

Recent Economic Developments

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July- December 2006

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Part 1: Review of Recent Economic Developments, July—December 2006

Main developments

Economic developments in the period reviewed—the second half of 2006—constituted in the main a continuation of the trends evident in the first half of the year. Although the fighting in the north that erupted at the beginning of the third quarter did affect real activity and act as a brake on a significant part of the positive developments that had taken place at the beginning of the year, its effect in most areas of economic activity was moderate and temporary. Thus, the Bank of Israel Research Department assesses the effect at only half a percent of GDP, and as early as the fourth quarter the rapid rate of growth seen in the first half of the year was renewed. As in the case of other exceptional events in 2006, so too in the period of the war in the north the stability of the financial markets was maintained, and after an initial fall in share prices and a weakening of the shekel against the dollar at the outbreak of the hostilities, share prices recovered and started rising again, and the shekel strengthened again against the dollar. On the nominal side, against the background of the considerable appreciation of the shekel and the drop in energy prices, inflation and inflation expectations declined in the period reviewed, reflected by undershooting the inflation target.

Fiscal policy achieved its objective—the deficit was below the ceiling, and expenditure was on target despite the budgetary implications of the war in the north and the continued reduction of taxes. These achievements were made possible by the large cumulative under-performance of civilian expenditure, and the increase in revenues that resulted from the rapid growth and large non-recurring revenues. Together with the advantages of these developments, which with the reduction in the deficit and the public debt showed adherence to fiscal discipline, and thereby contributed to the credibility of the policy and to the lowering of Israel's sovereign risk premium, there are also certain negative points, headed by the fact that the order of priorities set in the budget was not followed.

The unemployment rate fell in the third quarter, as did the rate of participation in the labor force, and the employment rate settled at a relatively high level. The rise in the number of employed persons in the third quarter of 2006 reflected an increase only in the public services, while the number in the business sector contracted. Unit labor costs stabilized

in the third quarter, after declining steadily during the last two years. The decline in labor costs is the outcome of the relatively fast rise in labor productivity alongside a slower rise in the hourly wage.

In 2006:Q3 the current account showed a surplus of \$ 2.4 billion, which together with the surplus in the first half of the year gives a cumulative surplus of about \$ 6.2 billion, compared with a surplus of about \$ 4 billion in the whole of 2005. Most of the increase in the surplus in the third quarter derived from the marked rise in current transfers and in from the improvement in the revenues account, which offset the slight drop in surplus in the goods and services account. The year 2006 was the fourth year in which a surplus was recorded in the current account despite the high rate of growth—a new situation for Israel—as a result of a combination of short-term forces serving to increase the surplus on the one hand (lower taxation on investments abroad, the rise in institutional investors investments abroad, the contraction of the differential between Israel's interest rate and that abroad, and greater-than-expected public saving), and long-term developments on the other (the change in the demographic composition and the drop in the rate of immigration, the reduction in the cyclically adjusted government deficit, and the decline in Israel's net liabilities to abroad). The increase in the current account surplus also reflects the combination of global forces, most of which served to increase the surplus, and domestic forces acting to reduce the rate of increase of imports. The other side of the picture of the current account surplus is the significant increase in net capital outflow in the last few years.

The Consumer Price Index (CPI) dropped by 1.7 percent in the second half of 2006, and over the whole of the year by 0.1 percent, which was below the lower limit of the inflation target of 1 percent to 3 percent a year considered price stability. The main reasons for the fall in prices in the period reviewed include the persistent appreciation of the shekel against the dollar and the sharp drop in global energy prices. Monetary policy in the period operated against the background of the turnaround in economic and security situation. At the beginning of the period, against the backdrop of the assessments of a rise in Israel's sovereign risk premium and the view that the factors tending to boost inflation in the first half of the year were still present, the Bank of Israel raised the interest rate by 25 basis points. Later in the period, with the emergence of domestic and

global forces acting to lower prices, the Bank cut the interest rate by a total of one percentage point, and at the end of the period it was 4.5 percent.

Part 2 of this review features broader discussions of two current issues—the effect of the hostilities in the north on the tourist industry, and the more stringent criteria governing the eligibility of young people to unemployment benefit.

Aggregate and by-industry real activity

The war in the north, that started at the beginning of the period reviewed, acted as a brake on the positive developments that had occurred in the first half of the year, to the extent that both activity and GDP declined significantly, mainly in the trade and services industries. GDP fell by 1.1 percent in the third quarter, reflecting a drop of 4.4 percent in the business-sector product. When the war ended a recovery was evident, and activity in most industries again showed rapid growth. National Accounts estimates for the fourth quarter (derived from the forecast for 2006) indicate a rapid rise in GDP, driven by a sharp increase in business sector product. In retrospect, the period of the war in the north may be viewed as a passing phase, whose effect on economic activity was temporary and relatively moderate. According to the assessment made by the Bank of Israel Research Department, the effect of the war amounted to about half a percent of GDP (for details of the calculation see Box 2.1 in the Bank of Israel 2006 Annual Report, due to appear in March).

A notable feature of uses, and in particular the investment items, is the great volatility between the figures for the third quarter and the estimates for the fourth, partly due to the war in the north. Overall, in the second half of the year activity could be seen reverting to its pre-war level, reflected in all components of uses.¹ Exports continued to constitute a major factor in growth, despite their slower rate of increase, together with private consumption, which continued its rapid rise. Investment in the principal industries persisted at a buoyant rate, which could indicate a convergence to full exploitation of the stock of capital accumulated and expectations of continued growth. The rise in investments was supported by high rates of return on capital relative to the low cost of raising capital, due to the relatively low interest level and the boom in the capital market.

GDP growth in the last two years went together with a marked rise in labor productivity, as measured by output per hour of labor, and with greater utilization of machinery and equipment, enabling the economy to grow without untoward pressure on wages and prices. Nevertheless, there are increasing signs that the possibility of raising supply by means of increasing capacity utilization is coming to an end: the rate of increase in productivity is falling, and unemployment among those with higher education is exceptionally low. Increased investment in the principal industries and real appreciation in 2006 also indicate the growing need to raise capacity in addition to raising productivity.

Figure 1.1

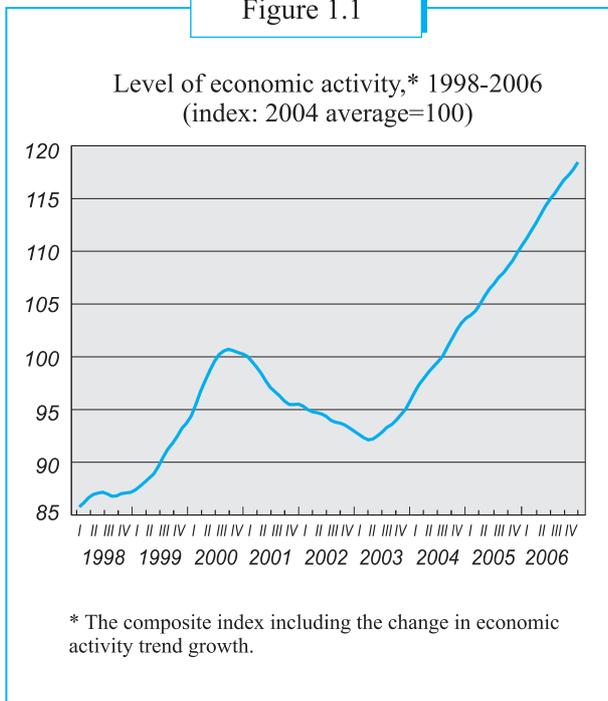
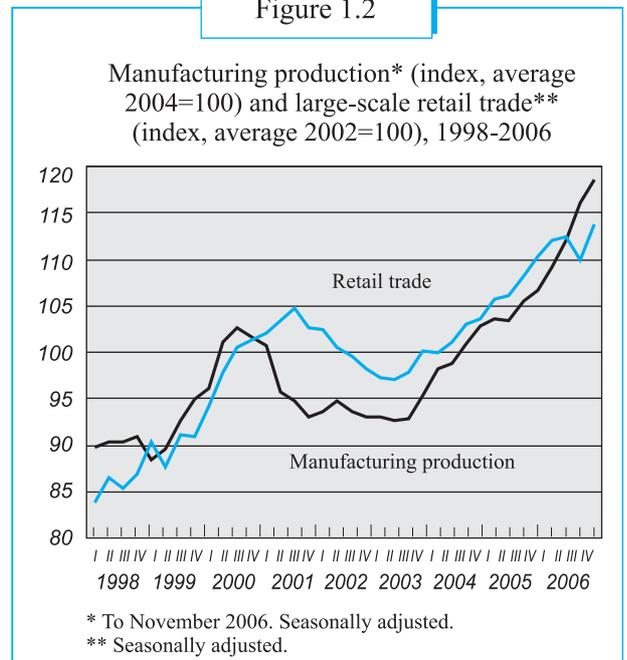


Figure 1.2



¹ Data relating to the fourth quarter and the second half of the year are estimates, derived from the forecast for 2006.

Other indicators of activity in the principal industries also suggest that growth is becoming more firmly based: the composite state-of-the-economy index, which is a weighted index comprising various indicators of overall activity, rose rapidly throughout the period reviewed, as did the index of manufacturing production. The Bank of Israel's Companies Survey shows that activity rose at a faster rate in the fourth quarter of 2006, after a modest rise in the third quarter that showed the effect of the war in the north. Trade and services revenue also surged throughout the second half of the year, except for a temporary dip in July.

Activity in the **manufacturing industry** continued rising quickly in the period reviewed, as seen from the indices of manufacturing production and from the Companies Survey.

