

RECENT ECONOMIC DEVELOPMENTS, 111

April–September 2005

Part 1: Review of current developments

Main developments

During the period reviewed, April–September 2005, the rapid growth rate that has characterized the economy in the last two years continued, but was not uniform for all industries: it accelerated primarily in commerce, services and tourism but slowed in manufacturing, including manufactured exports. Despite the heterogeneity of economic activity, the continued growth and expectations of persistent positive trends found expression in the labor market, in the stability of the capital market, and in the high level of yields, particularly of shares. The rise in domestic demand and local-currency depreciation during the period reviewed led to some increases in prices and inflation expectations. These developments, alongside a narrowing of the gap between local-currency and dollar yields, led the Bank of Israel to raise its interest rate towards the end of the period.

The period reviewed, and especially 2005:III, was replete with events, among them the implementation of the

disengagement from Gaza, grave natural disasters elsewhere in the world, and various political shocks. Against this backdrop, Israel's relative economic stability—in particular that of its financial markets—is notable. This stability—which was supported by a fiscal policy of adhering to the deficit target and a monetary policy which was consistent with maintaining price stability—brought about a further decline in Israel's risk premium.

Part II of this review contains a broader discussion of two topics which are relevant to the period reviewed: 1. A preliminary analysis of the 2006 budget proposal approved by the government and a long-term forecast of budgetary developments; 2. The estimate made by the CBS of nonfinancial activity in 2005 and a forecast for 2006.

Aggregate and by-industry nonfinancial activity

Several factors supported the continued growth rate during the period reviewed, chief among them: 1. The relatively

Figure 1.1

Level of Economic Activity,* 1998-2005
(index: 2004 average=100)

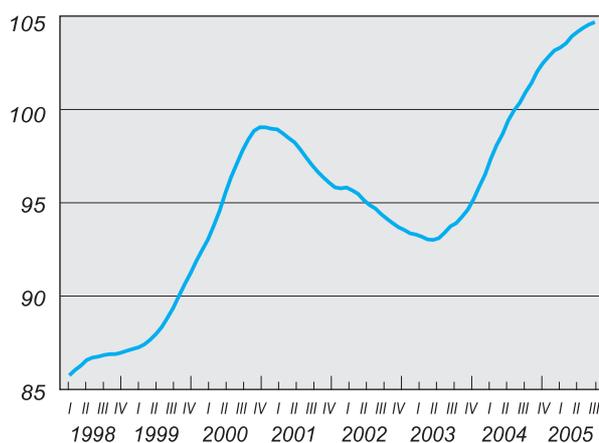
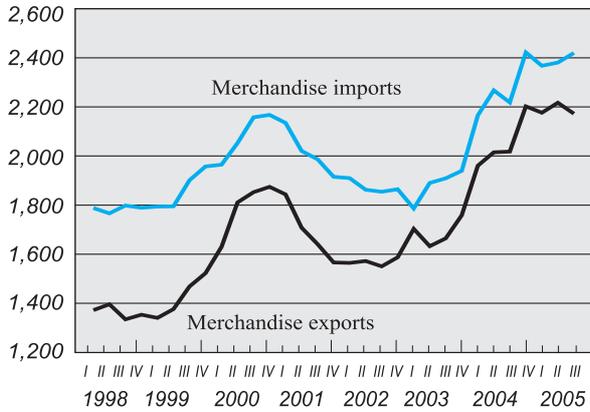


Figure 1.3

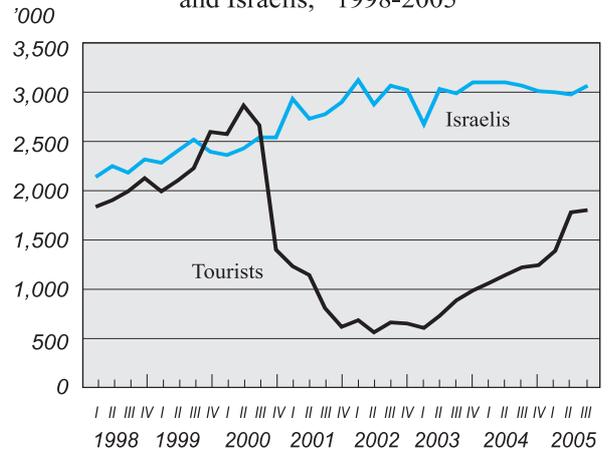
Foreign trade,* 1998-2005
(\$ million per month)



* Excluding ships, aircraft, diamonds, and fuel. To September 2005. Seasonally adjusted.

Figure 1.5

The hotel industry: bed nights of tourists and Israelis,* 1998-2005



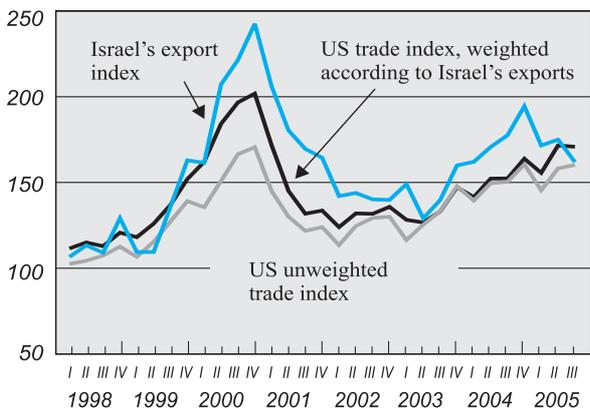
* To September 2005. Seasonally adjusted.

calm security situation; 2. Fiscal policy which was consistent with adherence to the deficit target while reducing taxes and the public-sector debt; 3. Expansionary monetary policy, which maintained a relatively low level of interest rates and supported domestic demand; 4. An increase in the public's wealth due to the rise in wages and high yields in the capital market. All these led to an increase in *domestic demand*, alongside an improvement in revenues and the various characteristics of *commerce and services*. The

improvement in the security situation and the cumulative local-currency depreciation during the years of recession also led to an upsurge in *tourist* entries (Table 2 and Figure 1.5). The Companies Survey for 2005:III also attests to

Figure 1.4

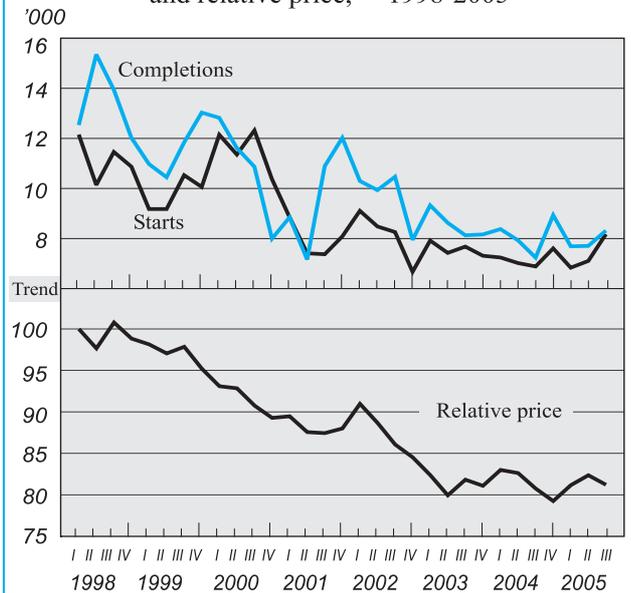
Israel's exports of and US trade in electronic components, electronic communication equipment, and scientific and monitoring equipment,* 1998-2005



* To September 2005. Third quarter 2005 extrapolated based on two months.

Figure 1.6

Housing units: starts and completions,* and relative price,** 1998-2005



* Original data, to July 2005. Third quarter 2005 extrapolated.

** Prices of owner-occupied dwellings relative to CPI. To July 2005.

continued growth, which encompassed most industries, as is the case with the preliminary *National Accounts* estimates, which predict a growth rate of 5.1 percent of GDP and a 6.4 percent increase in business-sector product in 2005, with an acceleration in the second half of the year (see Part II).

Another factor which might have served to reinforce economic activity, especially in manufacturing, was the continued growth and marked expansion of world trade, which were expected to persist despite the steep rise in oil prices (Table 5). These trends should have acted to increase demand abroad, expand exports, and in particular to boost high-tech exports.

