourth quarter following an increase in the third quarter, and their number at the end of the year was greater than at the beginning of the year. This contrasted with the government's declared policy of reducing the number of foreign workers. However, the number of workers from the territories fell in the last quarter of 2004, in comparison with both the third quarter of 2004 and the last quarter of 2003.

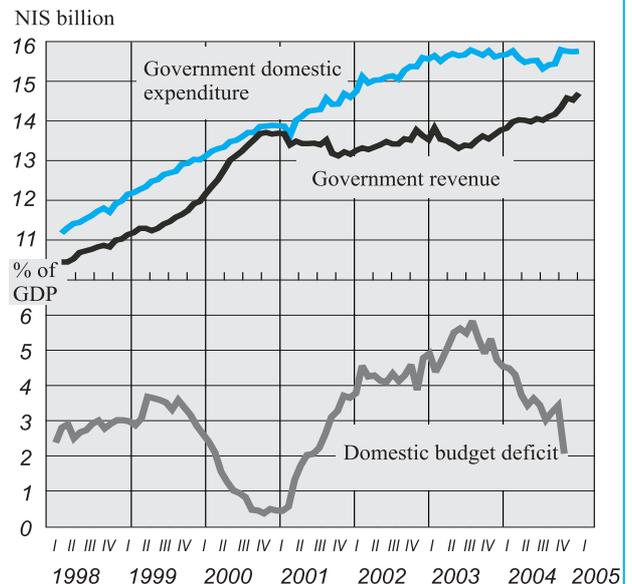
Real wages rose during the second half of 2004, and their level in the last quarter of the year was higher than in the same period of 2003 in the business sector and the public sector.

### The public sector

The State budget for 2005 was only approved at the end of March 2005. The new budget is the first that is subject to the multi-year targets set by the government - a deficit ceiling of 3 percent of GDP and a real growth in expenditure of one percent in each year. The government has displayed a commitment to these targets. The budgetary commitments that were made during the coalition negotiations that preceded the approval of the budget did not lead to a deviation from the target, but came at the expense of other cuts in the budget, especially lateral cuts in the budgets of government ministries. However, in order to finance the disengagement plan it was decided to raise the deficit target in 2005 to 3.4 percent of GDP (see below for more details). The budget deficit in 2004 amounted to 3.9 percent of GDP, which was slightly less than the deficit ceiling.

Figure 1.9

Government cash flows,\* 1998-2005 (12-month moving average)



\* To March 2005.

Because of the delays in approving the budget, during the first three months of the year the government operated on the basis of the 2004 budget. This may explain the large domestic budget surplus in the first quarter of 2005 (Table 6).

Government expenditures in the period reviewed deviated notably from the usual seasonal pattern. Spending was particularly low until November and was exceptionally high in December, which was only partly due to the bringing forward of expenditures that were intended for 2005 (vacation allowance and seniority bonus). In the first quarter of 2005 spending was lower than the seasonal pattern of the 2005 budget, apparently due to the delay in approving the budget. The decrease in government spending was reflected in public consumption and in transfer payments. Public consumption fell during the last quarter of 2004 following a decrease in the previous two quarters. The reduction in National Insurance allowances (which was continuing as of February 2005) was especially apparent in child allowances and unemployment benefits, reflecting legislative changes and the government's declared policy of encouraging integration in employment and reducing dependency on the allowances.

Government revenue from tax receipts during the period reviewed was higher than in the same period of 2003-2004 despite legislative changes that reduced tax rates, a fact that reflects the expansion in activity. Tax revenue in the first quarter of 2005 was less than the seasonal pattern. The Income Tax Commission's special enforcement campaign reduced the shortfall in tax receipts during that quarter. Revenue from indirect taxes was lower than the seasonal pattern, mainly because the Passover holiday was relatively late this year, with the result that a large part of the pre-holiday upsurge in shopping occurred only in April. The decrease in imports of consumer goods also contributed to the downturn in revenue from indirect taxes. Non-tax government revenue in the first quarter of the year was higher than forecast, due to one-off factors such as the withdrawal of money under the 'Avner Law'.

### The balance of payments

Developments in the **current account** and its components during 2004:IV excluding seasonal factors were similar to those in the third quarter (Table 4). The current account surplus contracted in each of these quarters, with the result that the current account was almost balanced at the end of the year. The decrease in the surplus during these quarters derived almost entirely from a growth in the deficit in the **balance of goods and services**. The deficit in revenue from factors of

production fell slightly, while the surplus in current transfers remained practically unchanged. The growth in the deficit in the goods and services account reflected a larger increase in imports than in exports. The growth in the deficit derived entirely from an increase in the goods account deficit, while the surplus in the services account scarcely changed.

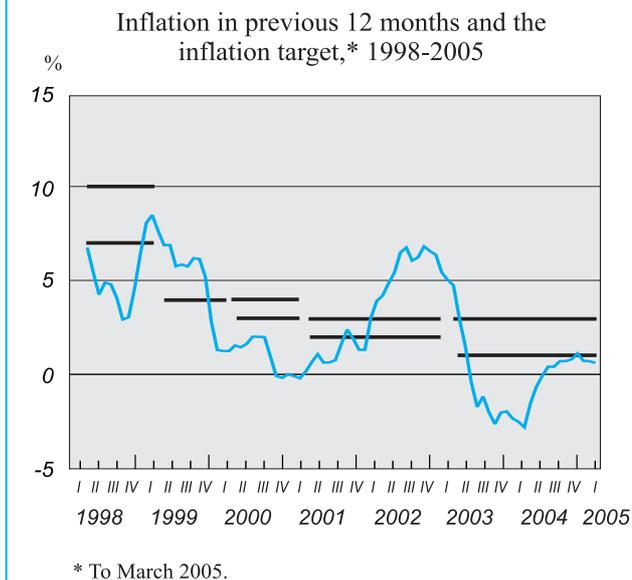
A large growth in Israelis' investments abroad and non-residents' investments in Israel was recorded in 2004:IV. The net result of these flows was a deficit in the **financial account** (Israelis' investments abroad exceeded nonresidents' investments in Israel). Following a surplus in this account in 2004:III, in the last quarter of 2004 the economy thereby reverted to its situation of the past two years, of a deficit in the financial account in almost every quarter. The growth in nonresidents' investments in Israel at the end of 2004 derived from similar-sized increases in direct investment and in portfolio investment, and reflected *inter alia* the growth in capital raising by Israeli companies abroad. Nonresidents' direct and portfolio investments increased in the first quarter of 2005 as well, and reached 60 percent of their amount in the whole of 2004. Capital exports in the first quarter of 2005 were lower than expected despite the tax reform applying to Israelis' investments abroad, and the further contraction of the interest rate differential between Israel and abroad.

No major changes were recorded in the **foreign exchange reserves** and their level at the end of the first quarter of 2005 was similar to that at the end of the first quarter of 2004. The growth in the reserves at beginning of the year mainly derived from the receipt of civilian aid from the USA.

### Prices, monetary policy, and the money and capital markets

The **consumer price index** (Table 7) remained unchanged during the last quarter of 2004, but fell considerably in 2005:I, with the entire decrease of 0.6 percent being recorded in January. Inflation during the whole of the period reviewed was therefore negative. Excluding the housing item, which dropped to a particularly large extent, items that are affected by seasonal fluctuations (fruit and vegetables, clothing and footwear) and controlled prices, the inflation recorded during the period was positive but still below the targeted range (which is 1-3 percent a year). The low inflation was recorded despite the growth in the economy and the rise in world prices for oil (see Part 2 for more details). A contributory factor in this respect was the continued appreciation of the NIS against the dollar.

Figure 1.10

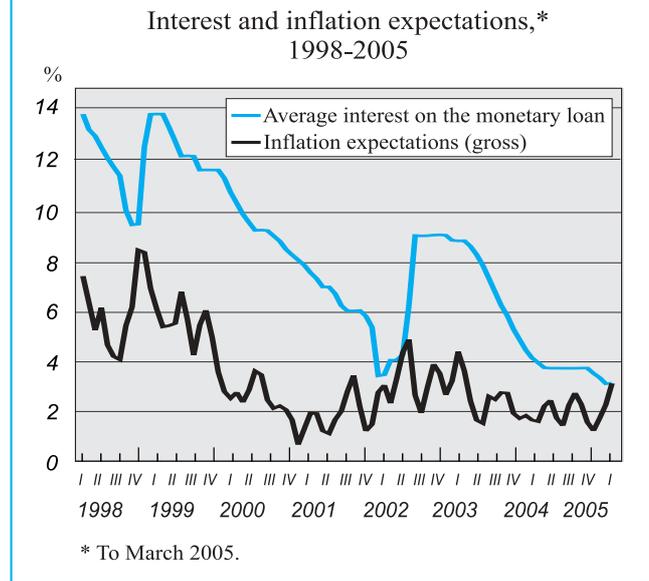


**Inflation expectations** for 12 months ahead, which fell at the end of 2004 (Table 9), rose during 2005:I to the highest level since mid-2003, but are still close to the middle of the targeted range. Inflation expectations for longer terms are also within the targeted range.