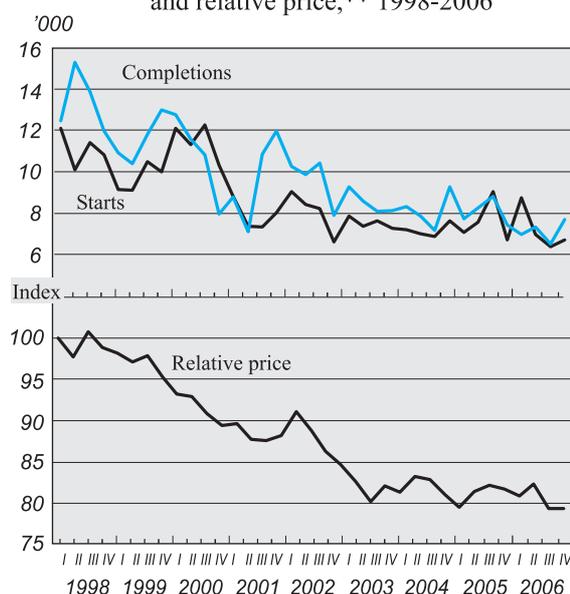
Activity in the **tourist industry** suffered the most severely as a result of the war in the north. Following the first half of the year when tourist arrivals were more than 20 percent higher than in the first half of 2005 (arrivals by air, raw data), the number of arrivals slumped in July, and in the second half of the year the number was 26 percent lower than in the second half of 2005. Tourist bed nights followed a similar pattern (Figure 1.3)—a sharp drop following an uninterrupted rise since the trough of 2002. According to all indicators of activity in the industry, with the Companies Survey heading the list,² it has still not recovered from the

effects of the war. (Part 2 contains a detailed discussion of the effects of the war on the tourist industry.) Bed nights of Israelis, on the other hand, remained steady, and even rose slightly at the beginning of the period, with the rise reflecting a switch from hotel bed nights in the north to other parts of the country, as well as the movement of residents of the north to other areas in order to place themselves out of range of the Katyusha rockets.

Based on the number of building starts and completions, activity in the **construction industry** continued along its downward path also in the third quarter of 2006 (Table 2 and Figure 1.4). In contrast, the output of residential construction (including renovations) rose, reflecting, at least in part, reconstruction activity related to the war damage caused in the north. Although the number of apartments and the area under active construction through private initiative showed a marked rise over the equivalent period in 2005, it was completely offset by the sharp decline in government-initiated construction, so that total active construction fell.

Figure 1.4

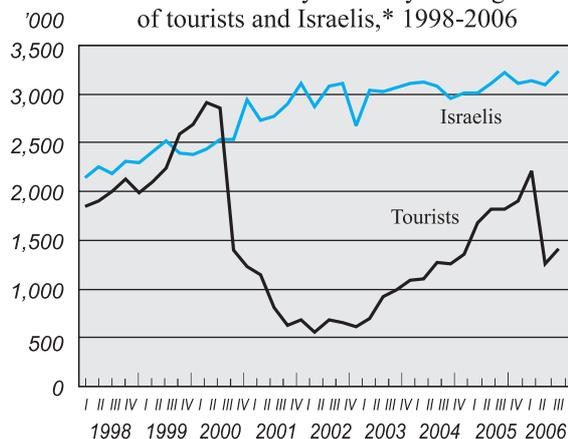
Housing (units per quarter) starts and completions,* and relative price,** 1998-2006



* Original data, to October 2006. Fourth quarter 2006 extrapolated.
 ** Prices of owner-occupied dwellings relative to CPI. To October 2006.

Figure 1.3

The hotel industry: monthly bed nights of tourists and Israelis,* 1998-2006



* To November 2006. Seasonally adjusted.

² Tourist companies' responses to the Companies Survey only relate to the change in activity compared with the equivalent quarter in the previous year. Hence the reports of a decline in activity in the fourth quarter does not indicate whether it continued to fall further following the drop in the third quarter.

Data in the Companies Survey for the fourth quarter of 2006 present a more optimistic picture: they show that also in the period reviewed the extent of activity continued to increase,

mainly in the construction of buildings and infrastructures, and the expectations were for a further rise in activity in the next quarter. On the other hand, the Survey showed that the extent of building starts and completions fell, and a persistent increase in the construction time of buildings.

The labor market

The unemployment rate dropped very notably in the third quarter, from 8.9 percent to 8.3 percent,³ with the depth of unemployment (the proportion seeking employment for more than half a year) also falling, but the decline reflected mainly a drop in the rate of participation in the labor force, so that the employment rate remained steady (Table 3 and Figure 1.5). It is important to bear in mind that the decline in the rate of participation in the third quarter followed a marked rise in the previous quarters, so that in 2006:Q3 the rate was 0.4 of a percentage point higher than in 2005:Q3. The employment rate in 2006:Q3 was also higher (by 0.6 of a percentage point) than in 2005:Q3.

The small increase (of about half a percent) in the number of employed persons in the economy in 2006:Q3 reflected the 4.4 percent rise in employment in the public services, following a similar rise in the second quarter, whereas employment and labor input in the business sector fell. These changes reflect the effect on economic activity of the war in the north: there was a temporary slowdown in business-sector activity in the north of the country, and an increase in the number of people employed in the public services, to meet the needs of the residents affected by the hostilities. This can also be seen from the considerable increase in the number of employees in the health and welfare services (a rise of about 16 percent, or 16,000 employees). Another effect on the labor market of the war was the significant jump in the number of temporary absentees from work.

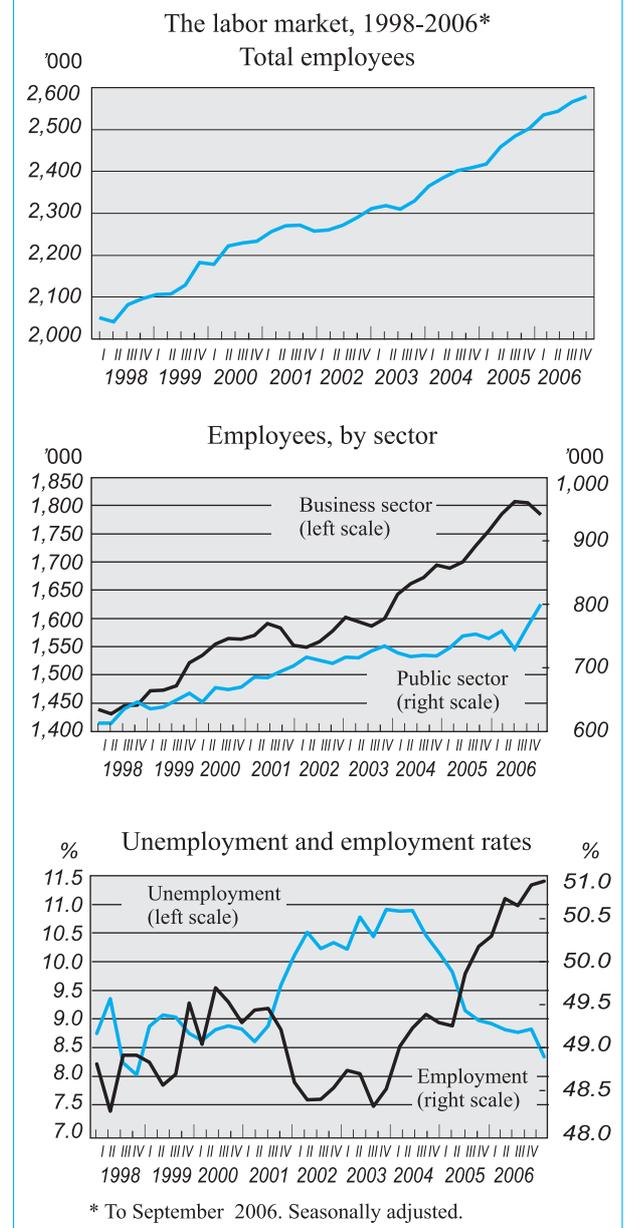
The number of non-Israeli workers rose again in 2006:Q3, after falling in the previous quarter, and after rising considerably in 2005. The volatility in the number of foreign workers is a sign of the difficulty in implementing the government's policy of reducing their number, despite the economic and social implications of their being employed here.⁴

The real wage rose relatively moderately during the second half of 2006 (Table 3 and Figure 1.6): the real wage per employee post rose by 1.3 percent in the first ten months

³ Trend data for October and November indicate that the rate settled at 8.3 percent.

⁴ The quarterly data on the number of non-Israeli workers are likely to fluctuate also because of problems of estimation.

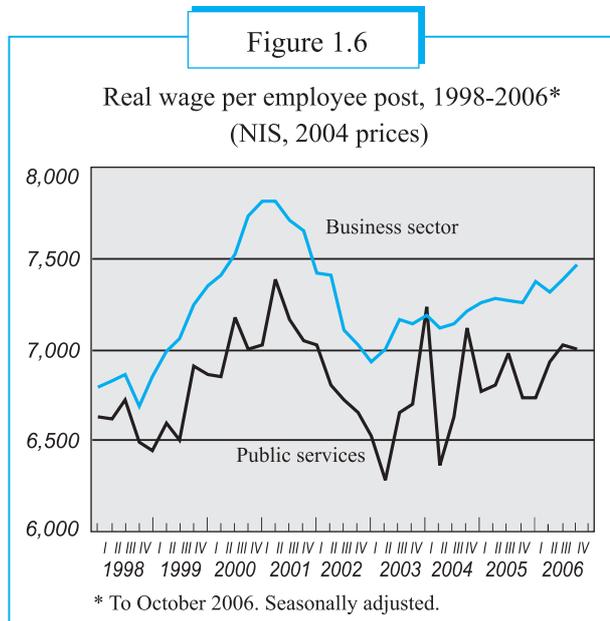
Figure 1.5



of 2006, at similar rates in both the business sector and in the public services.⁵ Within the business sector, however, there were considerable differences between wage rises in different industries: whereas in the banking, insurance and finance industry and in the electricity and water industries

⁵ This similarity disguises different paths followed during the year: in the public services the wage rose after falling in 2005, while in the business sector it remained at a relatively steady level throughout the period January to October 2006. In July–October 2006 the wage rose by 1.8 percent compared with the equivalent period in 2005.

there were considerable wage increases (of 7.1 percent and 5.8 percent respectively), with a significant (3.5 percent) rise also in the manufacturing industry, in the other industries the wage increased only slightly or even fell a little.



The moderate rise of the real wage was a feature of the last three years, as was the rapid rate of economic growth, and it followed two years of marked erosion of the real wage. Although erosion affords the labor market flexibility, enabling employment to react relatively quickly to an increase in activity, it may also indicate slack that still exists in the labor market and that is likely to slow down or reduce the intensity of its reaction to growth. This possibility may be seen from the relatively low level of unit labor costs: these stabilized in 2006:Q3 according to the Central Bureau of Statistics estimate, after an almost continuous decline since the second half of 2002, the result of output per hour of labor settling at the high level which it reached in the second quarter and only a small rise in the hourly wage.