Nevertheless, in spite of the rise in domestic demand and the favorable external backdrop for the continued expansion of production, the positive situation was overshadowed by the moderation of *manufacturing production*, and especially in the high-tech industries, which rallied only towards the end of the period reviewed—August and September (Table 2 and Figure 1.2). Manufactured exports and other indicators, such as the Composite Index and the extent of imported inputs, indicate that economic activity slowed in the period reviewed. The moderation of manufacturing production and exports since the beginning of 2005 may only be temporary and may be due to the offsetting of their acceleration in 2004 relative to the expansion of world trade or US imports, weighted by Israeli exports in that year (Tables 4 and 5, and Figure 1.4). The expansion of manufacturing production in the last two months also supports this contention, but at present it is impossible to tell for sure whether the slowdown is indeed temporary or will have an adverse effect on growth in the long term.

The slowdown in *construction* persisted, continuing the trend evident in the industry since the late 1990s, although according to several indicators there has been some improvement in activity during the period reviewed, apparently affected by the low level of interest rates, the increase in the public's wealth, and the low level of housing prices, which fell markedly in real terms in the last decade. The extent of building starts rose slightly in 2005:II, and that of completions dipped only moderately (Table 2 and Figure 1.6). Similarly, housing prices rose in the period reviewed, outstripping even the local-currency depreciation, while sales, which remained low, recovered slightly in June and July.¹ The Companies Survey of the state of the economy also recorded a moderate rise in economic activity in 2005:III, after stability in 2005:II.

¹ In order to stimulate home purchases in Galilee, the Negev, and Jerusalem, a campaign was inaugurated in June 2005 in which grants were awarded to purchasers of homes in those areas, in accordance with certain criteria. Preliminary data for June indicate that the campaign helped to increase sales in some areas. The campaign ended in October 2005.

The labor market

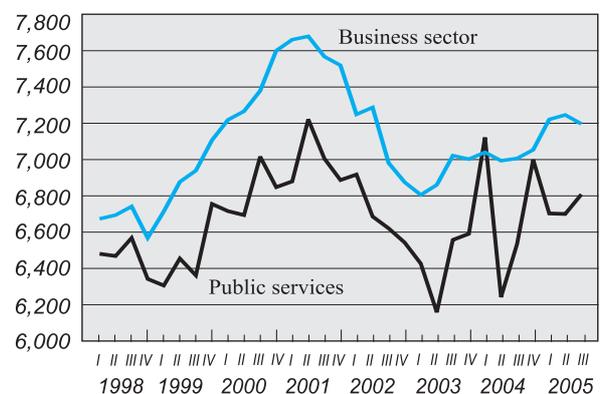
Labor Force Survey data for 2005:II indicate that the labor market continued to rally—with a rise in the labor-force participation and employment rates, a decline in the unemployment rate, which fell to 9 percent, and an increase in the share of full-time positions alongside a rise in the number of hours worked (Table 3 and Figure 1.8). Note that the rise in the labor-force participation rate served to moderate the rate of decline of the unemployment rate, which would otherwise have fallen significantly. Alongside the reduction in the unemployment rate, there was a rise in the depth of unemployment—apparently because the greater ease in finding employment caused the share of the chronically unemployed among the unemployed to rise.

Most of the increase in the rate of employment in 2005:II was in the business sector, and primarily in the services and infrastructure industries. The total number of non-Israelis employed in Israel rose during the period reviewed, in contrast with the government's policy on the subject. The number of foreign workers rose slightly, but the number of Palestinian workers soared due to the calm security situation and relaxation of restrictions relative to previous periods. Note that even though the number of Palestinian workers employed in Israel rose, it is still far lower than it was at the beginning of the 2000s.

During the period reviewed wages rose—primarily in the general government but also in the business sector—relative to the equivalent period in 2004 (Figure 1.7). The increase in employment in the business sector was particularly prominent in the business services industry, while in manufacturing it

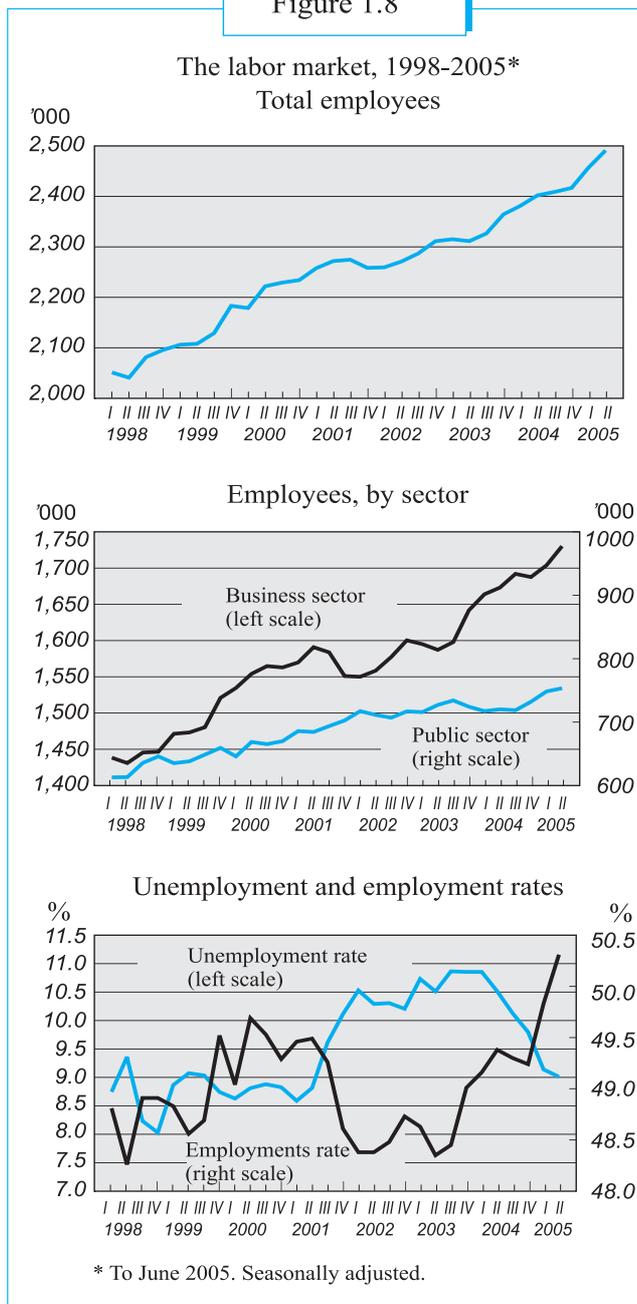
Figure 1.7

Real wage per employee post, 1998-2005*
(NIS, 2001 prices)



* To July 2005. Seasonally adjusted.

Figure 1.8



moderated. In the public sector the increase encompassed most industries. In the business sector, after continued wage increases since the beginning of the year and until May, wages fell in June and July (seasonally adjusted data), while public-sector wages fluctuated from one month to another.² In construction and agriculture wages of Israelis rose as the number of foreign workers in these industries contracted.

² In July, in accordance with agreements reached earlier, the two years of the reduction of wages in the general government sector intended to stimulate economic growth came to an end.

Unit labor costs rose notably in the first half of 2005, after declining in the preceding six months. The increase in labor costs is explained by the rise in wages and steep increase in labor inputs relative to the rise in output in the first half of the year, expressed in a fall in labor productivity. The rise in labor costs marks the conclusion of another stage in the business cycle: after a long period of declining labor costs—initially because of the recession, which caused the labor force to contract, and subsequently due to employers' reluctance to enlarge the labor force before economic expansion became entrenched—there was a turnaround late in 2004, when the number of hours worked rose, as did wages.

General government

The economic activity of the general government was overshadowed during the period reviewed by significant political developments, including the resignation of the Minister of Finance and the implementation of the withdrawal from Gaza. The effect of these events on the financial markets was short-lived, however, thereby attesting to the stability of the markets and the public's considerable confidence in economic policy.