**The exchange rate** of the NIS against the dollar appreciated considerably during the period reviewed (Table 7). The appreciation occurred mainly in the last quarter of 2004 and derived mostly from the worldwide weakening of the dollar, with the result that the appreciation of the NIS against the currency basket was much smaller. The appreciation occurred despite the continued contraction of the interest rate differential between Israel and abroad. The recent large volume of autonomous capital imports (which are not sensitive to the interest rate) may also have contributed to the appreciation.

In view of the low level of inflation expectations at the end of 2004 and the low level of actual inflation, the Bank of Israel adopted an expansionary monetary policy during the period reviewed. After seven months during which the Bank of Israel's interest rate had remained unchanged, during December 2004-February 2005 the central bank cut the rate by 0.2 percentage points in every month. At the end of the period, the interest rate thereby amounted to 3.5 percent. The interest rate was left unchanged in March and April. The US Federal Reserve raised its interest rate by 0.25 percentage points in almost every month since July 2004. The result has been a consistent decrease in the **interest rate**

Figure 1.11



**differential** between the two central banks. In April the differential dropped to the particularly low level of 0.75 percent as compared to 3.1 percent in April 2004. The Bank of Israel's real interest rate also fell during 2004:IV and 2005:I. The stability in the economy was maintained, as apparent from the development of the exchange rate, the relatively low volume of capital exports, and inflation expectations. The Treasury bill yield curve at the end of the period reviewed shows that the market is expecting a moderate increase in interest rates during the coming year.

The (M1) money supply in the economy expanded more rapidly than M2 in the first quarter 2005 (Table 8), reflecting the liquidation of assets. This phenomenon is consistent with the low interest rate and the additional cut in the rate at the beginning of the year. These developments were similar to those that were recorded during the first three quarters of 2004, while an aberration occurred in the last quarter of the year when the expansion in M1 was minimal and less than the growth in M2. The increase in the volume of liquid assets could also be indicative of the credibility of monetary policy, since the public are not apprehensive of holding large amounts of unindexed assets.

**Unrestricted credit** contracted during the period reviewed, especially in the first quarter of 2005. This should not be taken as indicative of a decline in economic activity because at least part of the decrease in credit derived from the raising of alternative sources such as issues in the stock market, and from the supervisory restrictions imposed on the banks.

Figure 1.12

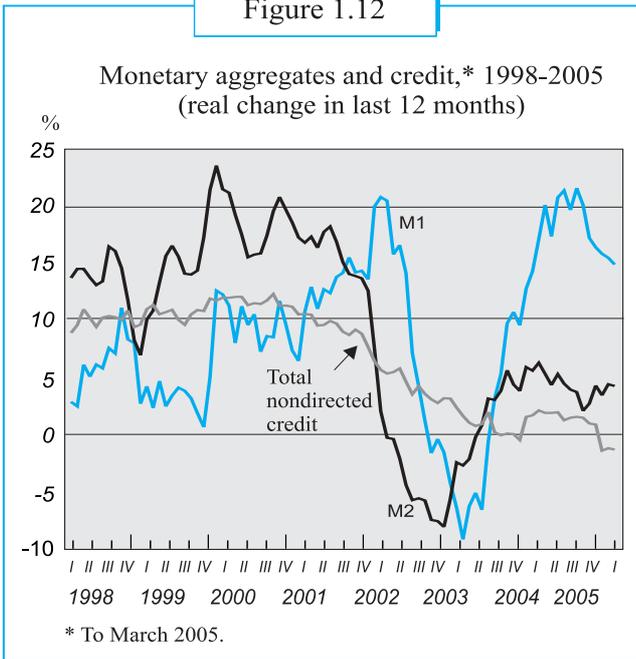
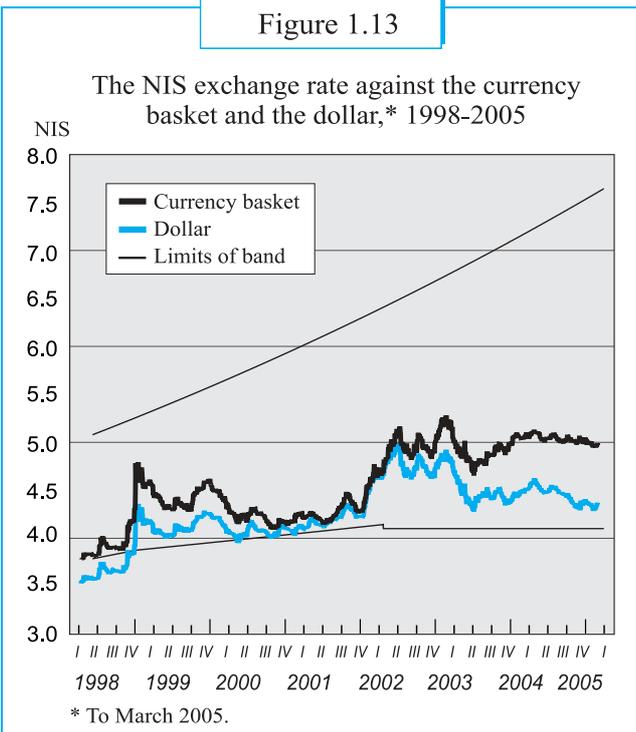


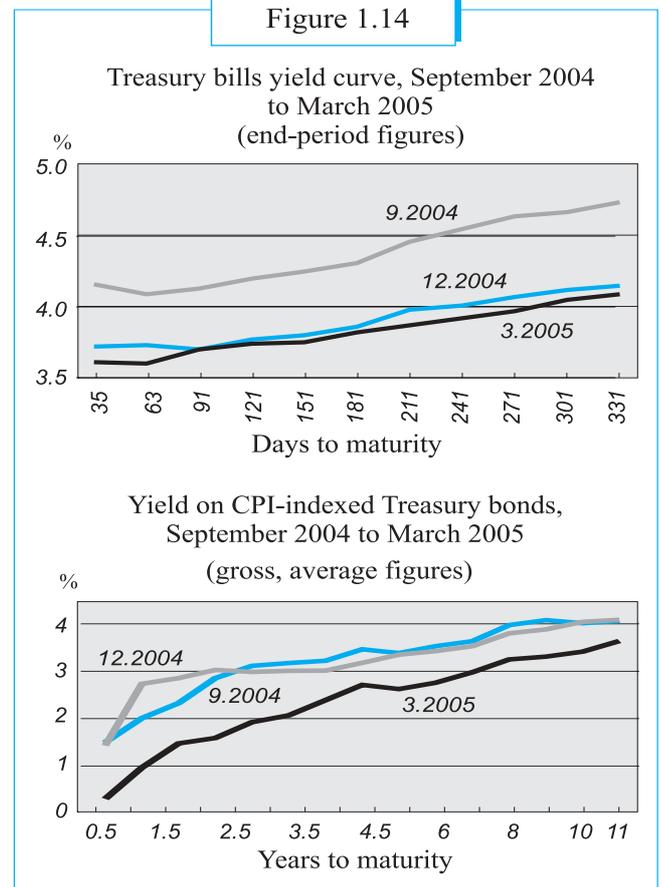
Figure 1.13



Nominal and real yields fell at the end of 2004 and in the first quarter of 2005 for the short term (Treasury bills for a year) and for the long term (5 and 10-year bonds). The reduction in interest rates supports an upturn in economic activity, and could also reflect the credibility of government policy with respect to the budget deficit.

The General Share Index rose appreciably during the period reviewed (Table 9), and revealed investors' optimism even though the rise in the index slowed considerably in the first quarter of 2005. The upturn in the index since the beginning of 2005 occurred despite a consistent downturn in the NASDAQ during January-March. Turnover in the stock market increased substantially during the period reviewed and nonresidents' proportion of trading rose to a notable extent, like the recent growth in foreign investment in other emerging economies.