At the beginning of September the Minister of Industry, Trade and Labor announced that he accepted the recommendations of the committee he had appointed, headed by Professor Yossi Tamir, regarding the improvement of the operation of the Mehalev welfare to work program (a.k.a. the “Wisconsin Plan”) and social balances in it. The main purpose of the changes is to ease the plight of participants confronting many obstacles to their entering the labor market, including single parents, older participants, the handicapped, and new immigrants. According to the recommendations, these will be dealt with in a distinct part of the program. Some

25 percent of the participants will benefit from the easing of the conditions. It was also decided, in December, to grant a monthly allowance of NIS 350 to participants in the program to those who integrate into the labor force and remain in it (up to a ceiling of NIS 4,200 a year), and that the government would pay part of the cost (up to a maximum of NIS 8,000) of retraining participants in the program who started working full time, or who increased the number of their hours of work for at least a year.

As a result of the recommendations of the committee, the Ministry of Finance also introduced a number of changes to enhance the program, mainly a change in the system of incentives—basing the incentives on the quality of the placement of the participant in a job and the occupational retraining given, instead of the saving in payment of allowances, which was the basis hitherto, encouraging participants to remain in jobs, and improving the service offered them, with additional supervision over the operators of the program.

The government

The hostilities in the north that began in July 2006 caused a significant increase in government expenditure, and a moderate decline in its revenue, essentially tax revenues⁶ (Table 6 and Figure 1.7). In this way the third quarter differed from the other quarters, when government expenditure was below the budget forecast and revenues were considerably higher than forecast. Total expenditure in 2006 matched the budget forecast, whereas revenues exceed the forecast by some NIS 11 billion, so that the total deficit in 2006 excluding net credit granted amounted to 0.9 percent of GDP,⁷ significantly lower than the ceiling set and the 2005 deficit.

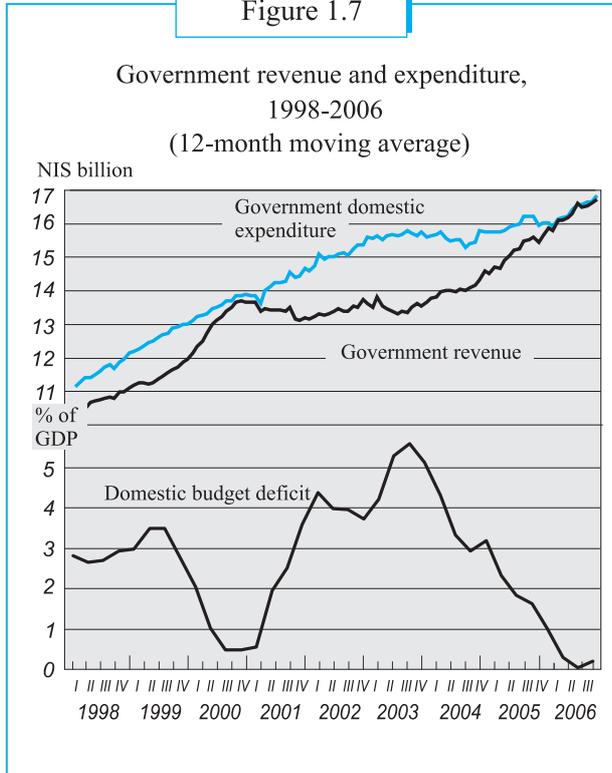
The government’s tax revenue in the second half of the year was higher than the seasonal path consistent with meeting the deficit target (henceforth the path) and higher in real terms than in the second half of 2005, but the differences were less than in the first half. Direct tax revenue in the third quarter was above the path due to the one-off income from the Iscar deal, but if that factor is removed, the revenue was lower than the path. In the fourth quarter too revenue from direct taxes was lower than the path, mainly due to legislative changes. Indirect tax revenue was also below the path in the third quarter, due to the cut in the rate of VAT and the reduction in the level of economic activity, but they rose again in the

⁶ Excluding the one-off income of NIS 3.5 billion from the taxation on the Iscar sale that was included in tax revenue in the third quarter.

⁷ Preliminary data.

fourth quarter, despite the effect of the legislative changes. In total, over the whole of the period reviewed, the cut in the rate of VAT in July, from 16.5 percent to 15.5 percent, reduced tax revenue by about NIS 1.5 billion.

Figure 1.7



Non-tax revenue in the period reviewed were above the path. The main gap between the actual revenue and the budget forecast derived from the increase in the National Insurance Institute surpluses that reflected mainly a decline in real terms in unemployment benefit and income support payments due to the recovery from the recession alongside a rise in old-age pension, maternity and child allowances.

Government expenditure in the third quarter—the period of the war in the north and a little after its end—exceeded the path by about NIS 4.1 billion. This closed a similar sized cumulative gap in the opposite direction between government expenditure and the path in the first half of the year. In the fourth quarter there was again a small underperformance of expenditure. As most of the exceptional expenditure in the third quarter were due to the rise in defense expenditure, over the year as a whole there was underspending by the civilian ministries (by 3 percent of the planned expenditure), and overspending on defense by about 8.2 percent of the original plan. The underperformance by the civilian ministries in 2006 followed some years of greater underspending, so

that in practice expenditure was higher than in 2005, in real terms, but considerably below the planned amount. Alongside the inherent advantage of reducing government expenditure from the point of view of controlling the deficit and the credibility of fiscal policy, persistent underspending could have an adverse effect on the efficiency of government activity, on the quality of the service to the public, and on following the correct order of priorities.

The balance of payments

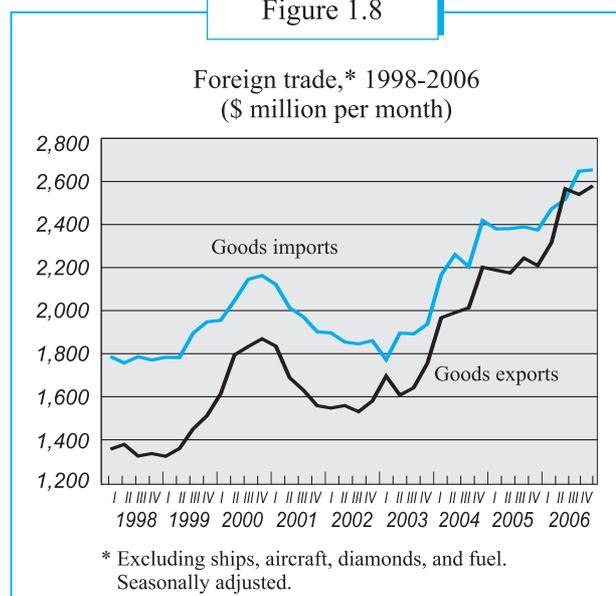
A surplus of \$ 2.4 billion was posted in the current account of the balance of payments, which together with the surplus cumulated in the first half of the year, totaled some \$ 6.2 billion, compared with a surplus of \$ 4 billion in the whole of 2005. The increase in the surplus in the third quarter reflected a notable increase in current transfers, together with a slight decline in the surplus in the goods and services account, which was offset by an improvement in the income account. The terms of trade index (excluding diamonds, ships and airplanes) deteriorated in the third quarter, vis-à-vis both 2005:Q3 and 2006:Q2, due to the faster rise in import prices.

The year 2006 is the fourth year in succession with a surplus in the current account at a time of rapid growth; this is a new situation for Israel's economy. The rise in the surplus represented a combination of short-term factors acting to increase the surplus (the lowering of taxation on investments overseas, the rise in investment abroad by institutional investors, the narrowing of the interest rate differential between Israel and abroad, and larger-than-expected public saving)⁸ on the one hand, and long-term developments (the change in the demographic composition and the drop in the rate of immigration, the reduction in the cyclically adjusted government deficit, and the decline in Israel's net liabilities to abroad) on the other. The increase in the current account surplus also reflects the combination of global forces, most of which served to increase the surplus, and domestic forces acting to reduce the rate of increase of imports, via their contribution to keeping the real exchange rate at a reduced level.⁹

⁸ These affected the surplus indirectly, by creating pressure for nominal and real depreciation. The process of real appreciation serving as a balancing mechanism in the current account became evident in the period reviewed because of the current account surplus which was higher than that needed to finance the demand for net investment abroad.

⁹ For a detailed description of the factors acting to increase the current account surplus see Chapter 7 in the Bank of Israel 2006 Annual Report, due to be published in March 2007.

Figure 1.8



Foreign trade data for the fourth quarter show a slowing of the rate of increase of good exports, while imports continued to rise at a rate similar to that in the first half of the year, with the exception of capital goods imports, the rise in which slowed down. Viewing exports according to the degree of technological intensity, high-tech exports were the first to recover, and exports of medium-low technology industries reverted to a relatively fast rate of increase. In contrast, exports of the medium-high and low technology industries leveled off and did not continue to rise.

Net capital exports totaled \$ 930 million in the third quarter of 2006, bringing the total for the first three quarters of the year to about \$ 5 billion. Net capital exports, in addition to being the other side of the picture of the surplus in the current account, also partially reflect the trend of significant changes in Israel's capital market, expressed by the marked increase in Israelis' investments abroad as well as that in nonresidents' investments in Israel. The former reflects the process of adjustment to structural changes that eased the limitations on capital exports (such as the change in the rules governing the investments of institutional investors), and also the increased profitability of investing abroad (due to the equalization of the tax rates, or for reasons of risk spreading, etc.). The considerable rise in nonresidents' investments in Israel, on the other hand, is affected by (a) Israel's improved economic situation, expressed among other things by the reduced sovereign risk premium, (b) the availability of capital globally seeking investment opportunities, and (c) the relative attraction of Israeli companies. The reform of the government bond market with the introduction of market makers, the implementation of which started in September

2006, boosted trade, and thus contributed to the improved accessibility of this market to nonresidents.

Global developments

Continued rapid global growth, particularly in high-tech industries, was one of the main factors that had a beneficial effect on real activity in Israel's economy and that to some extent offset the effects of domestic developments, with the war in the north the major one. On the other hand, unexpected events on the nominal side, such as the weakening of the dollar and the sharp fall in oil prices, were high on the list of developments that brought inflation down steeply.

In the second half of 2006 most of the advanced economies continued to show fast rates of growth. This was most notable in the US, where activity continued to increase rapidly, albeit more slowly than in the previous quarters. Growth persisted in Japan, and in the euro zone actually accelerated. The emerging markets (especially China) and the developing economies too registered fast rates of growth. Nevertheless, the continuation of growth in the advanced economies and the rise in oil and metal prices at the beginning of the year served to create inflationary pressure in some countries, that led to a series of interest rate hikes and to high volatility in the capital markets from May. According to the OECD forecast,¹⁰ in most countries supply and demand are matched, except for the US and Japan, where demand has strengthened more than supply, and the euro zone, where there is still slack. According to the forecast no slowdown is expected, but balanced growth, taken over the OECD countries: continued moderation of growth in the US and Japan, and a sharper rise in growth in the euro zone, China, Russia, and the emerging markets.