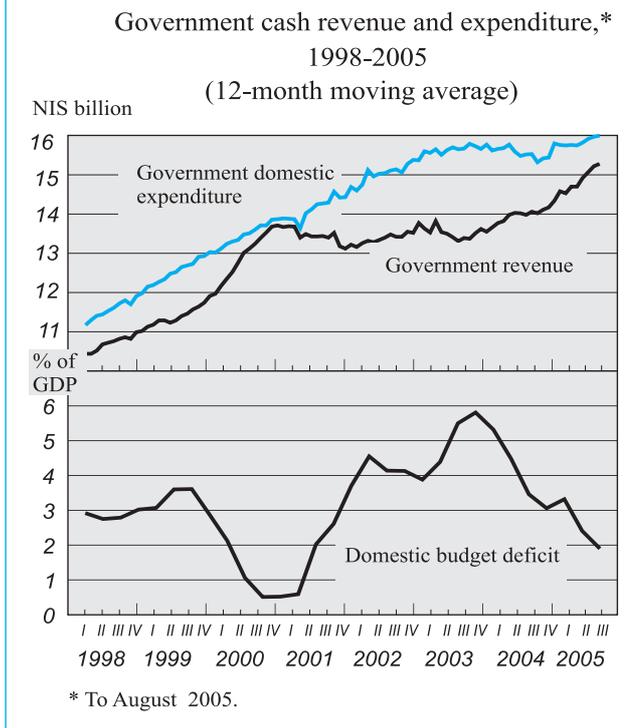
During the period reviewed the level of government expenditure was particularly low,³ and this together with large revenues from taxes and other sources served to reduce the deficit below the target set in the Budget Law. At the present stage it would seem that even if 2005:IV is characterized by an exceptional level of expenditure, the 2005 *budget deficit* will be below the target, which is 3.4 percent of GDP (Table 6 and Figure I-9). The total financing requirement for the budget was also low, and consequently general-government domestic tradable borrowing contracted, alongside a reduction in the extent of domestic loans throughout the period (see Part II).⁴

Domestic revenues in the period reviewed were higher than the forecast level, and considerably higher in real terms than in 2004. Tax receipts soared, in line with the seasonal path indicated by the budget forecast: the increase in income-tax receipts—despite the reduction of tax rates at the beginning

³ The figures obtained from the Ministry of Finance do not indicate an increase in public-sector expenditure at this stage; however, the CBS's annual forecast for the National Accounts indicates their expansion. Beyond the fact that the National Accounts data are for total public-sector expenditure while those of the Ministry of Finance are solely for public-sector consumption, note that the definitions employed for forecasting the National Accounts differ from those used for the budget, inter alia because the budget figures are on a cash basis while those of the National Accounts are on an accrual basis. For further details, see box in Chapter 3 of the Research Department's Annual Report for 2004.

⁴ At the end of September the government borrowed 750 million euros in Europe—almost double the amount planned—at a relatively low interest rate and without using the US government guarantees.

Figure 1.9



of the year—stems from the acceleration of economic activity and enforcement efforts undertaken during the year. In September, as revenues rose, VAT was reduced by 0.5 percent.

Domestic expenditure to date (excluding credit extended) is lower than the seasonal path of domestic budget expenditure, but still higher in real terms than during the equivalent period in 2004. Towards the end of the year expenditure is expected to rise as a result of the bringing forward of security expenditure and the withdrawal from Gaza, which were planned for 2006, thus reducing the annual deviation from the path.

The balance of payments

Foreign trade figures attest to a slight increase in goods exports in 2005:II and a decline in 2005:III, primarily due to a similar fall in manufactured exports, and high-tech exports in particular (Table 4 and Figure 1.3). Goods imports continued to expand in 2005:III, continuing the relatively moderate increase in 2005:II, as a result of the acceleration of capital goods and a slight rise in imported intermediates, which were offset to some extent by a decline in imports of consumer goods. Throughout the period reviewed *prices of imported energy* soared, leading to an increase in imports of energy goods in dollar terms and in the trade deficit. Adjusting for the effect of energy goods, the deficit contracted slightly.

In 2005:II the *current account of the balance of payments* was balanced (seasonally adjusted), after a surplus in 2005: I. The outstanding trend leading to the elimination of the surplus on the current account was the expansion of the deficit on the goods and services account, which derived, as stated, from the expansion of the trade deficit, while there was a surplus in the services account.

On the *capital account*, investment in Israel by nonresidents declined in 2005:II. The drop in direct investment was relatively moderate, and its level remained higher than the 2004 average, while nonresident portfolio investment contracted steeply, relative to both 2005:I and to the 2004 average. Direct investment abroad by residents remained virtually unchanged, however, and the extent of their portfolio investment rose—in the context of the narrowing interest-rate differential between Israel and abroad. Thus, capital inflow into Israel declined, although remaining above its 2004 level.

Global developments

During September two major hurricanes hit the Gulf of Mexico in the US, causing extensive damage to the oil infrastructure there, so that the growth rate of manufacturing production moderated. The number of job-seekers rose, largely as a result of the loss of a large number of jobs in the affected areas. Nonetheless, the negative effect will apparently be short-lived, and the massive rehabilitation efforts will in fact accelerate the growth rate in 2006, so that annual growth estimates for 2005 and 2006 are 3.5 percent.

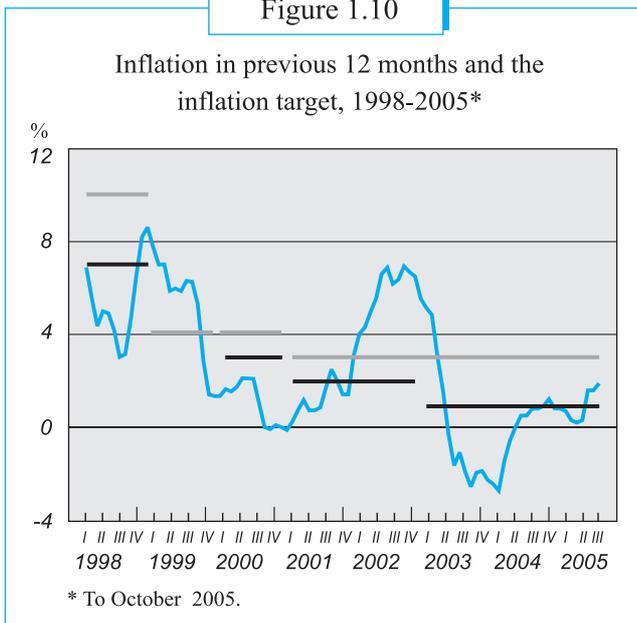
During the period reviewed there was some economic recovery in the *Eurozone*: unemployment rates fell in April-May and manufacturing production rose. On the other hand, the growth rate remained low: according to the estimates, and GDP is expected to rise by only 1.8 percent during the year. High oil prices and the increase in labor costs in the first half of the year, despite the high unemployment rates, could also hamper growth.

Forecasts of global economic expansion and trade have not yet been significantly affected by the rise in oil prices. The forecast for global GDP growth is 4.3 percent, inter alia due to high rates of expansion in the countries of east Asia, and the extent of world trade is expected to expand by 7.4 percent (Table 5). These growth rates are expected to act to continue increasing global demand, and also to boost Israel's exports and production in spite of their temporary moderation.