Figure 1.14



### Budgetary expenditure on the disengagement plan

The disengagement plan will impose a considerable burden on the State budget during the coming years and introduces some uncertainty as to its extent. The plan also raises issues of principle regarding the manner in which it is to be financed and its place in multi-year fiscal policy. A comparison with the cost of the withdrawal from Sinai is also a matter of interest. These three aspects of the disengagement budget are discussed below.

#### The cost

The overall budgetary cost of the disengagement plan is estimated at NIS 6.5–7 billion as assessed by the Finance Ministry, and is due to be staggered over the years 2005–2007. The State budget for 2005 allocates NIS 2.2 billion (0.8 percent of the total budget) for financing the plan. The Disengagement Law permits a similar amount to be spent in 2006. The amount of spending for 2007 has yet to be determined. In 2005 half of the expenditures will be civilian and half will be security related. The civilian spending is mainly designated for compensating the settlers, and the owners of businesses in the Erez industrial area and other entities. Although the military spending is mainly intended for the Ministry of Defense, the police and other sections of the security forces will also receive budgetary increments.

There is some degree of uncertainty regarding the total costs of the disengagement and their actual apportionment over the budget years. Firstly, the staggering of compensation payments over the years is dependent on the pace at which agreements are signed with the settlers and implemented. In particular, payments may be delayed from 2005 to 2006, with the result that spending in 2005 will be less than NIS 2.2 billion and more than that in 2006. Secondly, total compensation payments may exceed the forecast. The size of the payments may well increase as the result of legal deliberations under the existing ‘Evacuation-Compensation Law’ or due to changes in the law. Thirdly, the difference between the budgeted spending for 2005–

2006 (NIS 4.4 billion) and the overall cost estimate (NIS 7 billion) should be noted. The difference implies that spending in 2007 will be similar to that in each of the previous two years, or higher. This is despite the fact that most of the expenditures (compensation and especially military deployment) are likely to be concentrated within the next two years, and spending in 2007 can be expected to decrease considerably. Accordingly, if the present budget for 2005–06 accurately reflects the actual expenditures that will be incurred, the total costs are likely to amount to less than NIS 7 billion. If the total costs do indeed reach NIS 7 billion, the expenditures in 2005 and 2006 are likely to exceed the currently budgeted amounts.

#### Finance

The government decided to increase the budget deficit for 2005 by 0.4 percent of GDP in order to finance the disengagement plan. This growth in expenditure will be included in the budget base for the purpose of calculating total government spending in 2006. The method of finance in 2007 has yet to be determined. The decision to increase the deficit has a number of implications from the fiscal policy aspect:

- The disengagement expenditures in 2005 will not be at the expense of other government spending items in that year.
- The government will not raise the tax burden in 2005 in order to finance the disengagement.
- The public debt will increase.
- In 2005 the government raised its expenditure-related target (a growth of one percent a year) and the deficit target (3 percent of GDP), above the long-term targets.

A number of considerations may be noted regarding the method chosen for financing the disengagement plan. From the budgetary aspect, the disengagement plan is a one-off and exceptional event. A large budgetary expenditure is therefore necessary during a short period for the purpose of financing the plan. Logically, such a one-off event as distinct from a permanent increase in government spending, would be financed by creating debt. Without an increase in the deficit, a drastic cut in

spending or a large rise in the tax burden during the current year would be necessary. Debt creation makes it possible to stagger over time the cut in expenditures or a tax hike at moderate rates. More than once, countries have chosen to finance exceptional events (wars as well as one-off civilian needs) by means of an immediate increase in debt and its repayment over time.

Increasing the deficit for the purpose of financing the disengagement also raises two issues. Firstly, the government will deviate from the multi-year expenditure and deficit targets that it set itself only recently. However, the amendment to the Disengagement Law stipulates that the increase in the deficit will be for the purpose of financing the disengagement alone. It is therefore important that the deviation in this case, which is clearly one-off in nature, will not provide a precedent for deviating from the targets in normal circumstances. That is because the deviation could harm the government's credibility with respect to its commitment to these targets. This is particularly relevant when it is considered that in recent years the government exceeded its deficit targets several times or increased them when it realized that it would be difficult to adhere to them.

Secondly, any increase in the debt is problematical in view of the high debt/GDP ratio in Israel compared with the usual worldwide level. However, the one-off nature of the expenditure means that the increase in the debt is also one-off, and therefore does not create a long-term trend of growth in the debt (negative debt dynamics).

### Comparison with the cost of the withdrawal from Sinai

Table 1 presents the expenditure incurred in the evacuation of Sinai and the composition of the expenditure. A comparison between this expenditure and the expenditure expected on the disengagement plan raises a number of points. The total cost of vacating Sinai was much higher (over five times more) than the estimated cost of the present disengagement. However, the burden on the economy was considerably less than the amounts denominated in the table because most of the cost of the withdrawal from Sinai derived from military redeployment, which was largely financed with American aid. The compensation to the settlers (including the establishment of new settlements) accounted for only 14 percent of the total cost of the withdrawal from Sinai. But in the present disengagement plan, most of the cost is related to the evacuation of the

settlers and not to military deployment. Even if special aid is received from the USA, this is likely to be limited to the area of military deployment, and will therefore finance only part of the cost of the disengagement. From the finance burden aspect, the civilian expenditures that the economy will have to finance itself are therefore of particular importance. In the case of the withdrawal from Sinai these expenses totaled NIS 9 billion (2004 prices). In the present disengagement plan, the expenses are expected to amount to NIS 4.3 billion. Taking into account the growth in the economy over time, the difference in the burden on the economy is even more notable: the civilian expenditures accrued in the evacuation of Sinai and in the present disengagement account for 4.3 and 0.8 percent of annual GDP at the beginning of the 1980s and in 2004 respectively. The actual expenditure in the two cases is staggered over a number of years, which eases the finance burden. Despite the high cost of the withdrawal from Sinai, no explicit decision was made at the time to raise taxes or cut other expenditures in order to finance the withdrawal. Neither was the government committed to deficit or spending targets, meaning that a deviation from such targets was not an issue at the time.

**Table 1**  
**Total expenditure on the withdrawal from Sinai during the years 1979-1987**

	NIS million (2004 prices)	Percentage distribution
Military deployment	31,077	77.6
Infrastructure development	3,413	8.5
Establishment of 19 agricultural settlements*	2,108	5.2
Compensation for Sinai evacuees**	3,430	8.6
<b>Total</b>	<b>40,021</b>	<b>100</b>

\* Of 40 settlements that were established.

\*\* Urban residents and farmers.

SOURCE: Nurit Kliot and Shemuel Albeck, *Sinai – Anatomy of Settlement's Evacuation*, Ministry of Defense Press 1996, Table 13, p. 134. The original figures in the publication are at June 1990 prices.

### The wholesale price index and its impact on the consumer price index

A large 7.6 percent increase was recorded in the wholesale price index during 2004. In the same period the consumer price index rose by only a moderate 1.2

percent. These developments raise some questions regarding the relationship between the two indexes, particularly with respect to the intensity of the pass-through and its duration.<sup>1</sup>

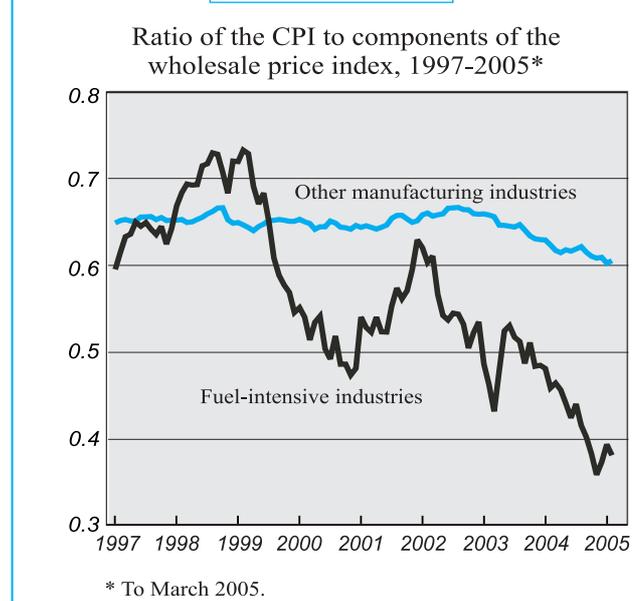
Although the rise in the wholesale price index partly derived from the weakening of the NIS against the currency basket (a depreciation of 2.2 percent), most of the increase is attributed to the development of fuel prices. The development of these prices led to a large increase in the prices of the inputs of the industries that use oil as a raw material for production (principally the oil refining industry, and the plastic and rubber industry), and raised production costs in other industries. Figure 2.1 demonstrates the function of fuel prices in creating the gap between the consumer price index and the wholesale price index: The ratio between the consumer price index and wholesale prices in fuel-intensive industries has fallen over time, while the ratio between the consumer price index and wholesale prices in other manufacturing industries has remained stable.