In the US there were signs that growth was slowing in the third quarter of 2006, but it remained relatively high. The main cause of the slowdown was that in housing investment, against the background of the cooling housing market, alongside a rise in imports and a decline in inventory. In contrast, the rapid rise in non-housing investment and private consumption (affected by the increase in disposable income and the fall in energy prices) served to strengthen growth. US trade in high-tech goods—in the production of which Israel enjoys a comparative advantage and in which Israel has a relatively large market segment—continued to expand steadily throughout the period reviewed, but Israel's exports of these industries, which had risen faster than did US trade, declined in the period reviewed (Figure 1.9).

¹⁰ OECD Economic Outlook 80, November 2006.

Figure 1.9

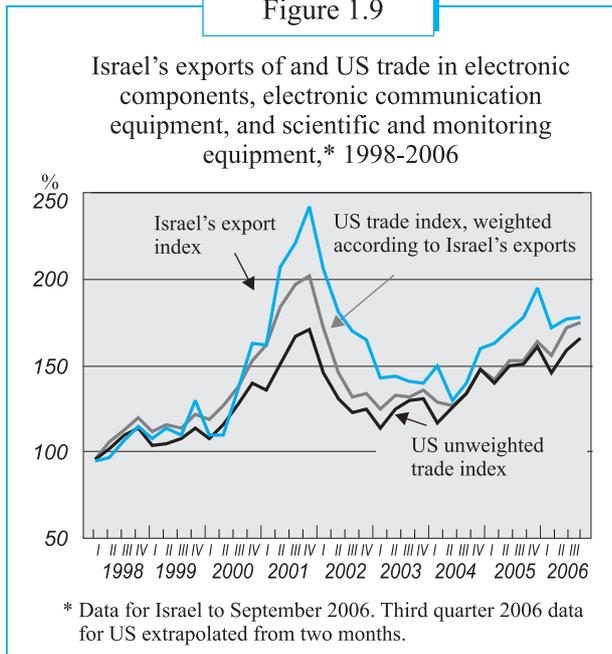


Figure 1.10



In Japan growth continued to become more firmly based, while inflation was kept a low level.

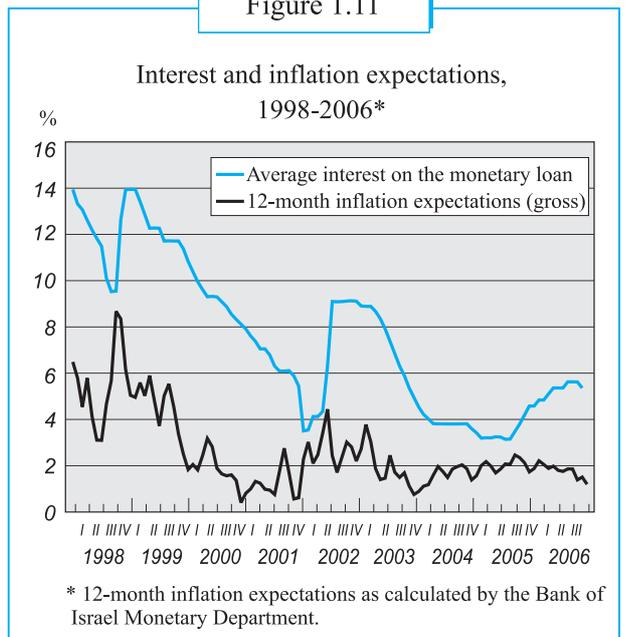
In the euro area, GDP grew in the third quarter by about 0.5 percent, after rapid growth in the first half of the year. Growth in the euro area was led by local demand, thereby strengthening expectations that growth will continue in the future. Consumer confidence indices and other indicators point to a consolidation of growth and a further improvement in the labor market.

Prices, monetary policy, and money and capital markets

The consumer price index fell during the period reviewed by 1.7 percent; for the year 2006 it fell by 0.1 percent, below the lower limit of the inflation target range (of 1 percent to 3 percent; Table 7 and Figure 1.10). It should be noted that from 2003 the Bank of Israel operates in the framework of a running inflation target, where the CPI figures are examined monthly, based on the cumulative change over the preceding 12 months. Comparing inflation in practice to the target shows that at the beginning of the period reviewed, price development matched the target, but in the last quarter of the year it dropped below the lower limit and was even negative, while for most of the first half of the year price development had deviated beyond the inflation target's upper limit.

Inflation expectations to twelve months ahead were already, by the beginning of the period reviewed, below the mid-point of the target range (Table 9 and Figure 1.11), and during the

Figure 1.11



period they continued to fall, approaching the lower limit of the inflation target range. Inflation expectations for longer periods ahead were within the target range throughout the period, though consistently on a downward path.

By the beginning of the period reviewed it was already clear that the pace of price increases was expected to be lower than that forecast in the first half of the year. Real and nominal developments during the period, among them budgetary

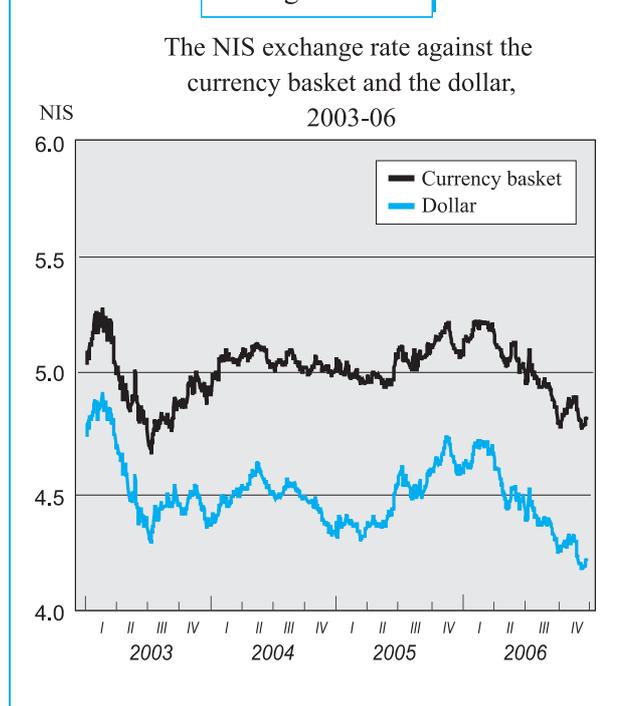
discipline and fiscal restraint, the appreciation of the shekel against the dollar and a drop in oil prices, all contributed to a stabilization of the CPI and a drop in inflation expectations. Despite a fear of instability arising from the outbreak of hostilities in the north, which contributed to the decision to raise interest rates, it became clear that this shock too failed to upset market stability, and its effect on activity in most industries was only temporary.

The dominant factor affecting price developments during the period reviewed and throughout 2006 was the **exchange rate** of the shekel against the dollar, which appreciated considerably during the period. The appreciation was characteristic of the entire period reviewed, except for a temporary depreciation at the outbreak of the war (Figure 1.12), and was similar to the rate of appreciation in currencies of the emerging market economies. The appreciation of the shekel greatly affected the housing index, and this contributed considerably to the fall in the consumer price index. The appreciation of the shekel during the period reviewed, along with additional developments that led to a reduction in Israel's country risk premium and the acknowledgement of the financial system's robustness in the face of passing shocks, allowed the Bank of Israel to cut the interest rate while opening a negative interest

points for January 2007. (For further details on the monetary policy during the period reviewed see the Inflation Report, July-December 2006).

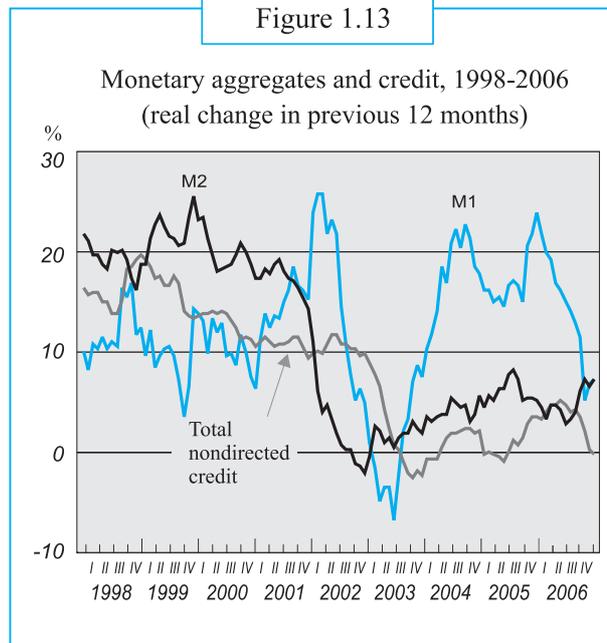
The rate of expansion of the **M1 money aggregate** moderated considerably during the period reviewed, further to the moderation since the beginning of the year (Table 8 and Figure 1.13). As in the past three years and despite this slowdown in expansion, the rate of growth in the money aggregate remained higher than the inflation rate *plus* the GDP growth rate. This is in line with the low interest rate as well as the tax reforms which lowered taxes, and the continued expansion in stock exchange activities. However under a regime of an inflation target, with the interest rate as a leading policy instrument, the influence of the quantity of money on prices is doubtful, and therefore the weight of this indicator in setting policy is relatively low. The monitoring of

Figure 1.12



rate gap between it and the US Federal Reserve. The Bank of Israel cut its interest rate three months in succession—by 25 basis points for November and December and by 50 basis

Figure 1.13



these money aggregates is intended to warn of instability in demand or/and any upset to the macroeconomic relationships that guide the setting of the interest rate. The rate of increase in the M2 aggregate slightly accelerated.