Prices, monetary policy, and the money and capital markets

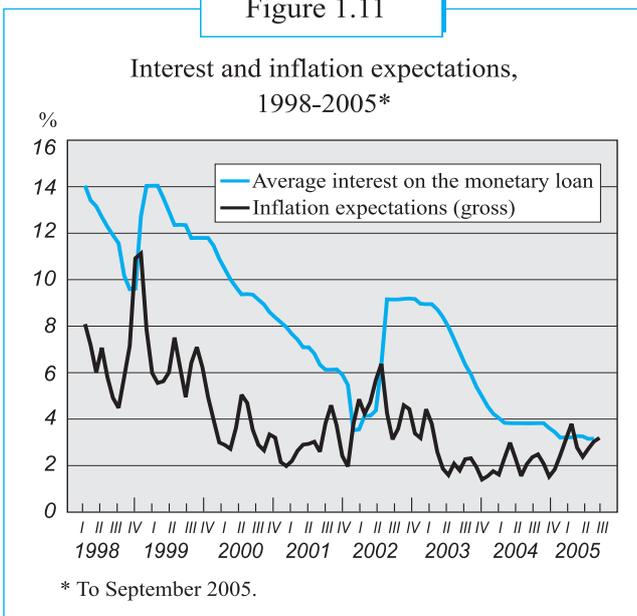
In the period reviewed, *prices* rose by 2.5 percent, after falling in the preceding six months (Table 7 and Figure 1.10). Even after adjusting for the seasonal price increases

Figure 1.10



which characterize the period, the rise in the CPI accelerated in the period reviewed. The acceleration of the rate of price increases was not uniform in every month, and was affected by surges in domestic demand, the local-currency depreciation, and the rise in housing prices—which outstripped even the dollar depreciation—in contrast to the downward trend of housing prices in previous months, as well as by the increase in energy prices. The wholesale price index rose steeply during the period reviewed, exceeding the increase in the CPI.

Figure 1.11



Inflation expectations for the next twelve months dipped slightly at the beginning of the period reviewed, and since July they have risen steadily (Table 9 and Figure 1.11). The *exchange rate* of the NIS fell markedly vis-à-vis the dollar in the period reviewed. In July there was local-currency depreciation—primarily because of the narrowing gap between domestic short-term interest and the US interest rate, and increased political and security uncertainty—but in September and October the local-currency depreciation persisted, largely due to the dollar’s rally worldwide (Figure 1.13).

Because of the creation of pressures for continued price increases and inflation expectations in order to maintain the inflation rate within the limits of the target set by the government, the Bank of Israel raised its *interest rate*, as expected, in both October and November, by 0.25 percentage points, after eight months in which this rate had remained unchanged (Table 9 and Figure 1.11). The interest-rate hike came after a long period in which, in order to stimulate economic activity, the interest rate had been kept below the rate consistent with long-term price stability, which is characterized by a lower unemployment rate than that currently prevailing. The increase in the interest rate came within the framework of the process of convergence to long-term equilibrium, with the acceleration of economic activity.

The *money supply* (M1) expanded sharply during the period reviewed, exceeding the rate of expansion of M2 (Table 8 and Figure 1.12). The increase in the money supply reflects the continued process of the liquidation of the asset portfolio

Figure 1.12

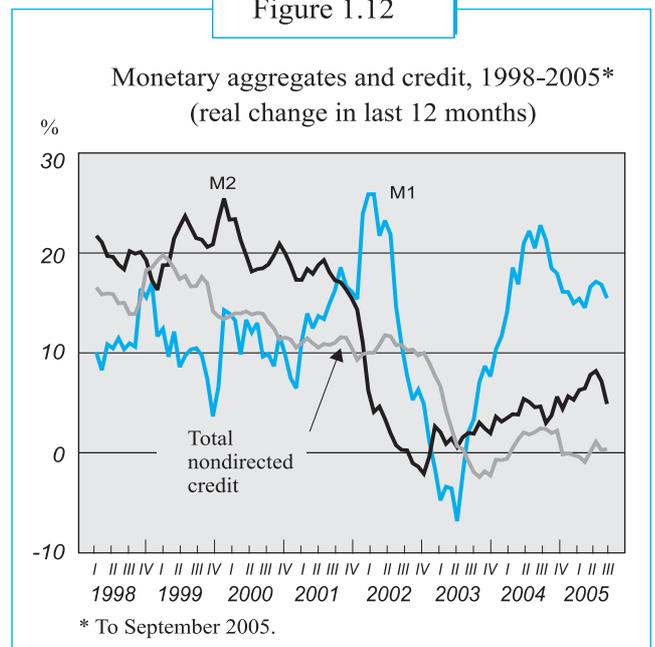
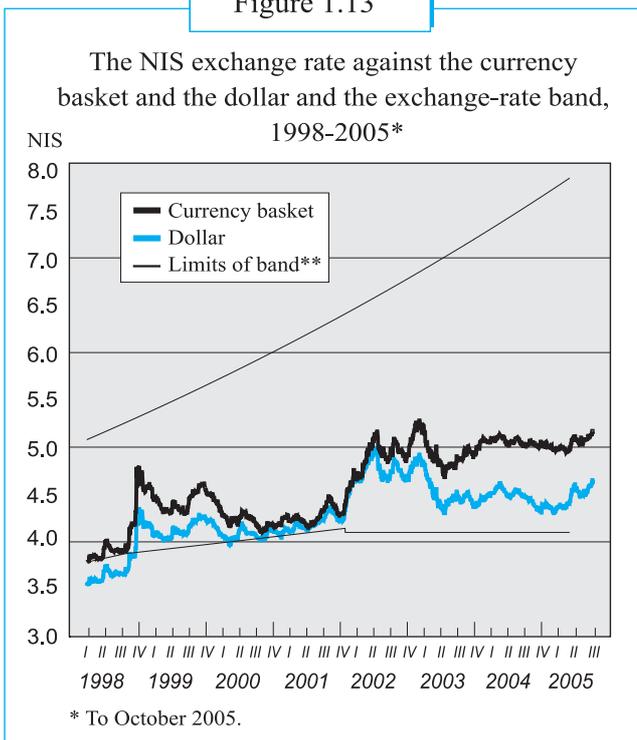


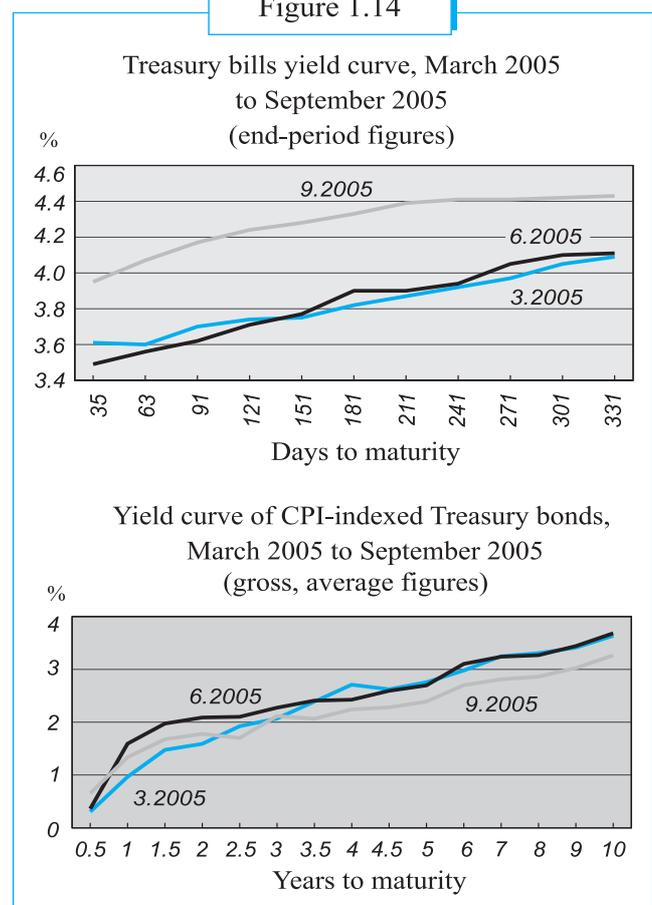
Figure 1.13



in view of the low rates of inflation and interest. *Nondirected bank credit* expanded, mainly during 2005:III, concurrent with the increase in capital raised on the stock market by firms, so that the expansion of total credit was substantially higher in the period reviewed than in the previous three years. The accelerated rise in credit to the business sector was made possible by the slower increase in credit to the government, and is explained by the expansion of economic activity in the last two years. Alongside the increase in bank credit, there was a change in its composition—a rise in local-currency credit (both indexed and unindexed) and a reduction in dollar credit; this change is consistent with the rise in dollar credit and the dollar’s global rally.