Since the wholesale price index measures the prices of industrial production for local destinations at the initial marketing stage, before its sale to households, it can be assumed that the changes in this index will spill over into the consumer price index to some extent. However, the intensity of the pass-through between the two indexes is unclear because the consumption basket that is measured includes not only local industrial output, but also a range of imported consumer products and various services. In addition, at the initial marketing stage part of industrial output might be sold to the local market as production intermediates (and is therefore included in the wholesale price index) and at the end of the production process does not reach local households but is exported (and is therefore not included in the consumer price index).

The relationship between the two indexes is examined under a two-stage approach. At the first stage, the long-term relationship between the trends in the two variables is examined. At the second stage, an examination is made of the short-term relationship, which is affected *inter alia* by deviations of the variables from the long-term relationship. The examination shows that during

<sup>1</sup> In contrast to the consumer price index, the wholesale price index includes only manufacturing output. If the housing, apartment maintenance, fruit and vegetable, education, culture and entertainment, and health components are excluded from the consumer price index, the maximum weighting of manufacturing output in it is 40-45 percent.

Figure 2.1



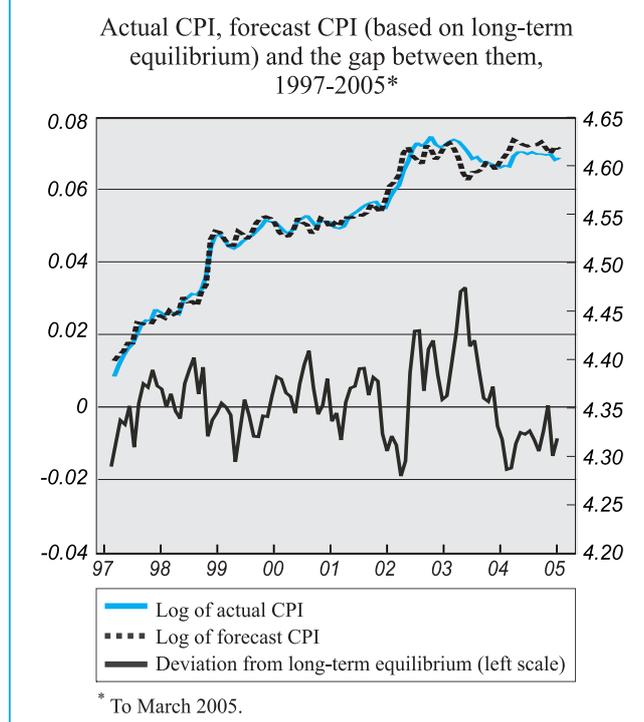
the years 1997 to 2005,<sup>2</sup> the consumer price index, the wholesale price index and the exchange rate of the NIS against the dollar (which partly reflects the prices of imported consumer goods) moved together, and in the long term the weightings of the wholesale index and the exchange rate in the consumer price index are 40 percent and 35 percent respectively.

Figure 2.2 describes the deviations of the consumer price index from the forecast long-term equilibrium level. It can be seen that for most of the sample period, the deviations are for short periods of time, while in the last two years the deviation has been prolonged - in 2003 upwards (continuing the deviation in 2002) and in 2004 downwards.

During the second half of 2002 and in 2003, the actual level of the consumer price index was higher than the forecast long-term level (positive deviation), since consumer prices in that period fell less than the exchange rate. The gap between the actual index and the forecast index closed towards the end of 2003, due to the rise in wholesale prices and the exchange rate concurrent with a continued moderate decrease in consumer prices.

<sup>2</sup> The estimate was made from January 1997 to February 2005. In the estimate, the wholesale price index was broken down into two groups: one – fuel-intensive industries (oil refining, and the plastic and rubber industry) whose weighting in the wholesale index is approximately 8 percent; and the other – the remaining industries.

Figure 2.2



During 2004 a prolonged deviation from equilibrium level was again apparent but this time downwards, so that the actual index was lower than forecast. This negative deviation, of about 1 percent on average, mainly derived from the large increase in wholesale prices (which resulted from the rise in fuel prices), as compared to the only moderate increase in the consumer price index. Due to the renewed rise in fuel prices and the depreciation in the local currency concurrent with the moderate decrease in the consumer price index, the negative deviation from long-term equilibrium remained at the beginning of 2005 as well. As can be seen from the diagram, these gaps do not persist over time and are expected to close.

On the basis of past experience, the gap can be expected to close as the result of a rise in the consumer price index during the coming months. This is because the examination shows that among the three variables that were estimated (consumer prices, wholesale prices and the exchange rate), only the consumer price index reacts to deviations from long-term equilibrium. When the actual index was lower than forecast (negative deviation), as the result of an upsurge in the wholesale price index and/or a larger rise in the exchange rate than in the consumer price index for example, a rise in the inflation rate was recorded during the subsequent months: As early as the first four months since the

emergence of a negative deviation of approximately one percent (all other parameters being fixed), inflation rose by half a percent.

### A regional examination of changes in economic activity

An interesting issue relating to the business cycle is whether it has a varying effect on the different sectors in the economy. This issue is examined here from a geographical aspect: whether it is possible to identify differences in economic activity between different regions of the country during the latest business cycle, since the year 2000. The intensity of the crisis at the beginning of the cycle and the subsequent pace of recovery provide a good opportunity for such an examination.

Regional differences can vary from industry to industry. We will examine below activity in three industries - manufacturing, business services and hotels.<sup>3</sup> The selection of the industries and the index for describing the activity of each industry was affected by limitations on the data available. The findings show that in the business cycle since 2000 regionality in manufacturing was neutral, in the business services industry neutral from the aspect of the direction of the changes and their intensity but not from the aspect of their timing, and in the hotel industry was biased towards the South.

A regional examination of the industries in question still does not provide an overall picture of each region's relative position. We will therefore conclude by examining the unemployment rate in different districts as an indicator of aggregate activity in them.

### Manufacturing and business services

Figure 2.3 presents the changes in the level of activity in manufacturing and in the business services industry according to the Bank of Israel Companies Survey. The index is based on the net balance of companies' responses regarding a rise or fall in the level of their activity in each quarter. Activity in manufacturing is measured according to output reports and in the business services industry, on the basis of revenue reports.

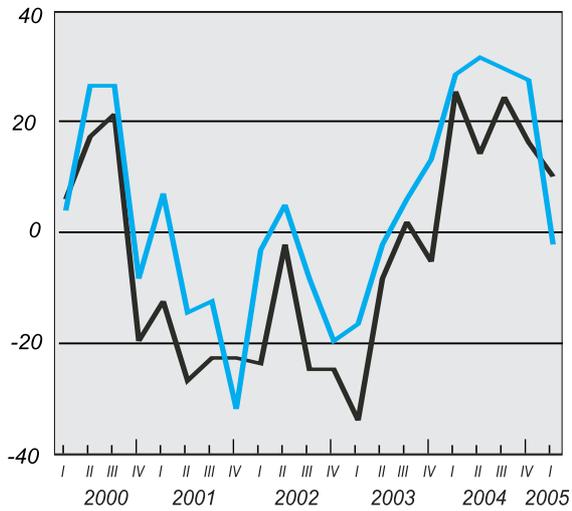
The companies were divided by their location into two regions - the center (the Tel Aviv, Central, Jerusalem and Judea and Samaria districts) and the outlying areas

<sup>3</sup> For a regional analysis of the construction industry (apartment completions), see the Bank of Israel Report for 2004, the chapter on Output and the Principal Industries.