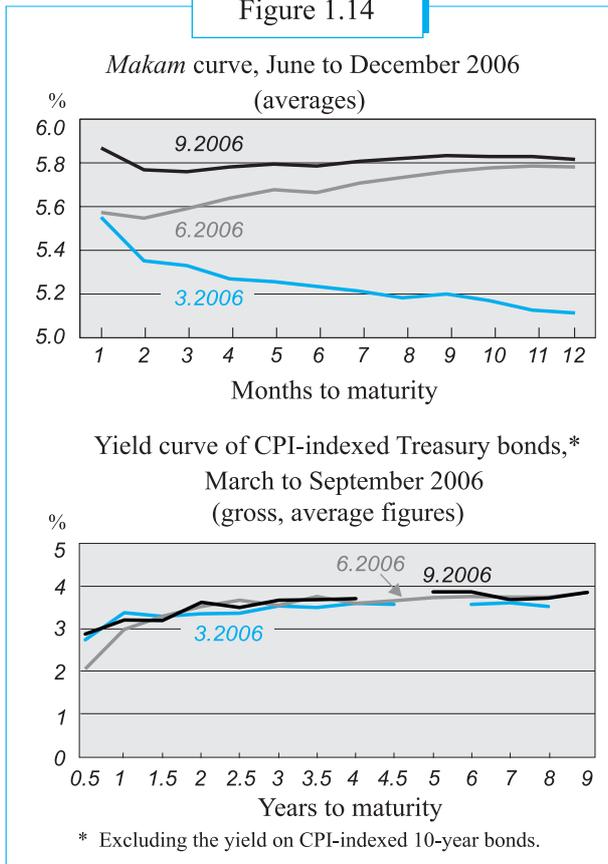
The rate of expansion of non-directed **bank credit** slowed down during the period reviewed. This slowdown followed four years of particularly slow expansion in bank credit, with the level remaining relatively low. This low level of bank credit reflects the shift of raising funds to non-bank sources,

which saw impressive growth in recent years. At the same time, there was a change in the composition of bank credit—an expansion in unindexed shekel credit and a reduction in indexed and dollar credit—which mainly expressed the developments of the exchange rate and the CPI.

The *makam* curve rose in the third quarter of 2006, all along its curve, while its slope moderated, mainly as a reaction to the rise in interest rate. In the fourth quarter the curve dropped considerably, while changing its slope (Figure 1.14), reflecting principally the Bank of Israel’s cut in interest rate (by a total of 1 percentage point over three months).

Real yields were influenced during the period reviewed by two opposing forces: on the one hand, a drop in the government’s budget deficit and lower borrowing by the government, together with easing restrictions on institutional investors’ investments, and relative stability in Israel’s risk premium, all acted to raise the demand for bonds (and therefore to push down yields); while developments in the global capital markets, first and foremost the hikes in interest rates in the developed countries, acted to raise yields. The combination of these opposing forces was expressed in the stability of the **yields-to-redemption** of indexed bonds (Table 9 and Figure 1.14); these remained unchanged in the third quarter at 3.9 percent, and began falling slightly from October.

Figure 1.14



The **market makers in the bond market reform** was implemented in September, and by the fourth quarter its effect on the market was already evident; trading volumes in government bonds grew by 60 percent, and the participation of nonresidents in issues, in trading and in holding government bonds increased greatly, while yields fell.

During the period reviewed the trend of households’ withdrawal from mutual funds continued. The withdrawals concentrated on those funds managed by banks, both those still managed by the banks and those that have passed to other fund managers after their sale following the Bachar reforms. However there seems to be little evidence of the claim that the reason for these withdrawals is the banks directing their customers to alternative investment options that earn the banks higher profits, such as structured deposits; analyzing the changes in the public’s asset portfolio shows that the money withdrawn from the mutual funds was directed mostly to ETFs and investments abroad, two channels whose returns to the banks are not necessarily higher than those marketed by the mutual funds.

Table 1. National Accounts,^a 2005-2006

	2005		2006			2006	Last month for which data available
	2005	IV	I	II	III	III ^b	
GDP	5.2	5.9	5.6	6.4	-1.1	4.1	Sep
Business-sector product	6.7	7.5	7.7	7.9	-4.4	4.5	Sep
Private consumption	3.4	0.9	7.9	5.8	3.7	4.5	Sep
Gross domestic investment	11.5	5.6	-0.5	-20.5	-39.2	-15.6	Sep
Fixed investment	2.9	8.0	6.5	-2.0	12.0	6.0	Sep
Goods and services exports ^c	5.1	-2.5	-1.7	42.6	-19.2	2.5	Sep
Goods and services exports							
excl. diamonds	7.5	2.0	5.7	38.0	-9.2	7.8	Sep
Goods and services imports ^d	3.4	-9.5	2.4	16.2	-21.4	-4.1	Sep
Goods and services imports							
excl. diamonds	5.2	-2.3	6.5	13.5	-12.5	0.8	Sep
Public sector consumption	2.7	0.5	3.9	1.7	15.5	5.2	Sep
Public sector consumption							
excl. defense imports	1.8	3.1	3.1	-1.0	10.2	3.8	Sep

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

^b Compared with 2005:III

^c New calculation - excluding subsidies.

^d New calculation - excluding taxes.

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,^a 2005-2006

	2005	2006					Jul 06- Dec 06 ^b	Last month for which data available
		IV	I	II	III	IV		
Composite state-of-the-economy index	3.3	6.9	7.8	8.3	6.8	5.9	7.3	Dec
Large-scale retail trade	5.6	7.9	6.1	1.4	-8.5	14.6	2.3	Dec
Manufacturing production								
(excl. diamonds)	4.6	4.9	9.6	10.3	15.3	9.0	10.7	Nov
Index of revenue in commerce	7.4	7.3	5.4	7.0	-0.6	19.0	5.7	Nov
Index of commerce and services revenue	8.1	11.4	7.5	8.0	4.0	10.5	7.8	Nov
Index of export - services	15.6	-11.4	-3.5	-0.4	-8.5	-23.2	-7.7	Dec
Tourist arrivals	27.1	-0.1	29.7	9.1	-85.6	104.8	-26.2	Dec
Residential construction ^c								
Starts	5.8	-12.0	23.6	-8.1	-29.2	0.0	-22.2	Oct
Completions	-1.3	-19.7	-9.8	-11.4	-25.9	0.0	-21.7	Oct
Nonresidential construction								
Area of starts		2.0	67.9	-7.5	0.0	0.0	-7.6	Jun
Survey of companies (net balance, percent) ^d								
Weighted balance of the business sector		27	37	27	13 ^e	32		Dec
Output of manufacturing firms	25	29	37	32	22	26		Dec
Sales by trading firms	27	23	39	29	24 ^e	37		Dec

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

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

^c Change from equivalent period one year earlier.

^d 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.

^e Not significant at 10% level.

SOURCE: Central Bureau of Statistics.

Table 3. Indicators of Labor Market Developments,^a 2005-2006

	2006		2005	2006				Last month for which data available
	III	IV	IV	I	II	III	IV	
	('000s)		percent change from previous quarter				Jul 06- Dec 06 ^b	
Civilian labor force	2,814		1.2	0.2	1.0	0.0	2.9	Sep
Israeli employees	2,579		1.3	0.3	0.9	0.5	4.1	Sep
Of which: in general government	800		1.5	-3.7	5.1	4.4	5.3	Sep
in business sector	1,784		1.7	1.2	-0.1	-1.2	3.6	Sep
Foreign workers and Palestinians (unadjusted)	362		-5.3	5.0	-0.7	2.1	-4.9	Sep
Average hours worked weekly per employee	35.9		-1.1	0.8	-0.6	-0.6	-4.4	Sep
Labor input in business sector (incl. foreign workers and Palestinians)	83,821		-1.8	3.4	-1.5	0.4	1.2	Sep
Of which: Israelis	73,116		-1.2	3.2	-1.4	-0.4	-1.1	Sep
Labor input in general government (Israelis)	19,693		0.3	-1.9	4.3	3.3	1.6	Sep
Unemployed	235		0.0	-0.4	1.7	-5.5	-8.1	Sep
Work seekers	219	210	-3.9	-0.5	-4.6	2.3	-2.0	Nov
Claims for unemployment benefit	70	67	-4.5	2.7	-1.6	-0.9	-3.7	Nov
Real wage per employee post ^c	7,285	7,066	-2.0	1.1	1.0	1.2	1.0	Oct
In general government	7,165	6,786	-3.4	0.0	2.9	-0.4	-0.2	Oct
In business sector	7,338	7,192	-0.1	1.5	-0.8	1.2	3.7	Oct
Nominal wage per employee post ^c	7,582	7,264	-0.7	1.5	1.6	0.2	2.5	Oct
In general government	7,458	6,975	-2.5	0.7	3.8	-1.8	0.4	Oct
In business sector	7,638	7,393	1.0	1.9	-0.3	0.2	4.3	Oct
Participation rate			55.6	55.5	55.8	55.6	1.2	Sep
Employment rate			50.7	50.6	50.9	50.9	2.1	Sep
Unemployment rate			8.8	8.8	8.8	8.3	-8.5	Sep
Depth of unemployment ^d			36.1	39.7	44.7	38.9	-5.3	Sep

^a Seasonally adjusted.^b Compared with July 2005 - December 2005 (unadjusted).^c Including foreign workers and Palestinians.^d Percent of unemployed seeking work for more than six months (unadjusted).

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

Table 4. Foreign Trade, Balance of Payments, and the Reserves,^a 2005-2006

	2005	2006					Jul 06- Dec 06 ^b	Last month for which data available
		IV	I	II	III	IV		
	percent change from previous period ^c							
Trade in goods ^d								
Goods imports	5.2	-0.6	4.1	1.8	5.2	0.2	11.3	Dec
Of which: Consumer goods	7.3	-0.4	7.6	2.0	2.8	-1.5	11.8	Dec
Capital goods	4.3	-5.8	6.1	-3.5	8.5	-0.5	7.5	Dec
Intermediates	4.9	1.3	2.3	3.7	4.8	1.0	12.5	Dec
Goods exports	7.8	-1.5	4.8	10.8	-1.0	1.6	14.9	Dec
Of which: Manufacturing	7.6	-1.7	4.9	11.3	-1.2	1.7	15.3	Dec
Of which: High-tech	6.0	1.3	4.4	18.9	-3.1	2.0	22.2	Dec
	\$ million							
Balance of payments								
Goods and services exports	57,874	14,578	14,908	16,186	15,586			Sep
Goods and services imports	57,525	14,428	14,553	15,635	15,203			Sep
Balance of trade in goods and services	349	150	355	551	383			Sep
Current account	3,756	862	1,998	1,813	2,433			Sep
Financial account (excl. foreign exchange reserves) ^e	-1,291	-1,886	-1,834	-1,448	-873			Sep
Of which: Nonresidents' direct investment ^e	1,396	3,203	2,183	1,882	5,400			Sep
Nonresidents' portfolio investment ^e	1,154	2,242	1,400	-1,583	-358			Sep
Residents' direct and portfolio investment abroad ^e	2,239	5,621	2,257	1,474	1,564			Sep
Net foreign debt (percent of GDP) ^e	-18.5	-20.3	-18.1	-17.2	-20.2			Sep
Bank of Israel reserves, end-period ^e	27,858	29,061	27,858	27,345	27,617	29,061		Dec

^a Seasonally adjusted.