During the period reviewed the budget deficit was especially low, and the government’s borrowing requirement dropped. This led to a decline in the extent of domestic bond issues, alongside an increase in fiscal credibility and in the demand for government bonds. The rise in demand pressures and the reduction of Israel’s risk premium served to continue the decline in *yields to maturity* of 5- and 10-year government bonds (Table 9 and Figure 1.14). In the unindexed bond market, yields continued to decline to some extent in 2005:II, but in 2005:III there was a trend switch, and yields to

Figure 1.14



maturity rose, alongside increased expectations of an acceleration in the inflation rate and a hike in the key interest rate.

The *Share-Price Index* soared during the period reviewed, after rising steeply in the preceding six months. The rise in the *Share-Price Index* reflects the increase in firms’ profitability during the period reviewed,⁵ especially in business services, and the optimistic assessments of investors as to its continuation. Concurrent with the surge in the stock market, there was an increase in trade and in nonresident investment in shares, and a large amount of capital continued to be raised via the stock market—in contrast with the negative yields on stock markets in other countries.

⁵ Figures on the profitability of firms are available only up to 2005:II.

Table 1. National Accounts,^a 2004–2005

	2004	2004		2005		2005	Last month for which data available
		III	IV	I	II	II ^b	
GDP	4.4	5.4	6.5	3.8	5.2	5.2	Jun
Business-sector product	6.3	7.5	9.0	4.1	5.9	6.6	Jun
Private consumption	5.0	0.3	8.9	0.2	3.5	3.1	Jun
Gross domestic investment	4.0	58.1	-16.7	-3.2	44.6	16.5	Jun
Fixed investment	-0.2	-0.5	18.6	-12.2	6.7	2.5	Jun
Goods and services exports	17.4	6.7	18.9	0.2	7.6	8.1	Jun
Goods and services exports excl. diamonds	19.3	13.7	15.6	0.7	7.0	9.1	Jun
Goods and services imports	11.8	9.6	6.4	-1.6	23.0	9.0	Jun
Goods and services imports excl. diamonds	12.7	2.2	12.2	0.5	12.7	6.7	Jun
Public sector consumption	-2.4	0.7	-1.5	6.6	9.4	3.7	Jun
Public sector consumption excl. defense imports	-1.8	-3.0	-1.4	3.7	3.5	0.7	Jun

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

^b Compared with 2004:II

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,^a 2004–2005

	2004	2004		2005			Apr 05– Sep 05 ^b	Last month for which data available
		III	IV	I	II	III		
Composite state-of-the-economy index	1.3	6.5	6.4	3.6	3.2	1.7	4.3	Sep
Large-scale retail trade	3.8	5.1	4.2	4.6	6.1	7.1	5.4	Aug
Manufacturing production (excl. diamonds)	7.2	8.4	7.9	1.1	1.4	6.1	4.6	Aug
Index of revenue in commerce	6.7	8.4	9.1	8.5	3.0	2.6	6.5	Aug
Index of commerce and services revenue	7.9	8.1	6.9	7.6	4.0	0.3	6.2	Aug
Tourist arrivals	41.6	24.0	0.0	43.9	53.9	3.7	25.8	Sep
Residential construction ^c								
Starts	-5.3	-10.3	3.5	-5.6	1.2		6.2	Jul
Completions	-5.2	-10.9	9.5	-8.2	-2.8		2.0	Jul
Nonresidential construction								
Area of starts		-31.2	25.8	-21.8	-1.2		-1.2	Jun
Survey of companies (net balance, percent) ^d								
Weighted balance of the business sector		19	15 ^e	22	21	22		Sep
Output of manufacturing firms		22	26	21	22	28		Sep
Sales by trading firms		18	37	38	27	19 ^e		Sep

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

^b Compared with April 2004-September 2004.

^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 2004–2005

	2005		2004		2005			Apr 05– Sep 05 ^b	Last month for which data available
	II	III	III	IV	I	II	III		
	('000s)		(percent change from previous period)						
Civilian labor force	2,738		-0.1	0.0	0.9	1.2		2.0	Jun
Israeli employees	2,491		0.3	0.3	1.7	1.4		3.8	Jun
<i>Of which:</i> in general government	753		-0.2	1.9	2.2	0.7		4.7	Jun
in business sector	1,730		1.1	-0.3	1.0	1.6		3.4	Jun
Foreign workers and Palestinians (unadjusted)	374		5.7	1.2	1.2	1.7		10.1	Jun
Average hours worked weekly per employee	37		0.0	-0.5	1.1	1.1		0.8	Jun
Labor input in business sector (incl. foreign workers and Palestinians)	78,182		1.0	-0.3	3.5	1.2		5.5	Jun
<i>Of which:</i> Israelis	73,151		0.3	0.0	3.4	1.0		4.5	Jun
Labor input in general government (Israelis)	19,017		0.5	0.9	4.6	1.4		5.0	Jun
Unemployed	247		-3.8	-3.3	-5.8	-0.2		-13.5	Jun
Work seekers	232	228	2.8	-3.1	1.1	0.8	-1.7	-0.6	Aug
Claims for unemployment benefit	73	74	-2.9	-3.4	0.6	4.2	1.1	0.3	Sep
	Nominal NIS (unadjusted)								
Real wage per employee post ^c	7,070	7,189	1.5	2.0	0.3	1.1	-0.1	4.6	Jul
In general government	6,796	7,043	4.7	7.1	-4.2	0.0	1.6	6.7	Jul
In business sector	7,201	7,257	0.2	0.7	2.4	0.3	-0.7	3.6	Jul
Nominal wage per employee post ^c	7,194	7,406	1.9	2.4	-0.1	1.3	0.8	5.2	Jul
In general government	6,916	7,256	4.2	6.4	-4.4	1.8	2.4	7.4	Jul
In business sector	7,327	7,476	0.5	1.1	1.8	0.4	0.8	4.2	Jul
			Percent, seasonally adjusted						
Participation rate			54.8	54.6	54.8	55.3		0.2	Jun
Employment rate			49.3	49.2	49.8	50.3		1.9	Jun
Unemployment rate			10.1	9.8	9.1	9.0		-14.3	Jun
Depth of unemployment ^d			39.7	42.6	41.0	43.9		3.1	Jun

^a Seasonally adjusted.^b Compared with April 2004–Sep 2004 (unadjusted).^c Including foreign workers and Palestinians.^d 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,^a 2004–2005

	2004	2004		2005			Apr 05– Sep 05 ^b	Last month for which data available	
		III	IV	I	II	III			
		(percent change from previous period ^d)							
Trade in goods ^c									
Goods imports	20.8	-2.2	9.3	-2.3	0.6	1.7	7.1	Sep	
<i>Of which:</i> Consumer goods	17.4	-1.2	12.8	-4.0	7.1	-2.8	13.7	Sep	
Capital goods	15.0	-3.2	3.2	0.0	1.2	5.7	5.7	Sep	
Intermediates	24.3	-2.2	10.6	-2.5	-1.7	1.7	5.7	Sep	
Goods exports	21.5	0.2	9.2	-1.2	1.9	-2.0	8.9	Sep	
<i>Of which:</i> Manufacturing	21.4	0.5	8.5	-1.8	2.6	-1.8	8.6	Sep	
<i>Of which:</i> High-tech	21.5	2.5	2.3	-2.2	7.0	-3.8	6.3	Sep	
		\$ million							
Balance of payments									
Goods and services exports	51,445	12,925	13,733	13,771	13785			Sep	
Goods and services imports	52,040	13,125	13,744	13,884	14578			Sep	
Balance of trade in goods and services	-595	-200	-11	-113	-793			Sep	
Current account	1,474	346	609	465	4			Sep	
Financial account (excl. foreign exchange reserves) ^e	-570	296	93	-2,012	-2,173			Jun	
<i>Of which:</i> Nonresidents' direct investment ^c	416	-368	775	1,926	1,180			Jun	
Nonresidents' portfolio investment ^c	1,391	563	1,725	2,697	651			Jun	
Residents' direct and portfolio investment abroad ^c	1,375	695	1,069	1,786	1,439			Jun	
Net foreign debt (percent of GDP) ^e		-7.8		-13.7	-17.4			Jun	
Bank of Israel reserves, end-period ^e	26,632	25,839	26,632	26,704	26,210	27,323		Sep	

^a Seasonally adjusted.^b Compared with April 2004-September 2004 (unadjusted).^c Data on trade in goods do not include ships, aircraft, diamonds, and fuel.^d The change relates to the dollar values of imports and exports, not to their volumes.^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	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 ^c	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 ^d (%)				
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

^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 2004 was \$37.76 .