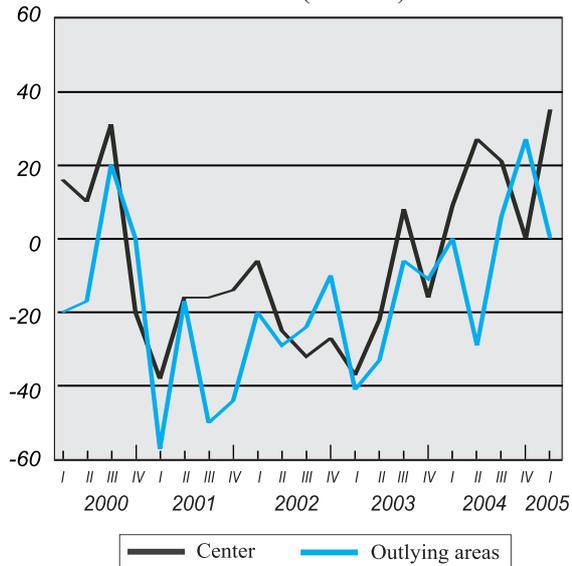
Figure 2.3

Activity according to the Bank of Israel's  
Companies Survey, 2000-2005\*

Manufacturing (output)



Services (revenue)



\* To March 2005.

(the northern, Haifa and the southern districts). The classification of the companies by regions makes it necessary to leave out large companies whose activity is dispersed nationwide. Also left out of the examination were industries in which the company's location is of no significance, such as construction, transport and communications companies.

It can be seen that a clear correlation exists in both of the industries between activity in the center and in the

outlying areas. The start of a recession in the economy at the end of 2000 - as well as the end of the recession in 2003 - was evident in both industries in each of the regions. The intensity of the changes was also similar. However, there is an interesting difference between the industries. The changes in activity in manufacturing occurred simultaneously in the center and in the outlying areas. (A statistical test shows a significant simultaneous correlation.) Although the change in the business services industry was simultaneous until 2003, a gap in the timing of the change in activity emerged from the beginning of 2003. The change in the center preceded the change in the outlying areas by two quarters. (The lag is statistically significant.) The simultaneous correlation in manufacturing appears reasonable because a factory's sales are usually to the nationwide market or for export, and are therefore not dependent on the level of economic activity in its region. However, sales by the business services industry are partly more local in nature, and it can therefore be assumed that their activity is affected by regional demand. The present recovery in the economy is based on the high-tech industries, which are mainly located in the center of the country. It is quite reasonable therefore that the recovery will be felt in that region earlier. Nevertheless, it is not clear why a similar timing gap did not emerge as the economy entered a recession at the end of 2000, when the adverse impact was felt mainly in the high-tech industries.

One of the implications of these findings is that unlike other industries, the existence of manufacturing industry in the outlying areas is likely to reduce the differential effect of the business cycle on the different regions of the country, that is, moderate the short-term gaps between the regions that are caused during a high or low in the business cycle. But it should be remembered that the outlying areas has also suffered from the long-term effects of the weakening of traditional industry, which is concentrated there. In addition, if different industries are set up in different regions, each region will be exposed to that industry's unique risks.

### The hotel industry

Hotels provide an interesting example for examining the regional aspect of changes in economic activity. The regional differences between them derive from two factors. Firstly, they differ in the extent of the dependence on Israelis as compared to tourists, with the result that changes in incoming tourism relative to internal tourism will affect them differently. Secondly, the hotels in the different regions are exposed to the impact of terror attacks to differing extents.

Figure 2.4

The hotel industry, bed nights by area, 1991-2004

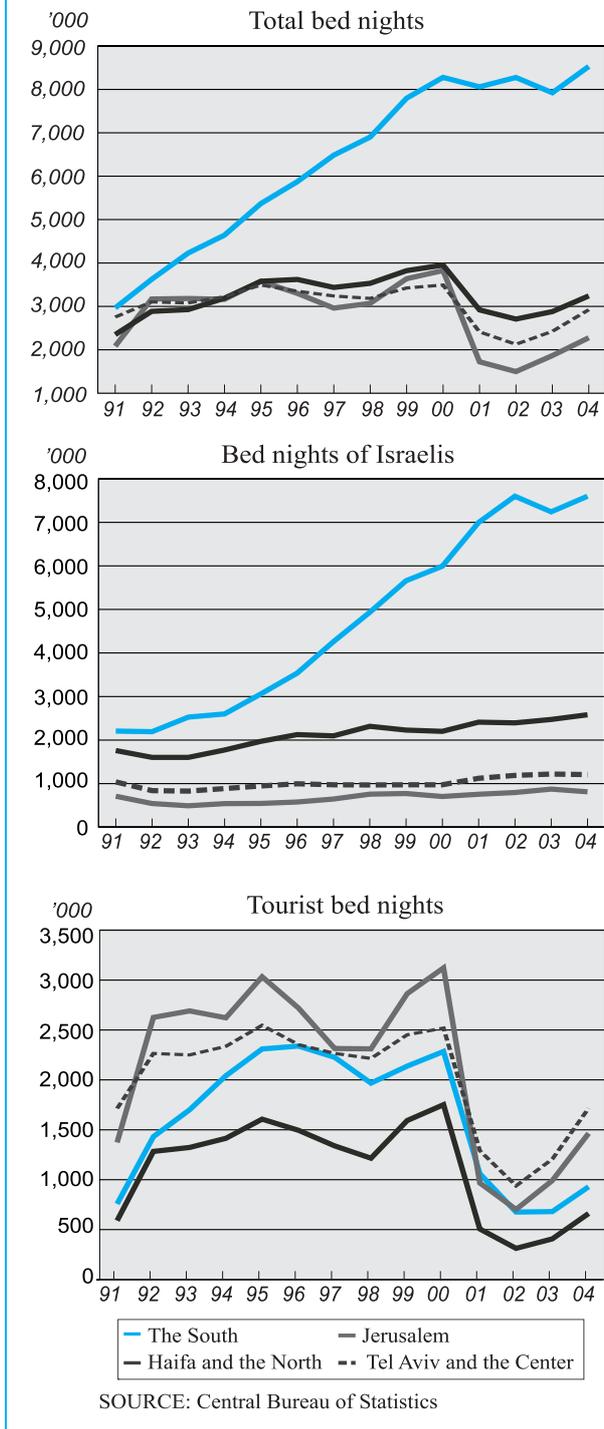


Figure 2.4 describes the development of the overall number of bed nights and the number of bed nights attributed to Israelis and to tourists in hotels by region during the years 1991-2004. The four regions that were

defined are the north, Tel Aviv and the center, Jerusalem, and the south. A long-term increase in the number of bed nights is notable in the south (Eilat and the Dead Sea) compared with the other regions of the country. The increase derived almost entirely from bed nights attributed to Israelis. This trend is of major significance with respect to the impact of the crisis in incoming tourism.

The crisis in incoming tourism at the end of 2000 was clearly apparent from the decrease in the number of bed nights attributed to tourists in all the regions. But in its effect on hotels' overall activity, the difference between the regions is great. The crisis demonstrates the regions' differing sensitivity to incoming tourism as opposed to internal tourism, and to the security situation. The differences are especially notable when comparing the South to Jerusalem and the center. The overall number of bed nights fell slightly in the south, but dropped heavily in the other regions. This was despite the fact that bed nights attributed to tourists in the south fell by a higher rate than in Jerusalem and the center. There are two reasons for this: One is the particularly low proportion of tourist bed nights in the south (approximately 10 percent during recent years). The other reason is that the number of bed nights attributed to Israelis in the south continued to rise considerably even during the recession years compared with only slight increases in the other regions. Although the proportion of tourists in the north is similar to that in the south, the decrease in total bed nights in the former is more similar to the decreases in Jerusalem and the center (albeit more moderate than them), because the rate of decrease in the number of tourist bed nights in the north was more extreme than in the other regions.

The adverse impact of the recent recession on the hotel industry in the south was therefore less intense than in the other regions. Yet it should be noted that a number of factors limit the contribution of the large number of bed nights to the economy of the south: the increase in the number of bed nights by Israelis during the recession years was accompanied by a decrease in prices; the hotels in the south are concentrated in two sites (Eilat and the Dead Sea) and some of those employed in them are foreign workers.