^b Compared with July 2005 - December 2005 (unadjusted).

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

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

^e Unadjusted data.

SOURCE: Central Bureau of Statistics.

Table 5. Indicators of Economic Development in Advanced and Developing Countries^a
(annual rate of change, percent)^b

	2002	2003	2004	2005	Projection 2006	Projection 2007
World GDP	3.1	4.1	5.3	4.9	5.1	4.9
Advanced countries	1.5	1.9	3.2	2.6	3.1	2.7
Developing countries	5.1	6.7	7.7	7.4	7.3	7.2
World trade	3.4	5.3	10.6	7.4	8.9	7.6
Advanced countries						
Imports	2.6	4.0	9.1	6.0	7.5	6.0
Exports	2.3	3.3	8.8	5.5	8.0	6.0
Developing countries						
Imports	6.1	10.2	16.4	11.9	13.0	12.1
Exports	6.9	10.8	14.6	11.8	10.7	10.6
Commodity prices (US\$)						
Oil ^c	2.5	15.8	30.7	41.3	29.7	9.1
Nonfuel	1.7	6.9	18.5	10.3	22.1	-4.8
Inflation (CPI) in advanced countries	1.5	1.8	2.0	2.3	2.6	2.3
Short-term interest ^d (%)						
Dollar deposits	1.6	1.0	1.4	3.2	5.0	5.3
Euro deposits	3.3	2.3	2.1	2.2	3.1	3.7
Unemployment rate in advanced countries	6.3	6.6	6.3	6.0	5.6	5.5

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

^b Except for unemployment and interest rates.

^c Average price per barrel in 2005 was \$53.35.

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

SOURCE: World Economic Outlook (IMF), September 2006.

Table 6. Government Budget Performance vis-à-vis Deficit Target, 2005-2006

	2005	2005	2006				Jul 06- Dec 06	Last month for which data avail- able
		IV	I	II	III	IV		
Domestic deficit as percent of GDP	-0.6	-3.8	5.9	-0.2	-1.2		-1.2	Sep
Deviation from domestic budget path, excl. credit extended ^a (NIS billion) ^b								
Government revenue	-0.8	0.4	3.6	2.7	3.0	0.7	3.5	Sep
Government expenditure	-6.2	-2.0	-3.6	-0.1	4.1	-0.1	6.8	Sep
Domestic deficit	-5.4	-2.4	-7.2	-2.8	1.1	-0.8	3.3	Sep
Total government surplus (deficit)	-10.8	-7.7	7.8	-3.2	-2.0	-8.1	-0.6	Sep
Real percentage change from respective period, previous year								
Government tax revenue	5.9	3.3	7.7	4.0	7.2	10.4	7.1	Nov
of which: income tax, net	7.9	6.2	9.7	9.5	19.4	12.9	13.7	Nov
VAT, gross	4.5	1.0	8.5	5.2	-1.9	6.5	2.0	Dec
Government expenditure	-0.3	-8.3	-4.1	3.8	7.1	6.5	6.8	Dec
National insurance allowances	-0.3	-1.0	1.2	0.5	2.3	9.3	5.7	Nov
of which: Unemployment benefit	-7.2	-3.1	-3.4	-5.9	-4.9	-2.1	-2.4	Nov
Income support	-6.9	-8.1	-6.8	-9.0	-6.7	-5.6	-6.1	Nov
National insurance contributions received from the public	3.5	2.1	-1.0	0.3	3.4	2.9	4.3	Nov

^a The path was determined on the basis of a deficit of 3.4 percent of GDP in 2005, and 3 percent of GDP in 2006.

^b Change from respective period, previous year, seasonally adjusted.

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

Table 7. Selected Price Indices,^a 2005-2006

	2005	2005	2006				Jul 06- Dec 06 ^b	Last month for which data avail- able
	2005	IV	I	II	III	IV		
CPI	2.4	0.5	0.6	1.0	-0.8	-0.9	-1.6	Dec
CPI excl. housing, fruit and vegetables	1.8	0.2	0.5	2.0	-0.8	-0.7	-1.6	Dec
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	1.7	-0.7	1.5	1.7	-0.5	-1.4	-1.8	Dec
Index of housing prices	5.9	2.1	0.3	-3.2	-0.3	-2.9	-3.2	Dec
Wholesale price index	5.2	0.9	3.3	2.3	-0.6	-2.8	-3.3	Dec
NIS/\$ exchange rate	6.2	1.6	1.7	-4.6	-2.7	-3.5	-6.1	Dec
NIS/currency-basket rate	1.6	0.2	2.1	-3.0	-2.5	-2.4	-4.9	Dec

^a Rates of change during period, percent.

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

SOURCE: Central Bureau of Statistics.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2005-2006
(annual terms, percent)

	2005	2005		2006			Cumulative in previous 12 months	Jul 06- Dec 06	Last month for which data available
		IV	I	II	III	IV			
Rates of change							During period		
M1 ^a	17.5	23.6	10.8	6.6	11.0	-2.0	7.3	8.7	Dec
M2 ^b	6.1	-0.2	2.8	5.5	10.0	10.0	7.3	12.5	Dec
M3 ^c	7.9	2.6	9.1	6.1	6.4	7.2	7.6	9.8	Dec
Nondirected bank credit	1.0	9.5	0.3	4.0	2.4	-3.4	-0.2	-3.2	Dec
Unindexed local-currency credit	10.8	13.8	7.2	16.8	13.9	11.3	11.1	9.5	Dec
CPI-indexed credit	-2.6	7.8	-2.1	-0.9	-0.3	-7.6	-4.1	-6.2	Dec
Credit in and indexed to foreign currency	-7.8	4.7	-7.7	-10.0	-14.2	-23.8	-14.6	-21.8	Dec

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

^b M1 plus short-term local-currency unindexed deposits.

^c M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2005-2006
(quarterly average, percent)

	2005	2005		2006			Jul 06- Dec 06 ^a	Last month for which data available
		IV	I	II	III	IV		
Nominal interest								
SRO deposits	2.8	3.2	3.7	4.1	4.3	4.3	4.3	Nov
Nondirected local-currency credit	6.4	7.0	8.3	8.4	8.7	8.8	8.7	Oct
Effective local-currency credit	3.8	4.2	4.8	5.3	5.6	5.5	5.5	Nov
LIBID 3-month dollar interest	3.4	4.2	4.6	5.1	5.3	5.2	5.3	Dec
Yield to maturity on:								
Treasury bills	4.3	4.9	5.5	5.8	5.8	5.1	5.5	Dec
Yield on 10-year bonds	3.0							
Yield on 5-year bonds	3.0	3.1	3.5	3.8	3.9	3.6	3.8	Nov
Risk premium ^b		0.3	0.3	0.3	0.3	0.3	0.3	Dec
Expected inflation	2.0	2.1	2.0	1.9	1.8	1.4	1.6	
General Share-Price Index (change)	33.2	11.7	1.7	-8.4	5.2	7.5	13.2	Dec

^a Compared with July 2005 - December 2005.

^b As measured by the 5-year credit-default-swap (CDS) market.

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

SOURCE: Bank of Israel.

Part 2: Broader Review of Selected Issues

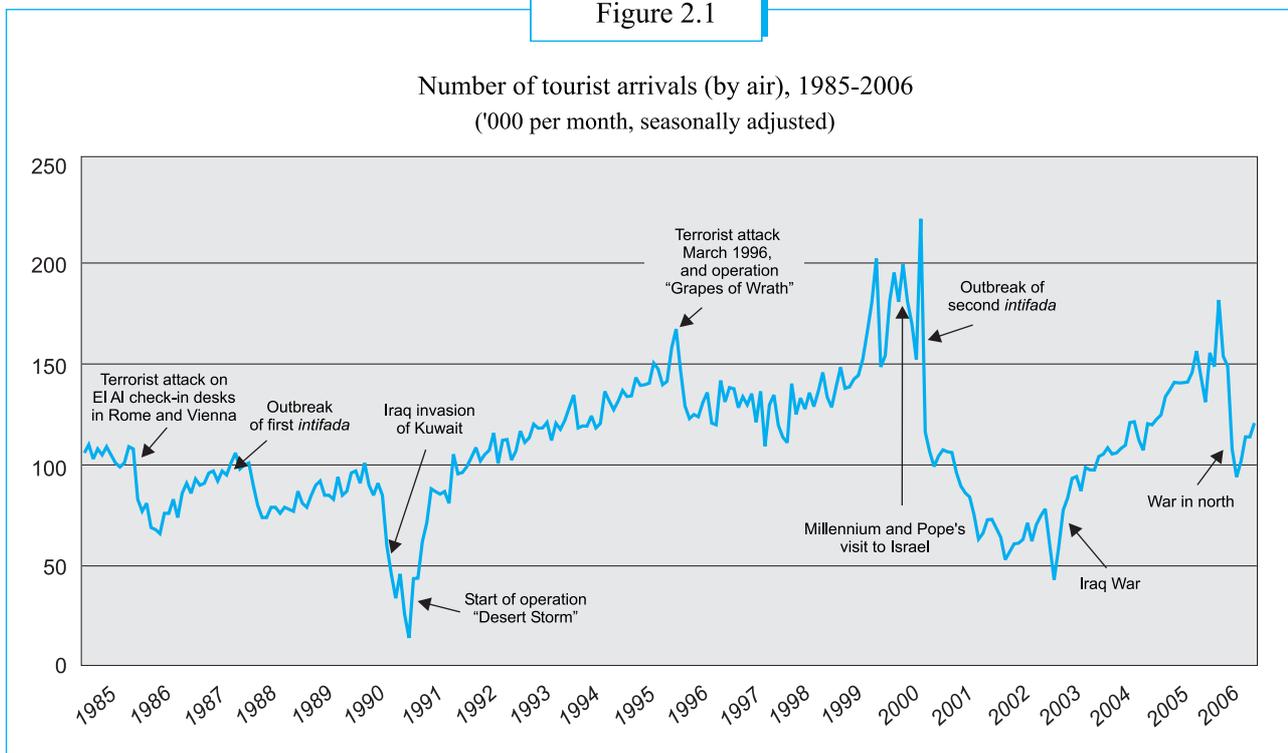
The Effect of the Hostilities in the North on Tourism

Output of the tourism industry, and in particular that of incoming tourism, is very sensitive to the security situation in Israel and the world (Figure 2.1). As the security situation worsens, there is a sharp and sudden drop in numbers of incoming tourists, and the recovery process is a slow one, dependent on the duration of the security event. Due to the war in the north in 2006, the number of tourists that came to Israel by air dropped from 149,000 in June to 108,000 in July though since then, the numbers have rallied to some extent.¹¹

added to the economy from tourism income in Israel in 2006 was \$ 320 million and the loss from travel fees was \$ 60 million, bringing a total loss of \$ 380 million. In terms of total output, the loss was 0.37 percent of business-sector output (or 0.27 percent of GDP), leaving annual tourism output to account for about 1.69 percent of business-sector product.