^d 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			Apr 05– Sep 05	Last month for which data available
		III	IV	I	II	III			
Domestic deficit as percent of GDP	-2.9	-1.3	-5.8	3.5	-1.5		-1.5	Jun	
Deviation from path ^a (domestic budget, excl. credit extended) (NIS billion)									
Government revenue	-1.5	-2.3	2.8	1.7	-0.9	-0.2	13.0	Sep	
Government expenditure	-3.4	-4.5	3.1	-2.6	-3.3	-0.8	4.6	Sep	
Domestic deficit	1.9	2.2	-0.3	-4.3	-2.4	0.6	-8.4	Sep	
Total government deficit	-20.4	-3.3	-9.8	3.7	-5.0	-0.5	-7.7	Sep	
Percent change from respective period, previous year									
Government tax revenue	4.7	0.3	5.0	3.1	8.7	12.8	9.3	Jul	
<i>Of which:</i> income tax, net	3.1	-0.9	1.5	5.0	8.9	12.0	8.4	Jul	
VAT, gross	5.0	5.3	4.8	1.2	6.3	9.8	8.1	Sep	
Government expenditure	0.2	-4.4	11.7	-1.0	4.4	4.6	4.0	Aug	
National insurance allowances	-4.9	-4.6	-0.5	-3.4	1.7	2.0	2.4	Jul	
<i>Of which:</i> Unemployment benefit	-12.8	-18.3	-8.7	-18.4	-3.2	-0.4	-2.0	Jul	
Income support	-9.7	-4.4	6.9	-10.2	-3.5	-1.8	-3.4	Jul	
National insurance contributions received from the public	1.6	-0.7	4.5	2.1	4.5	12.1	5.9	Jul	

^a 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,^a 2004–2005

	2004	2004			2005			Apr 05– Sep 05	Last month for which data available
		III	IV	I	II	III			
CPI	1.2	-0.8	0.0	-2.4	4.5	5.7	5.1	Sep	
CPI excl. housing, fruit and vegetables	2.1	-1.9	2.0	-1.5	5.1	3.1	4.1	Sep	
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.5	0.7	-0.3	0.9	2.4	6.4	4.4	Sep	
Index of housing prices	-2.5	0.4	-14.9	-4.8	6.4	14.0	10.1	Sep	
Wholesale price index	7.6	2.4	7.7	4.0	6.3	6.7	6.5	Sep	
NIS/\$ exchange rate	-1.2	-1.7	-13.1	-1.2	15.2	4.9	9.9	Sep	
NIS/currency-basket rate	1.8	-1.7	-1.4	-3.5	4.3	5.0	4.7	Sep	

^a 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			Aug 04–	Apr 05–	Last month for which data available
		III	IV	I	II	III	Sep 05	Sep 05	
Rates of change	Change from preceding period						During period		
M1 ^a	18.0	21.4	1.4	17.3	23.4	25.5	15.5	24.6	Sep
M2 ^b	4.2	7.7	5.7	7.7	6.3	7.4	4.9	6.5	Sep
M3 ^c	4.6	5.7	5.1	9.9	8.8	13.3	8.3	10.8	Sep
Nondirected bank credit	1.2	-0.6	0.4	-2.1	0.8	3.8	0.4	2.6	Sep
Unindexed local-currency credit	5.6	6.6	11.7	15.5	6.3	8.0	9.3	6.5	Sep
CPI-indexed credit	0.0	-4.0	-6.9	-8.1	1.5	5.6	-1.5	3.9	Sep
Credit in and indexed to foreign currency	-2.8	-5.2	-4.3	-17.1	-8.7	-5.6	-9.7	-5.6	Sep

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

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

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

SOURCE: Bank of Israel.

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

	2004	2004		2005			Apr 05–	Last month for which data available
		III	IV	I	II	III	Sep 05 ^a	
Nominal interest on								
SRO deposits	3.1	3.1	3.1	2.7	2.7	2.7	2.7	Aug
Nondirected local-currency credit	6.8	7.0	6.8	6.3	6.2	5.8	6.1	Jul
Effective local-currency credit	4.4	4.3	4.2	3.7	3.7	3.6	3.6	Sep
LIBID 3-month dollar interest	1.5	1.6	2.2	2.7	3.2	3.6	3.4	Sep
Yield to maturity on								
Treasury bills	4.8	4.8	4.6	4.2	4.0	4.2	4.1	Sep
Ten-year bonds (CPI indexed)	4.2	4.3	4.2	3.8	3.7	3.5	3.6	Sep
Five-year bonds (CPI indexed)	3.8	3.8	3.6	3.1	3.0	2.7	2.8	Sep
Risk premium ^b	0.6	0.6	0.4	0.4	0.3	0.3	0.3	Sep
Expected inflation	1.4	1.3	1.5	1.8	2.1	2.4	2.2	Sep
General Share-Price Index (change)	17.4	-9.7	12.5	6.6	-1.2	13.2	11.8	Sep

^a Compared with April 2004–September 2004.

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

SOURCE: Bank of Israel.

Part 2: Broader Review of Selected Issues

Preliminary analysis of the government's budget for 2006 and a multi-year projection of developments in the budget

Based on a preliminary analysis of the proposed state budget for 2006, which was presented to the Knesset at the end of October, it appears that if it is approved, the government is likely to meet its budgetary objectives in 2006, as it did in 2004 and probably also in 2005. The macroeconomic assumptions underlying the budget proposal largely match recent economic developments, projected income is compatible with the macroeconomic assumptions, and the budgeting of expenses is consistent with the multi-year growth ceiling (a real rate of one percent), while maintaining an appropriate reserve for unexpected developments. Moreover, the 2006 budget proposal and the decisions made by the government regarding its budgetary framework and its components for the coming years, position it on a course that will lead to a continuing reduction of the deficit, of the proportion of public expenses in the GDP and of the public debt to-GDP ratio. Achieving these objectives is important for positioning the economy on a path of sustainable growth, while reducing the financing costs of the public sector. At the same time, in order to achieve these objectives, it is necessary that the government and the Knesset adhere to the course decided upon, and that the government also implements its existing budgetary decisions for the coming years.

The 2006 Budget

The income projection in the 2006 budget is based on a projected growth of about 4 percent, similar to that of the Bank of Israel (see below). The budget projection is that income from taxes in 2006 will total NIS 169.2 billion, and that total income (excluding credit) will reach NIS 211.5 billion. The projection according to the tax model of the Research Department regarding income from taxes is very similar, as is the overall-income projection. From this it follows that if the macroeconomic assumptions underlying the projections are realized, it is likely that the government deficit will be within the vicinity of the objective of 3.0 percent of GDP, even in the event that the budget is fully

spent.⁶ The deficit objective for 2006 (which includes the costs of the Disengagement Plan) is less than the objective for 2005 (3.4 percent of GDP), but slightly higher than the actual expected deficit this year.

The ceiling of expenses in the 2006 budget is consistent with the government's decision that the real growth rate of its expenditures (including the provision of credit) for the years 2005-2010 will be one percent per year. The nominal growth rate of expenditures compared with the original 2005 budget, is 1.7 percent. Taking into account the expected rise in prices in 2006 of about two percent, and in light of the fact that the average price rise in 2005 was actually less than the budgetary projections by slightly more than one percent, the increase of the expenditure ceiling does in fact meet the objective.⁷ While the experience of recent years shows that the government does not deviate from the expenditure ceiling determined in the budget, during some of the years considerable budgetary adaptations were required during the year, and sometimes even at the beginning of the year, to prevent these deviations. It is thus of great importance for the budget to include sufficient reserves to meet unexpected needs and negative macroeconomic developments that reduce income—without the need for large-scale adaptations during the year which harm the operational efficiency of the government ministries and the various bodies that are budgeted. In this context, it appears that the 2006 budget provides the government with sufficient maneuverability to enable it to weather “surprises” to a reasonable extent. Admittedly, a large part of the reserve appearing in the budget is already earmarked for specific purposes, but beyond this there is an additional reserve within the ministries' budget of about one-and-a-half percent that is available to meet the deficit objective. Furthermore, it appears that the budgeting of the interest item is such that not all the budget needs to be spent during the year if income is less than expected—or alternatively it allows to allocate resources to other items if expenditures are required for unexpected needs.