### The unemployment rate

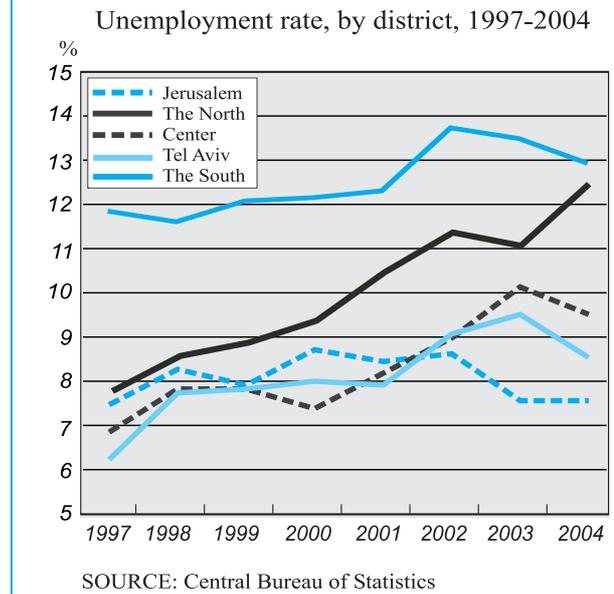
The discussion above relates to three selected industries, and cannot be taken as revealing the overall economic situation of each of the regions. The regional unemployment rate could reflect to a greater extent the level of overall activity in each region. Figure 2.5 presents the unemployment rate in five districts during the years

1997-2004. The diagram demonstrates the differences between the regions in the level of unemployment over time and in its development in the course of the latest business cycle. From a long-term perspective, it is clear that the unemployment rate in the south and the north is consistently higher than that in the center of the country.

The recession that prevailed in the economy from 2000 was reflected by a rise in the unemployment rates in most districts during the years 2001 and 2002. The recovery was apparent from a decline in the unemployment rate in some of these districts at the end of the period. Despite differences in the level of unemployment, the direction of its development in the south during recent years is similar to that in the Tel Aviv and central districts. In the north and in Jerusalem however, a number of important differences can be discerned. In contrast to the other districts, the sharp rise in the unemployment rate in the north did not begin with the onset of the recession at the end of 2000, and had continued for many years in succession although an upsurge was evident during the recession years. In addition, in 2004 this was the only district where the unemployment rate increased. The development of unemployment in Jerusalem is unique in comparison with the other regions of the country, and could be related to the high proportion of employment in the public sector in the city. In contrast to the large rise in the unemployment rate in the other regions, the rate in Jerusalem hardly rose at all during the peak years of the recession (2001-2002), and did not fall in 2004 when it dropped in the other regions (except for the north, where unemployment rose as stated).

The recovery from the recession during the past two years was reflected by the unemployment rates in the center in a different manner than in the other regions of the country. With the start of the recovery in 2003, unemployment actually continued to rise in the Tel Aviv and central districts while falling slightly in the south and the north, and more notably in Jerusalem. However, when growth consolidated in 2004 the

Figure 2.5



improvement in the labor market was mainly felt in the center: Unemployment fell most in the Tel Aviv District, dropped more moderately in the center and in the south and rose in the north as stated.

The unemployment rate also has disadvantages as an indicator for comparing the economic situation in the different regions. This is because the changes in the unemployment rate in each region are affected by changes in the labor force participation rates, by migration between the regions and by changes in the age composition, and due to the fact that for some of the individuals concerned the region of residence differs from the region of employment. It should also be remembered that apart from differences in the unemployment rate, other indicators of the situation in the regional labor market may differ, such as the ratio of persons employed in part-time posts and the level of wages.

Table 1. National Accounts, <sup>a</sup> 2004

	2004	2004				Oct 04– Mar 05 <sup>b</sup>	Last month for which data available
		I	II	III	IV		
GDP	4.3	3.4	4.4	3.4	4.8	4.0	Dec
Business-sector product	6.1	4.4	5.7	4.8	7.5	5.6	Dec
Private consumption	5.7	6.1	3.2	3.2	14.0	6.5	Dec
Gross domestic investment	6.4	-16.6	11.4	52.3	-1.2	8.7	Dec
Fixed investment	-1.7	6.8	-8.8	0.6	14.7	3.0	Dec
Goods and services exports	14.9	34.7	12.2	2.3	5.7	13.0	Dec
Goods and services exports excl. diamonds	16.2	35.0	17.0	3.9	1.9	13.7	Dec
Goods and services imports	12.0	27.6	7.7	12.3	4.7	12.7	Dec
Goods and services imports excl. diamonds	12.9	31.9	14.6	-0.6	13.9	14.4	Dec
Public sector consumption	-1.9	2.0	0.6	-2.7	-4.9	-1.3	Dec
Public sector consumption excl. defense imports	-1.3	2.3	-0.3	-5.7	-4.4	-2.1	Dec

<sup>a</sup> Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.

<sup>b</sup> Compared with October 2003–March 2004.

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity, <sup>a</sup> 2004–2005

	2004	2004				2005	Oct 04– Mar 05 <sup>b</sup>	Last month for which data available
		I	II	III	IV	I		
Composite state-of-the-economy index	4.3	7.2	6.0	3.9	3.4	-1.5	4.0	Mar
Large-scale retail trade	4.0	0.4	4.3	7.4	3.4	0.8	3.9	Mar
Manufacturing production (excl. diamonds)	7.2	12.0	3.2	8.7	7.9	2.0	6.8	Feb
Index of revenue in commerce	7.5	13.0	2.2	2.1	14.5		7.8	Dec
Index of commerce and services revenue	8.3	13.7	4.6	8.5	7.2	4.1	8.0	Feb
Tourist arrivals	42.8	20.2	35.6	14.6	2.9	57.9	48.8	Mar
Residential construction								
Starts	-8.9	-8.3	-7.7	-22.5	66.3		2.2	Dec
Completions	-7.6	12.7	-29.0	-27.9	96.0		3.1	Dec
Nonresidential construction								
Area of starts	-15.1	568.3	-65.2	-8.6	48.5		33.3	Dec
Survey of companies (net balance, percent) <sup>c</sup>								
Weighted balance of the business sector		33	18	17	15	23		Mar
Output of manufacturing firms		32	20	22	26	16		Mar
Sales by trading firms		60	12 <sup>d</sup>	16 <sup>d</sup>	37	41		Mar

<sup>a</sup> Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted except for construction industry data.

<sup>b</sup> Compared with October 2003–March 2004.

<sup>c</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.

<sup>d</sup> Not significant at 10% level.

SOURCE: Central Bureau of Statistics.

Table 3. Indicators of Labor Market Developments, <sup>a</sup> 2004–2005

	2004	2005	2004				2005	Oct 04– Mar 05 <sup>b</sup>	Last month for which data available
	IV	I	I	II	III	IV	I		
	('000s)		percent change from previous quarter						
Civilian labor force	2,677		0.7	0.5	-0.1	-0.2		1.3	Dec
Israeli employees	2,410		0.9	0.8	0.2	0.0		2.2	Dec
<i>Of which:</i> in general government	728		-0.6	0.7	-0.7	1.4		0.9	Dec
in business sector	1,686		1.4	0.8	1.0	-0.4		2.8	Dec
Foreign workers and Palestinians (unadjusted)	227		-5.3	-6.3	7.1	-1.0		-6.0	Dec
Average hours worked weekly per employee	36		0.5	-0.8	-0.3	-1.1		-0.3	Dec
Labor input in business sector (incl. foreign workers and Palestinians)	79,614		1.2	-1.7	0.6	-1.0		-1.0	Dec
<i>Of which:</i> Israelis	69,447		2.1	-1.1	-0.3	-1.0		1.9	Dec
Labor input in general government (Israelis)	17,672		-0.8	-0.2	-0.6	-0.3		1.5	Dec
Unemployed	267		-1.1	-2.2	-2.9	-2.1		-5.9	Dec
Work seekers	229	229	-0.6	-1.5	2.9	-2.8	0.0	-1.2	Jan
Claims for unemployment benefit	70	70	-3.7	-11.4	-2.6	-3.5	-0.1	-17.9	Mar
	<i>Nominal NIS (unadjusted)</i>								
Real wage per employee post <sup>c</sup>	6,679	6,938	3.1	-3.8	1.6	2.0	-0.4	1.4	Jan
In general government	6,488	6,791	8.3	-13.0	4.8	7.3	-1.6	1.0	Jan
In business sector	6,768	7,009	1.0	-1.0	0.5	0.7	1.6	1.6	Jan
Nominal wage per employee post <sup>c</sup>	7,096	7,329	3.0	-3.5	1.9	2.4	-0.5	2.3	Jan
In general government	6,893	7,173	7.4	-11.1	4.7	6.7	-2.5	2.0	Jan
In business sector	7,190	7,404	0.7	-0.3	0.7	1.1	1.3	2.5	Jan
			<i>percent</i>						
Participation rate			55.1	55.2	54.9	54.5		-0.8	Dec
Employment rate			49.2	49.4	49.3	49.1		0.3	Dec
Unemployment rate			10.7	10.5	10.2	10.0		-8.9	Dec
Depth of unemployment <sup>d</sup>			38.7	42.6	39.7	42.6		21.0	Dec

<sup>a</sup> Seasonally adjusted.<sup>b</sup> Compared with October 2003–March 2004 (unadjusted).<sup>c</sup> Including foreign workers and Palestinians.<sup>d</sup> Percent of unemployed seeking work for more than six months.