To calculate the damage, we had to calculate the actual output from tourism and compare it to the theoretical output had there been no war. The actual output from tourism was calculated as a sum of the tourism output figures for the three quarters for which data were available and the Central Bureau of Statistics estimate for income from incoming tourism in

Figure 2.1



The damage to tourism output is made up of the damage to value added income from tourism in Israel (principally through food and catering, commerce and transportation services) and of Israeli companies' income from travel fees on international routes. According to an estimate by the Research Department of the Bank of Israel the loss of value

added to the economy from tourism income in Israel in 2006 was \$ 320 million and the loss from travel fees was \$ 60 million, bringing a total loss of \$ 380 million. In terms of total output, the loss was 0.37 percent of business-sector output (or 0.27 percent of GDP), leaving annual tourism output to account for about 1.69 percent of business-sector product.

¹¹ Seasonally adjusted.

Israelis' and Tourists' Bed Nights, by Areas, Percent Change from 2005 to 2006, by Half Years

		Haifa and the North	Jerusalem	Tel Aviv and Cen- tral District	South	Total
First half of 2006 vis-à-vis first half 2005	Change in Israeli bed nights	-8	-3	-18	5	1
	Change in tourist bed nights	65	47	18	28	33
	Change in total bed nights	13	35	6	9	13
Second half of 2006 vis-à-vis second half 2005	Change in Israeli bed nights	-32	16	45	4	3
	Change in tourist bed nights	-43	-25	-26	-20	-26
	Change in total bed nights	-35	-11	-8	1	-7

SOURCE: Central Bureau of Statistics.

by air had there been no war. We assumed that in the absence of the war, the number of tourist bed nights would have risen in the second half by about 10 percent compared to the first half on average, and the number of tourists arriving by air would have risen by about 1 percent.¹²

Geographic dissection of war's impact on tourism

In the first half of the year the number of tourist bed nights rose by 44 percent compared to the parallel period of the previous year, and the number of Israeli tourist bed nights rose by some 0.6 percent. The impact on bed nights—of domestic and foreign tourists—in the second half of the year was not uniform; in general, the more the area relied on foreign tourism, and the closer the area was to the north, the greater the impact. In Jerusalem, the effect was moderate, while in the center and the south it was slight. Jerusalem and the center saw a rise in the number of Israeli tourist bed nights in the second half of the year, a rise that compensated for the drop in foreign tourist bed nights (Table 2.1).

Tightening Criteria on Young People's Eligibility for Unemployment Benefits

In the Economic Arrangements Law for the budget year 2007, the criteria for becoming eligible for state unemployment benefits were tightened for those under 28 years old.¹³ This was aimed at encouraging young unemployed people's integration in employment and to reduce the level of

payments on unemployment benefits. The maximum period for which someone aged 25-28 can receive unemployment benefit was shortened from 100 days to 67 days. (For those younger than 25, the limit remained unchanged at 50 days). The maximum period that young unemployed individuals can refuse to accept unsuitable work was also shortened from 60 days to 14 days for those under 25 and to 30 days for those aged 25-28. In addition, unemployment benefit was cut by 25 percent.

The budgetary savings implicit in these changes are marginal. According to data from the National Insurance Institute¹⁴ payments for unemployment benefit to those younger than 28 totaled NIS 152 million in 2005, some 9 percent of all unemployment benefits paid that year. Reducing the unemployment pay by 25 percent will reduce this total by only NIS 38 million *ceteris paribus*. The other changes are not expected to save more than NIS 20 million.

The Unemployment Insurance Law is intended to ensure a minimum income for the unemployed, to help them survive during their job-search period as well as to improve the match of the individual's qualifications with the place of work, thereby maximizing his earning capacity and his long-term employment. There is indeed a positive correlation between the generosity of the unemployment benefit and the duration of time spent in the system, however on the other hand research worldwide shows a positive effect between the length of time of eligibility for drawing unemployment benefit and the quality of match—and in particular with the subsequent duration—of the job found.¹⁵

¹² We found an upward trend of 4.7 percent according to trend figures from the first half of 2006, and of 15.7 percent when seasonally adjusted. We therefore assumed an average rise of 10.2 percent and a loss of 0.37 percent of GDP, the range of the loss forecast is between 0.32 and 0.41 percent of business-sector output.

¹³ For those with less than three dependents.

¹⁴ "Economic Arrangements Law 2007: Proposed Amendments to National Insurance Institute Pensioners", NII, Director of Research, Planning and the Legal Office, December 2006.

¹⁵ Belzil, C. (2001), "Unemployment Insurance and Subsequent Job Duration: Job Matching Versus Unobserved Heterogeneity," *Journal of Applied Econometrics* 16, No.1, 619-636.

From the end of the 1990s, the conditions in the Unemployment Insurance Law in Israel worsened; the criteria for eligibility for unemployment benefit were tightened, the maximum period eligible to draw benefit was shortened, and the level of the benefit as a rate of wage earned prior to receiving the benefit (the replacement ratio) was reduced. In international comparison in 2006, Israel has some of the toughest criteria for receiving unemployment benefit.

International comparison of unemployment insurance for the young shows that also here Israel is one of the strictest, whether in terms of the duration of work required prior to unemployment as a criterion for receiving benefit (Figure 2.2), the ratio between that duration of work needed in order to qualify for unemployment pay and the period during which such duration of work has to be accumulated, or the maximum period eligible to receive unemployment pay (Figure 2.3). Most other countries do not set more stringent criteria for the young, and some (for example Greece and Austria) even relax the criteria for the young who are just joining the work force.¹⁶ When a distinction is made between the young unemployed and others, it generally turns on the level of pay. Comparing the replacement ratio in Israel with elsewhere shows that after the change in the law it is outstandingly low in Israel (Figure 2.4).

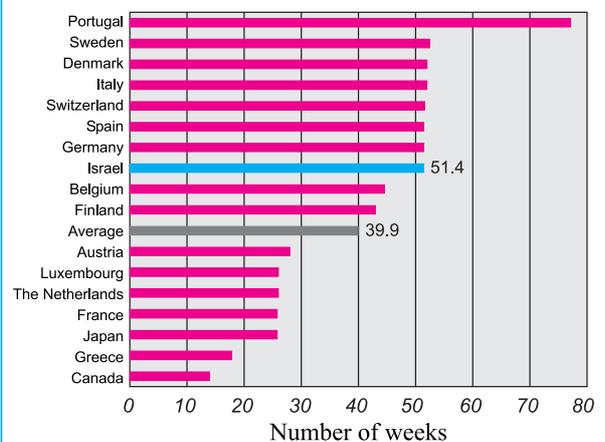
The relatively strict criteria for receiving unemployment benefit among the young stands out in light of the long compulsory army service in Israel, a period in which most young people cannot further their education or accumulate work experience or property that would help them extend their period of job search. The group of young unemployed includes a relatively large number of new participants in the work force, that have only recently finished their professional training, though they have no experience and therefore need more time to find a suitable job that will be the starting point to take full advantage of their qualifications. The great importance of unemployment benefit in reducing friction in the work force and easing the search for suitable employment is made all the sharper given the relatively advanced age of those newly joining the work force in Israel. The assumption in the amendment to the law and in public debate on this topic is that the young could and should accept financial assistance from their parents. But data from the National Insurance Institute also shows that a considerable number of young receiving unemployment benefit live independently, have their own families—some 30 percent of them are parents—and it seems unreasonable to assume that these young adults will turn to their parents for financial assistance

during the time of searching for work. Since the young from low socioeconomic backgrounds will find little assistance from their parents, the change in the law has made it all the harder for those from the weakest strata of society.

It is unclear if these amendments in the Unemployment Insurance Law are efficient in reaching their stated goals. The terms of the law are already stringent. This further stringency could harm one of the law’s major objectives considerably—that of allowing the unemployed to find long-term work suitable for their qualifications. The absorption of the young in the work force, which is the major objective of the amendment to the law according to the Economic Arrangements Law, will be achieved through the efficient usage of active labor market policies. Preventing abuse of unemployment benefit, which is often brought up in public debate as one of the reasons for the amendment to the law, should focus on enforcement, including stricter observance of the employability test.

Figure 2.2

Minimum Qualifying Period of Work Required for those Aged Under 28^a Years to be Eligible for Unemployment Benefit, Israel and Selected Countries, 2006^b



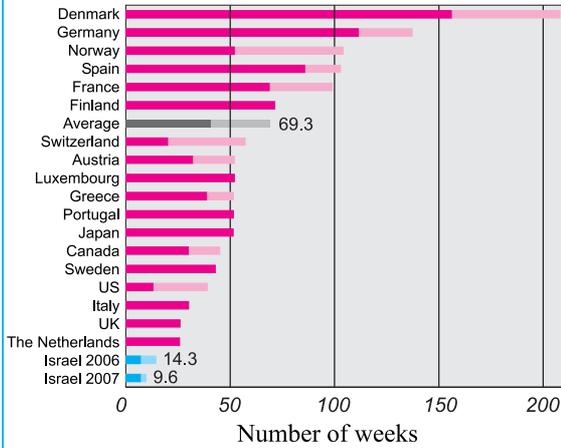
^a With up to three dependents (i.e., non-working spouse and/or children). In several countries the minimum period of work required is determined according to number of dependents, age, etc. Rules applicable to small populations have been ignored.
^b The figure for Japan is for 2005.