⁶ The Bank of Israel's projected income from taxes assumes growth of 4.3 percent in the gross domestic product, an average real salary growth of 1.9 percent for a salaried post, a real growth of 4 percent in imports of consumer goods and stability of the NIS/dollar exchange rate at a level of about NIS 4.6 to the dollar.

⁷ For a detailed explanation of the calculation of the expenditure ceiling in the budget, see Chapter 3 of the Research Department's section of the 2004 Bank of Israel Report (pp. 172-173).

Multi-Year Projection from 2006 to 2010

a. Structure of the analysis and the major assumptions

The projection for 2006-2010 is based on the multi-year budgetary framework of the Research Department of the Bank of Israel⁸ and on estimates of implementation of the 2005 budget. The projection is based on government decisions regarding specific steps in the state budget in the coming years, and examines the compatibility between these steps and the government's deficit and expenditures objectives. The projection is based on many assumptions, as detailed below. In order to examine the sensitivity of the conclusions to changes in the assumptions, an analysis is also presented for alternative assumptions.

The major assumptions of the analysis are:

- Real GDP will grow in 2006 by 4.3 percent, and by 4.0 percent per annum in the years 2007-2010. The expected rate of growth is based on employment growing faster than the growth in the labor force, such that unemployment will attain its natural rate (about 6.5 percent) in 2010, and on an annual growth of 1.34 percent in labor productivity, similar to that averaged over the past thirty years.
- Expenses connected to the Disengagement Plan will terminate in 2006.
- The real wage in the economy will increase at the same rate as labor productivity.
- The real yield on the bonds that the government will issue from 2006 will be 4.0 percent, similar to the average of the past decade (6.5 percent on 10-year unindexed bonds).
- The government will stand by its decisions to freeze the number of its employees and the nominal budgets in the public sector. Furthermore, the rate of increase of the public consumption deflator (excluding education and health) will be similar to that of the consumer price index.
- Various private laws whose implementation was postponed in the past, and which are supposed to come into force in the coming years, will again be postponed.
- The civilian assistance from the United States Government will be reduced according to the multi-year agreement by 120 million dollars a year, and the defense assistance will be increased by 60 million dollars a year.

- Income from taxes, after deducting legislative changes, will increase with an elasticity of 1.1 in relation to the growth in GDP from 2007 onward, similar to its growth in the past 15 years. Income for 2006 is estimated using the Research Department's tax model, as detailed above.
- The tax reforms and reductions in the other taxes, including reducing employer and self-employed payments to the National Insurance Institute will be executed as planned. VAT will be reduced to 16 percent in January 2007.
- The NIS/dollar exchange rate will be NIS 4.7 at the end of 2006 and NIS 4.8 at the end of 2007. The CPI will increase by 2 percent per annum.
- Education and health expenses will increase according to changes in the size and composition of the relevant populations. The quantitative growth of these services—for all service recipients—will be according to the growth in labor productivity. The total factor productivity will not change, and the rate of growth of wages per employee in education and health will be similar to that of the average wage in the economy. The cost of implementing the conclusions of the Dovrat Committee will be set off against other expenses.
- The indexation differentials on bonds issued by the government since 2001 will be recorded as a budget expense on the date of redemption.
- No additional privatizations will be undertaken in the coming years.
- The balance of issues covered by the guarantees of the United States Government will be spread equally over the years 2006-2008. The risk premium costs (scoring) paid in this respect will be recorded in the budget, spread over 20 years.

One of the major difficulties in the projection is that of assessing the development of the defense budget in the coming years. Recently the State Comptroller also pointed to a significant gap between interpretations by the defense system and by the Ministry of Finance regarding the course of the defense budget derived from government decisions, and from decisions made by the prime minister in the past. In practice, decisions regarding the size of the defense budget are made almost every year in discussions with the prime minister. Thus the projection of the defense budget in this analysis is not based on existing decisions, but rather on the assumption that under conditions of stability in the security situation, the defense budget will grow by 0.6 percent in real terms in 2007 (reflecting the increase in security assistance), and by half a percent per annum from 2008 to 2010. From this figure we deduct the across-the-board cuts decided on by the government, the costs of the Disengagement Plan and the costs of building the separation fence.

⁸ For a detailed description of the structure of the system, which is continually updated, see Jakob Braude and Adi Brender (2003), "The Impact of the Economic Program on the Government Budget in the Years 2003-2008", Bank of Israel, Position Paper.

A further important component of the projection is the estimate of execution of the 2005 budget. In view of the fact that the proportion of the budget spent in December has grown considerably in the past two years, and also that the rate of annual expenditure within the budget has changed, uncertainty surrounds the total end-of-year budget expenditure even at this late stage of the year. The present analysis is based on the assessment that by the end of the year government expenditure will total about NIS 221 billion (gross, excluding credit), which is about 98.5 percent of the original budget, and that the government deficit will reach NIS 15.5 billion, which is 2.8 percent of the GDP. Despite the expected deficit, the budget financing plan to the end of the year published by the government includes significantly less net borrowing than the deficit, even when taking into account expected receipts from privatization.⁹ This will result in a reduction of more than two percentage

points in the (gross) public debt-to-GDP ratio at the end of 2005 (compared with the end of 2004).

b. The basic scenario—maintaining the expenditure ceiling

This scenario assumes that the government will increase its expenditure by one percent a year, in real terms, from 2006 to 2010. According to the expenditure projection compiled on the basis of specific decisions that the government has already made, it seems that the magnitude of the additional steps required to meet this objective in 2007 as well will be about NIS 1.6 billion. Furthermore, on the basis of the above assumptions regarding the development of the defense budget, it will be possible to maintain the expenditure ceiling in 2007 with an increase of more than two percent in non-interest civilian expenditure—beyond the rate of population growth. Similarly, in 2008 as well no large-scale adjustments will be required to maintain the expenditure ceiling (Table 10). Large-scale steps will, however, be necessary in the following two years, among others, because the government has still not decided about specific steps to contain expenditure for this period.

⁹ The government is legally entitled to make use of its deposits in the Bank of Israel to finance the deficit.

Table 10. The Expected Path of the Main Budget Aggregates Under Different Scenarios, 2002 to 2010 (percent of GDP)

	2002	2003	2004	Estimate 2005	Forecast 2006	Forecast 2007	Forecast 2008	Forecast 2009	Forecast 2010
Scenario of adherence to the expenditure target									
Total revenue (excluding repayment of credit)	39.2	37.1	37.0	37.2	36.2	35.6	35.3	35.1	34.6
<i>Of which:</i> tax revenue	30.2	28.9	29.1	29.8	29.1	28.8	28.6	28.4	28.0
Expenditure (excluding credit granted)	43.0	42.7	40.8	40.1	39.1	37.8	36.8	35.7	34.7
Deficit, excluding credit	-3.8	-5.6	-3.8	-2.8	-2.9	-2.3	-1.4	-0.7	-0.0
The public debt, gross	104.4	106.4	105.5	102.0	99.6	97.0	93.4	89.2	84.6
<i>Of which:</i> government debt	101.8	103.8	102.9	99.5	97.3	94.8	91.3	87.2	82.7
Extent of additional steps required to keep below the expenditure ceiling	-	-	-	-	-	0.3	0.5	1.4	1.9
Scenario of adherence to the expenditure target, with 3 percent growth from 2006									
Expenditure (excluding credit granted)	43.0	42.7	40.8	40.1	39.5	38.7	37.9	37.2	36.5
Deficit, excluding credit	-3.8	-5.6	-3.8	-2.8	-3.0	-2.8	-2.4	-2.0	-1.8
The public debt, gross	104.4	106.4	105.5	102.0	100.8	99.6	97.8	95.6	93.4
Scenario of 2 percent a year rise in expenditure									
Expenditure (excluding credit granted)	43.0	42.7	40.8	40.1	39.1	38.2	37.5	36.8	36.1
Deficit, excluding credit	-3.8	-5.6	-3.8	-2.8	-2.9	-2.7	-2.2	-1.7	-1.5
The public debt, gross	104.4	106.4	105.5	102.0	99.6	97.4	94.5	91.4	88.1
Scenario of tax reduction and adherence to deficit of 3 percent of GDP every year									
Total tax revenue	30.2	28.9	29.1	29.8	29.1	28.1	27.2	26.2	25.0
The public debt, gross	104.4	106.4	105.5	102.0	99.6	97.7	95.5	93.5	91.7