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. Foreign Trade, Balance of Payments, and the Reserves, <sup>a</sup> 2004–2005

	2004	2004				2005	Oct04– Mar05 <sup>b</sup>	Last month for which data available
	<i>percent change from previous period<sup>c</sup></i>							
Trade in goods <sup>d</sup>								
Goods imports	21.2	11.1	5.8	-3.3	10.2	-2.5	17.2	Mar
<i>Of which:</i> Consumer goods	17.8	9.7	0.4	-2.4	13.5	-5.3	13.3	Mar
Capital goods	16.0	13.1	5.9	-3.7	3.9	0.0	12.5	Mar
Intermediates	24.4	10.8	7.4	-3.4	11.6	-2.5	20.2	Mar
Goods exports	21.1	11.7	2.8	0.3	8.9	-3.6	16.4	Mar
<i>Of which:</i> Manufacturing	21.0	11.0	3.7	0.8	8.0	-4.2	16.1	Mar
<i>Of which:</i> High-tech	21.2	11.8	5.4	1.2	3.2	-6.3	12.4	Mar
	<i>\$ million</i>							
Balance of payments								
Goods and services exports	50,376	11,961	12,601	12,825	13,145			Dec
Goods and services imports	52,048	12,402	12,609	13,198	13,770			Dec
Balance of trade in goods and services	-1,672	-440	-8	-373	-625			Dec
Current account	504	164	327	269	16			Dec
Financial account (excl. foreign exchange reserves) <sup>e</sup>	-2,668	-1,397	-1,067	409	-613			Dec
<i>Of which:</i> Nonresidents' direct investment <sup>e</sup>	1,618	511	744	-361	724			Dec
Nonresidents' portfolio investment <sup>e</sup>	5,404	2,150	1,149	482	1,623			Dec
Residents' direct and portfolio investment abroad <sup>e</sup>	4,461	3,348	424	509	180			Dec
Net foreign debt (percent of GDP) <sup>e</sup>	-9.7	-6.7	-8.0	-7.2	-9.7			Dec
Bank of Israel reserves, end-period <sup>e</sup>	26,632	26,162	25,712	25,839	26,632	26,703		Mar

<sup>a</sup> Seasonally adjusted.<sup>b</sup> Compared with October 2003–March 2004 (unadjusted).<sup>c</sup> The change relates to the dollar values of imports and exports, not to their volumes.<sup>d</sup> Data on trade in goods do not include ships, aircraft, diamonds, and fuel.<sup>e</sup> Unadjusted data.

SOURCE: Central Bureau of Statistics.

**Table 5. Indicators of Economic Development in Advanced and Developing Countries<sup>a</sup>**  
(annual rate of change, percent)<sup>b</sup>

	2002	2003	2004	Projection 2005
World GDP	3.0	4.0	5.1	4.3
Advanced countries	1.6	2.0	3.4	2.6
Developing countries	4.7	6.4	7.2	6.3
World trade	3.3	4.9	9.9	7.4
Advanced countries				
Imports	2.6	3.6	8.5	6.5
Exports	2.2	2.8	8.1	5.9
Developing countries				
Imports	6.1	8.9	15.5	12.0
Exports	6.7	10.7	13.8	9.9
Commodity prices (US\$)				
Oil <sup>c</sup>	2.5	15.8	30.7	23.2
Nonfuel	0.8	7.1	18.8	3.8
Inflation (CPI) in advanced countries	1.5	1.8	2.0	2.0
Short-term interest (%) <sup>d</sup>				
Dollar deposits	1.9	1.2	1.8	3.3
Euro deposits	3.3	2.3	2.1	2.3
Unemployment rate in advanced countries	6.4	6.6	6.3	6.1

<sup>a</sup> According to "World Economic Outlook" Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

<sup>b</sup> Except for unemployment and interest rates.

<sup>c</sup> Average price per barrel in 2004 was \$37.76 .

<sup>d</sup> Six-month Libor rate for US dollar deposits, and three month Libor rate on euro deposits.

SOURCE: "World Economic Outlook" (IMF), April 2005.

Table 6. Government Budget Performance vis-à-vis Deficit Target, 2004–2005

	2004	2004				2005 I	Oct 04– Mar 05 <sup>a</sup>	Last month for which data available
		I	II	III	IV			
Domestic deficit as percent of GDP	1.2	0.3	1.4	0.6	2.6			Dec
Deviation from path <sup>b</sup> (domestic budget, excl. credit extended) (NIS billion)								
Government revenue	-1.5	0.5	-2.5	-2.3	2.7	1.7	7.1	Mar
Government expenditure	-3.4	0.1	-2.2	-4.5	3.0	-2.5	4.2	Mar
Domestic deficit	-1.9	-0.4	0.3	-2.2	0.3	-4.2	-2.8	Mar
Total government deficit	20.4	-0.1	7.4	3.3	9.8	-3.7	-5.4	Mar
<i>percent change from respective period, previous year</i>								
Government tax revenue	4.6	10.0	5.6	1.0	4.8	4.2	4.5	Mar
<i>Of which: income tax, net</i>	3.1	7.8	1.4	-1.7	1.4	6.1	3.9	Mar
VAT, gross	4.7	4.1	6.1	4.1	4.8	1.2	2.9	Mar
Government expenditure	0.2	-2.1	-5.2	-4.4	11.7	-1.0	5.6	Mar
National Insurance allowances	-4.9	-6.5	-7.6	-4.6	-0.5	-3.6	-1.3	Mar
<i>Of which: Unemployment benefits</i>	-12.8	-7.8	-16.2	-18.3	-8.7	-17.2	-14.1	Feb
Income support	-9.7	-15.9	-19.8	-4.4	6.9	-10.8	0.7	Feb
National Insurance contributions received from the public	1.6	2.7	0.0	-0.7	4.5	2.2	3.3	Mar

<sup>a</sup> Compared with October 2003–March 2004.

<sup>b</sup> The path was determined on the basis of a deficit of 4 percent of GDP in 2004, and 3 percent of GDP in 2005. Figures comparing October 2004–March 2005 to respective period in 2003–2004 relate to the change in each item, not to the deviation from the path.

SOURCE: Ministry of Finance.

Table 7. Selected Price Indices,<sup>a</sup> 2004–2005

	2004	2004				2005 I	Oct 04– Mar 05	Last month for which data available
		I	II	III	IV			
CPI	1.2	-0.4	6.2	-0.8	0.0	-2.4	-1.2	Mar
CPI excl. housing, fruit and vegetables	2.1	0.0	8.5	-1.9	2.0	-1.5	0.2	Mar
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.5	2.6	7.2	0.7	-0.3	0.9	0.3	Mar
Index of housing prices	-2.5	0.0	5.8	0.4	-14.9	-4.8	-10.0	Mar
Wholesale price index	7.6	9.2	11.1	2.4	7.7	4.0	5.8	Mar
NIS/\$ exchange rate	-1.2	10.4	1.2	-1.7	-13.1	-1.2	-7.4	Mar
NIS/currency-basket rate	1.8	11.5	-0.5	-1.7	-1.4	-3.5	-2.5	Mar

<sup>a</sup> Annual rates of change during period, percent.

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2004–2005  
(annual terms, percent)

	2004	2004				2005 I	Apr 04– Mar 05	Oct 04– Mar 05	Last month for which data available
		I	II	III	IV				
Rates of change		<i>Change from preceding period</i>					<i>During period</i>		
M1 <sup>a</sup>	18.0	32.1	24.2	21.4	1.4	20.3	15.9	8.8	Mar
M2 <sup>b</sup>	4.2	3.6	−0.4	7.7	5.7	6.9	5.1	2.8	Mar
M3 <sup>c</sup>	4.6	7.0	4.2	5.7	5.1	9.3	6.4	5.6	Mar
Nondirected bank credit	1.2	7.4	1.8	−0.6	0.3	−3.4	−0.6	−2.3	Mar
Unindexed local-currency credit	5.6	8.5	7.0	6.6	11.5	9.1	8.6	8.4	Mar
CPI-indexed credit	0.0	16.4	−3.4	−4.0	−7.0	−6.1	−4.3	−4.7	Mar
Credit in and indexed to foreign currency	−2.8	−5.7	2.5	−5.2	−4.3	−16.5	−7.7	−13.6	Mar

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

<sup>b</sup> M1 plus short-term local-currency unindexed deposits.