SOURCE: Based on ISSA (2006), Social Security Programs Throughout the World, 2006, and data from the National Insurance Institute.

¹⁶ See “Social Security Programs Throughout the World, 2006”, ISSA (2006) and “Raising the Age of Eligibility for Unemployment Benefit from 20 to 28”, Senate 297 on socioeconomic issues, November 2006 (Hebrew).

Figure 2.3

Maximum Period in which Unemployment Benefit is Paid^a to those Aged Under 28 Years,^b Israel and Selected Countries, 2006^c



^a The maximum period of entitlement to unemployment benefit depends on the qualifying period of work, the number of dependents, age, etc. Rules applicable to small populations have been ignored. The top (left) part of each bar represents special rules applicable to some of those eligible.

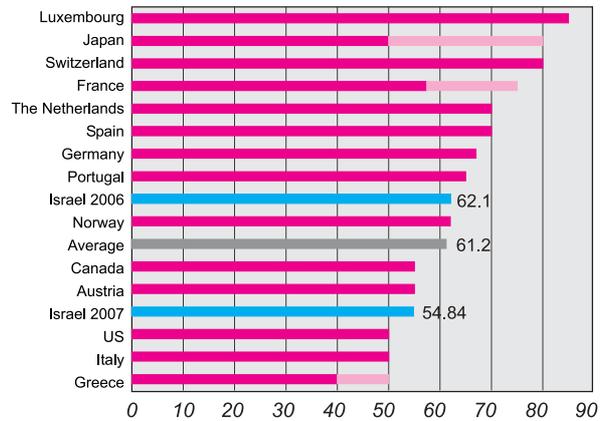
^b With up to three dependents (i.e., non-working spouse and/or children).

^c The figures for Japan and the US are for 2005.

SOURCE: Based on ISSA (2006), Social Security Programs Throughout the World, 2006, and data from the National Insurance Institute.

Figure 2.4

The Replacement Ratio^a for those Aged Under 28^b Years, Israel^c and Selected Countries, 2006^d



^a The ratio between the unemployment benefit and wages prior to unemployment. For countries in which the replacement ratio is a range, the middle of the range has been taken. For countries in which the replacement ratio declines after a certain period of eligibility, the original ratio has been taken. Many countries have minimum and maximum amounts of unemployment benefit.

^b With up to three dependents (i.e., non-working spouse and/or children).

^c The figure for Israel is calculated from the distribution of income (Income Survey 2005) by the National Insurance Institute levels of replacement ratios.

^d The figures for Japan and the US are for 2005.

SOURCE: Based on ISSA (2006), Social Security Programs Throughout the World, 2006, and data from the National Insurance Institute.

Diary of Events from July 2006 to December 2006

Month	Date	Event	Details
July	1	New directive on bank credit comes into effect	The directive is intended to remove uncertainty for customers whose overdraft extends beyond the agreed framework, to arrange orderly banking management, and to improve the payment ethic in the economy.
	12	Military flare-up in the north	The IDF began operations in south Lebanon in response to an attack by Hezbollah forces, including the capture of two soldiers. At the same time as Israel's response, Hezbollah began firing rockets into Israeli settlements in the north.
	25	Standard & Poor's rating agency confirms a "Stable" outlook for the Israeli economy	Prime Minister Ehud Olmert praised S&P's announcement and stressed the need to maintain fiscal discipline, particularly to stay within the budget constraints—the deficit and expenditure ceilings—as defined by the government.
	30	Government approves proposal by Minister of Finance regarding paying wages in north and comprehensive damage compensation	The government approved a proposal by the Minister of Finance regarding paying wages in north and comprehensive damage compensation, based on the arrangement reached between the minister, chairman of the Histadrut and president of the Coordinating Bureau of Economic Organizations.
August	14	Ceasefire comes into force, fighting in south Lebanon stops	The Second Lebanon War lasted 33 days. During the fighting 3,917 rockets fell on Israel, 42 citizens were killed and 4,304 wounded.
	21	Ra'anana Municipality raises NIS 150 million from institutional investors	For the first time, a municipality registered on the Stock Exchange's institutional floor (Retsef Mosadiim), which allows trade in securities between institutional investors.
	30	Finance Committee approves a NIS 2 billion cut across-the-board to pay for the Lebanon war.	The cut in non-defense spending was approved after three earlier failed attempts in the Knesset Finance Committee, and after three MKs on the committee were replaced.
	31	National Insurance Institute releases its poverty report for 2005	Among its major findings: <ul style="list-style-type: none"> • In 2005, incidence of poverty among families remained relatively stable, though the upward trend continued among individuals and children. The gap in disposable incomes also widened. • Against a background of rising living standards in Israel, the cut in child allowances further worsened the relative situation of low-income families with children.
September	5	Accountant General and Tel Aviv Stock Exchange launch reform of the government bond market	As part of the reforms, the Accountant General appointed 18 lead market makers, who are obligated to quote purchase and sale prices for government bonds at large quantities and at limited spreads. The market makers are also committed to buying minimum quantities of government bond issues on an annual basis. This will open a large and important segment of local banks' activities to competition.
	11	Bank Leumi completes the transfer of Psagot-Ofek investment house to York Capital for NIS 1.284 billion.	This is the largest deal to date resulting from the implementation of the Bachar recommendations.

Month	Date	Event	Details
	12	Multi-year budget plan for 2007–09 approved by government	
	17	Twelve years after passing State Health Insurance Law, Finance and Health Ministries sign agreement passing insurance responsibility for mental health services to HMOs	The agreement was signed based on a government decision from January 2003 which stated that the ministries would act to pass responsibility of mental health services to the HMOs, and a government decision from February 2006 which set the date of the start of the mental health service reforms at 1/1/07.
	19	Minister of Industry, Trade and Employment adopts recommendations of the team headed by Prof. Yossi Tamir that checked employment testing and improving social balance of the “Mehalev” welfare to work program (a.k.a. the “Wisconsin Plan”)	Major recommendations of the team include: <ul style="list-style-type: none"> • Men and women 7 years prior to retirement age will be exempt from regular participation in the plan, and will be directed to a special (professional) course. • Recipients of disability allowances, those designated mentally disabled, those cared for by mental health services and others suffering from psycho-sociological problems are exempt from regular participation in the plan, and will be directed to a special (professional) course.
	25	State instructs state-owned companies to furnish it with list of their property	The director of the Government Companies Authority issued a land memo, instructing all state-owned companies to comprehensively examine their assets. This is intended to prevent unauthorized and illegal use of company property.
	26	Bank of Israel announces that the interest rate for October will remain unchanged at 5.5 percent	This was the third consecutive month that the Bank of Israel interest rate was left at 5.5 percent.
	29	World Economic Forum places Israel 15th in their competitiveness index	The improvement in ranking stems from the recovery of the high-tech industry, fiscal discipline, growth and reforms that have increased competition.
October	3	Privatization of the Oil Refineries plant in Ashdod completed	The state transferred control in the oil refinery to the Paz fuel company for NIS 3 billion.
	15	Minister of Finance instructs a further NIS 140 million be budgeted to the Higher Education Council to allow the new academic year to begin	A new team, to be established, will examine the basic changes necessary to strengthen the higher education system in Israel and to encourage pursuit of excellence in research and teaching.
	26	Tel Aviv Stock Exchange raises the threshold for issuing ETFs	The required equity of issuers of exchange-traded funds (ETFs) has been raised to NIS 36 million. However a company with insurance (as required for mutual funds) and for which the value of the ETFs issued is less than the amount set in the regulations, will be required to have a lower equity of NIS 16 million or NIS 8 million.
November	6	The Concluding Statement of the IMF Mission is presented, on their visit to Israel	Main points of the statement: <ul style="list-style-type: none"> • The Israeli economy is performing very well considering the significant uncertainties related to political and security developments earlier in the year • The foundation for continued real GDP growth of 4 percent or more in 2007 is strong.

Month	Date	Event	Details
	15	Banking Supervision refers to the rise in banking fees that the banks have announced.	the Supervisor of Banks approached the Price Controller with a recommendation to supervise certain banking charges and to examine the need to subject other fees to supervision.
	27	The Bank of Israel announces that the interest rate for December 2006 will be lowered by 25 basis points to 5 percent.	The major factor behind this decision was the intention to gradually bring the inflation rate to around the midpoint of the inflation target range, while preserving financial stability.
	29	Histadrut leads general strike in protest at non-payment of wages in several local government authorities	Among those on strike: government offices, local authorities, the Bank of Israel, the Israel Airports Authority, Israel Postal Company and Israel Railways.
	30	Ministry of Finance completes private placement abroad of bonds indexed to the Brazilian real, of \$ 500 million	The Ministry of Finance conducts a swap that converts the cash flow into shekels.
December	6	Based on section 34 in the Basic Law: The Government, Minister of Finance decides to remove the Accountant General's authority over credit arrangements for 20 local authorities until 31/3/08	The Minister of Finance, Avraham Hirschson, removed the Accountant General's authority over approving contracts with the Union of Local Authorities, and personally approved the contracts. This provided temporary relief for those local authorities refused credit.
	10	Paz launches the largest IPO ever on the Tel Aviv Stock Exchange (initial issue that is not an offer of sale)	Paz raised NIS 1.7 billion.
	17	Banking Supervision publishes amendment to instructions on managing credit arrangements in checking accounts	The amendment allows banks to honor checks and debits if the deviation from the arrangement is small—up to NIS 1,000—and only if the deviation does not continue for any length of time.
	18	Credit rating agency Fitch raises Israel's foreign and local currency outlook to "Positive"	
	25	Bank of Israel lowers interest rate for January by 50 basis points to 4.5 percent	Bank of Israel announced that it was cutting the interest rate for January by 50 basis points to 4.5 percent. This was part of the Bank's policy to maintain long-term price stability, in line with inflation of 1 percent to 3 percent a year.
		Stock Exchange launches new bond index: the Tel-Bond 20	The new index will comprise 20 series of CPI-indexed bonds of companies and banks with the highest market values.
	26	European Investment Bank to grant credit of hundreds of millions of euros to finance projects in Israel	The EIB, among the largest investment banks in the world, decided for the first time to extend credit of millions of euros to finance projects in Israel. The bank, which is owned by all EU member states, will finance economically proven projects, with an emphasis on pollution abatement, infrastructure and generation of economic activity.