<sup>c</sup> M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2004–2005  
(percent)

	2004	2004				2005 I	Oct 04– Mar 05 <sup>a</sup>	Last month for which data available
		I	II	III	IV			
Nominal interest								
Effective interest on monetary loan	3.9	4.3	3.8	3.8	3.8	3.3	3.5	Mar
SRO deposits	3.1	3.4	3.1	3.1	3.1	2.7	2.9	Feb
Nondirected local-currency credit	7.4	7.9	7.4	7.3	7.2	6.7	7.0	Feb
3-month Eurodollar	1.5	1.0	1.2	1.6	2.2	2.7	2.4	Mar
Yield to maturity on:								
Treasury bills	4.8	4.8	5.0	4.8	4.6	4.2	4.4	Mar
Yield on 10-year bonds	4.2	4.1	4.3	4.3	4.2	3.8	4.0	Mar
Yield on 5-year bonds	3.8	3.8	3.9	3.8	3.6	3.1	3.4	Mar
Expected inflation	2.0	1.8	2.2	2.2	1.8	2.5	2.1	Mar
General Share-Price Index (change)	17.4	9.2	5.8	−9.7	12.5	6.6	19.9	Mar

<sup>a</sup> Compared with October 2003–March 2004.

SOURCE: Bank of Israel.

## Events in July 2004–January 2005

Month	Date	Event	Details
<b>October</b>	18	The Knesset approves on first reading an amendment to the Income Tax Code that equalizes the tax rates on externally and domestically traded securities. The amendment went into effect on Jan. 1, 2005.	Since the tax reform went into effect in early 2003, gains from the sale of domestically traded securities have been taxed at 15% and those traded elsewhere at 25%. The amendment moves up the implementation of the original reform.
	19	OPC wins tender for construction of NIS 1.23 billion independent power plant at Rotem Plain.	The dual fired combined cycle gas turbine plant will be a B.O.T. project—designed, financed, operated, and maintained by the franchiser for 25 years and then transferred to the state.
	28	Israel raises \$750m in 20-year bonds guaranteed by the US Government.	
	29	Eight bidders vie for controlling equity in Bezeq.	The State intends to sell 30% of Bezeq share equity plus warrants for another 10.6%. Today, the State has a 46.4% share in Bezeq share equity.
<b>November</b>	11	An administrative order concerning bank loans to municipal authorities is signed.	The order defines municipal authorities' interest payments on the bank loans as a "crucial expenditure," thus allowing authorities to meet payrolls without risking garnishment of their funds.
	14	To stimulate construction, the number of credit days given by contractors to general government is reduced to 5.	
	22	After eight months without change, the Bank of Israel lowers the key rate by 0.2 of a percentage point, setting it at 3.9 percent for December.	The NIS–\$ interest spread narrows to 1.65%.
	25	Israel and China conclude their second financial cooperation accord.	The accord promotes bilateral trade by allowing Chinese companies to take long-term loans to do business with Israeli exporters in the fields of capital products and infrastructure.
	<b>December</b>	14	Israel, Egypt, and the US conclude a QIZ (Qualifying Industrial Zone) agreement.
16		The contractors' association and the Government conclude an accord that, from May 2005, replaces the allocation of permits for employment of foreign workers in construction with the issuance of employment licenses for companies.	As part of the agreement, the quota of foreign construction workers is lowered from 20,000 today to 17,500 in 2005 and 15,000 in 2006. The license fee will be raised from NIS 4,000 per worker per year to NIS 10,800 from 2005 on.
22		The Knesset Finance Committee approves the government bond-market reform.	The reform is expected to lower the cost of capital to the government and, in turn, to firms and households, and to broaden the investor base in government bonds, including foreign financial institutions.

Month	Date	Event	Details
	23	Regulations allowing independent producers to integrate into the electricity system are signed.	The regulations include: 1) the possibility of building cogeneration plants that sell surplus power to other consumers; 2) allowing independent producers to build power plants and giving them an incentive to sell power to end users and not to the Israel Electric Corp. 3) encouraging independent producers to build pump-back power plants.
	23	The privatization of El Al Israel Airlines is completed; the company is taken over by Knafaim, Ltd.	
	26	The Ministerial Privatization Committee approves a proposal to split up and privatize Israel National Oil Refineries Co., Ltd.	The country's two refineries—in Ashdod and in Haifa—will be split into two independent refining corporations. The Ashdod refinery will be sold off in full.
	27	The Bank of Israel lowers the key rate by 0.2 percentage point, setting it at 3.7% for January.	The NIS–\$ interest spread narrows to 1.45%.
<b>January 2050</b>	1	As the current stage of the “Rabinovitch reform” begins, tax brackets are widened at all wage levels and the maximum marginal tax rate on labor is lowered to 49% as against 60% two years ago.	For example, an individual earning NIS 20,000 per month will pay a 39% marginal rate as against 50%; at NIS 12,000 37% as against 45%; and at NIS 4,000—under the tax threshold as against 20%.
	11	S&P upgrades Israel's credit rating from “Negative” to “Stable.”	
	16	The Government approves implementation of the Dovrat Committee Report on education-system reform.	
	17	Prof. Stanley Fischer appointed eighth governor of the Bank of Israel.	
	18	Child allowances are cut, starting in Jan. 2005, for children born up to May 31, 2003.	
	21	Details of the sale of Israel Discount Bank, Ltd., are finalized.	The Bronfman-Schron group will acquire a controlling interest in IDB by purchasing 26% of share equity for NIS 1.3 billion, with an option for another 25% at the same price.
	24.	The Bank of Israel lowers the key rate by 0.2 percentage point, setting it at 3.5% for January.	The NIS–\$ interest spread narrows to 1.25%.
<b>February</b>	1	The government signs contracts with the companies that were successful bidders in the tender to erect employment centers	The centers, expected to start operating in July 2005, will help recipients of income support benefits to join the labor force (the Wisconsin program).

Month	Date	Event	Details
	1	The arrangement with the EU regarding marking of goods produced in Judea, Samaria and the Gaza strip comes into effect.	
	13	The Minister of Finance and the Minister of Defense decide on a process to privatize Israel Military Industries (Ta'as).	It was decided that part of the activities would be sold to Rafael (the Armaments Development Authority); Ta'as will be privatized by selling the State's shares; the country's vital interests in Ta'as will be protected.
	14	The international rating agency Fitch raises its forecast of Israel's long-term local-currency credit rating from "negative" to "stable."	
	16	The Knesset passes the Disengagement Program Implementation Law.	This law deals with, among other things, payment of compensation to settlers, and the temporary change in the government's deficit target.
	24	The agreement between the Ministry of Finance and the Histadrut (General Federation of Labour) relating to the privatization of the ports is signed, and its implementation starts.	The agreement includes <i>inter alia</i> the establishment of a separate company in each port, guarantees of the workers' rights, and the future privatization of the port companies.
<b>March</b>	1	The State sells 6.5% of the shares of Bank Leumi to Deutsche Bank for NIS 1.162 billion.	
	28	The Minister of Industry, Trade and Labor adopts the recommendations of the committee formed to investigate the shortage of labor in the construction and infrastructure industry.	The committee recommended ways to encourage the participation of Israelis in the industry, including government subsidies, contractors' obligation to pay a fair wage, and the provision of professional training on building sites.
	29	The Knesset passes the budget and the Arrangements Law for 2005.	
	30	The Ministry of Finance announces that it will operate an experimental program in Beit She'an to increase the aid to working mothers by participating in the cost of day care centers. In Arad an experimental program will operate to recognize child-care expenses for tax purposes.	The programs will operate in the next school year; their purpose is to encourage women to join the labor force.
	30	The Knesset Finance Committee approved the reform in the Research and Development Law that will enable know-how supported by the Chief Scientist to be transferred abroad.	The amendment permits know-how developed with aid from the Office of the Chief Scientist in the Ministry of Industry, Trade and Labor to be transferred abroad. A payment for such transfer will be made to the Office of the Chief Scientist, which will be reinvested in Research and Development.

## HEBREW SECTION