SOURCE: Bank of Israel

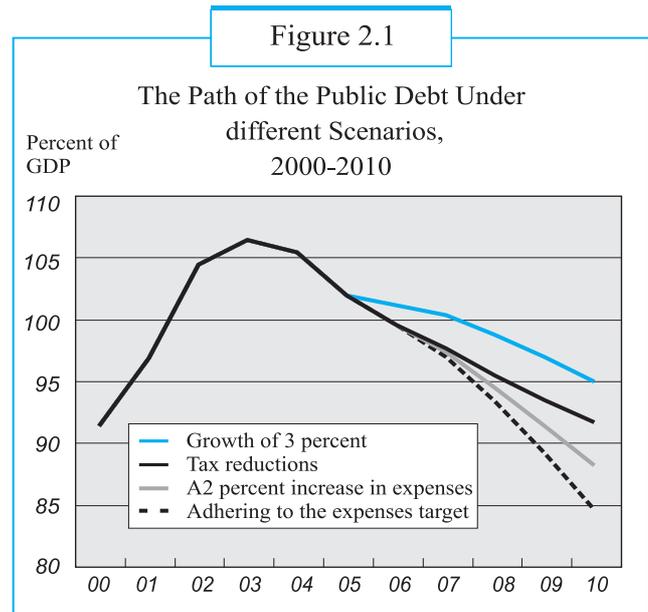
Adhering to the expenditure ceiling at the growth rates assumed in the scenario will enable a significant reduction in the share of government expenditures in GDP. In 2010 this rate is expected to reach about 35 percent of GDP, six percentage points lower than in 2004 and eight percentage points lower than in 2002. The significant decline in the share of public expenditures in GDP will facilitate a continual reduction in the deficit despite the considerable reductions in tax rates decided by the government and the Knesset. According to this scenario it is expected that the government budget will be balanced in 2010, parallel to a 6.5 percent unemployment rate—the estimated “natural” rate. A reduction in the deficit will also facilitate a continual reduction in the public debt-to-GDP ratio (Figure 2.1) to about 93 percent of GDP in 2008 and about 85 percent of GDP in 2010. The realization of this scenario is, of course, dependent on the implementation of existing government decisions on limiting the pace of expenditures growth and on taking new decisions to ensure that the expenditure ceiling in the years 2008-2010 will also be maintained. Reducing the deficit to levels significantly lower than the ceiling of 3.0 percent of GDP will increase the government’s ability to undertake long-term planning of its expenditures in various areas of its activity, as it did regarding the budgeting of investments in railways, the road infrastructure, children’s allowances, and in financing the pension funds’ deficits.

c. Alternative scenarios

In order to estimate the sensitivity of the multi-year projection to assumptions regarding the rate of growth and the policy courses, three alternative scenarios were examined. The first scenario assumes GDP growth of only 3 percent in each of the years 2006-2010. According to this scenario, the deficit in 2009 and 2010 will reach more than 2 percent of GDP even if the government does not deviate from its expenditure objective. In this case, the public debt-to-GDP ratio in 2010 is expected to be 95 percent, still above its 2000 level (Figure 2.1). This analysis emphasizes the considerable impact of macroeconomic developments on policy outcomes.

The second scenario examines the implications of a change in the expenditure ceiling, starting from 2007, such that it will grow by two percent per annum as opposed to one percent. As a result of this change, the deficit in 2010 will reach 1.5 percent of GDP, even if GDP grows by four percent a year over the whole period, and the public debt-to-GDP ratio will reach 88 percent. The proportion of public expenditure in GDP according to this scenario will reach 36 percent, about 1.5 percentage points higher than the basic scenario.

The third scenario reflects a policy in which the government consistently reduces tax rates while maintaining a deficit ceiling of 3.0 percent of GDP and does not deviate from the expenditure ceiling. According to this scenario, the tax burden will be significantly reduced over the period, and the total of government taxes (excluding National Insurance



payments and health tax) will reach 25 percent of GDP, in comparison with 30 percent of GDP in 2002. At the end of the period, the tax burden in Israel according to this scenario will be significantly lower than in most developed countries. But, as a result of this policy, the public debt-to-GDP ratio will decrease far less than in the basic scenario, and will reach 92 percent in 2010—despite the rapid growth from 2006-2010 and a low rate of unemployment. Moreover, if a policy is adopted of not reducing the deficit below the threshold of 3 percent of GDP throughout the period, then if the rate of growth of GDP is three percent on average, the debt-to-GDP ratio in 2010 will be more than 96 percent.

From these scenarios it emerges that if the government meets the budgetary objectives for the years 2006-2010, it will be possible to significantly reduce the public debt-to-GDP ratio and the proportion of public expenditure in GDP, keeping these within the acceptable level in the developed countries. Furthermore, the tax reductions that have already been approved are expected to continually reduce the tax burden, a situation which is likely to continue if the expenditure ceiling is maintained. By these means the government can continue to support sustainable GDP growth in the coming years.

Estimate by the Central Bureau of Statistics of Real Growth in 2005 and Projection for 2006

According to the preliminary estimate of the Central Bureau of Statistics, the gross domestic product in 2005 is expected to grow by 5.1 percent. The business sector gross product is expected to grow at a rate of 6.4 percent, similar to its 2004 growth rate, from which we can conclude that the accelerated

Table 11. Economic Indicators, 2003 to 2006

	2003	2004	2005 CBS forecast	2006 forecast
Sources and uses				
	(volume change, ^a percent)			
1. GDP	1.7	4.4	5.1	4.3
2. Business-sector product	2.5	6.3	6.4	5.4
3. Private per capita consumption	-1.0	3.2	1.6	2.4
4. Public consumption excluding defense imports	-1.1	-1.9	2.8	1.1
5. Investment in fixed assets	-4.4	-0.2	0.3	4.5
6. Domestic uses excluding defense imports	-1.2	3.1	3.8	3.9
7. Goods and services exports	7.5	17.4	6.5	6.5
8. Civilian imports	-0.9	12.9	3.6	5.6
Balance of payments				
	(\$ billion, at current prices)			
9. Civilian import surplus, goods and services	-0.1	-1.3	-0.9	-0.5
10. Current-account deficit	-0.4	-1.5	-1.4	-1.2
Population, employment and prices				
	(percent change)			
11. Average population	1.8	1.8	1.8	1.7
12. Unemployment rate (percent of labor force)	10.7	10.4	8.8	8.4
13. Total number of Israelis employed	2.0	3.0	4.2	2.8
<i>Of which: In business sector</i>	2.3	4.3	4.1	3.4

^a At 2003 prices

growth relative to 2004 is a result of the change in the output of public services, which is expected to increase, as opposed to a decrease in previous years. The projected growth for 2006 was updated on the basis of the preliminary estimate of the Central Bureau of Statistics for 2005.¹⁰

The assumptions underlying the growth projections for next year are:

- The relative calm in the security situation will continue.
- The growth rate of world trade and the GDP in the developed countries will be similar to those of 2005.
- The external terms of trade will worsen, although relatively less than the worsening in 2005, mainly as a result of stabilization in fuel prices.
- Fiscal policy will be more restraining than in 2005, especially regarding defense expenditures, according to the government's objectives, and despite the fact that 2006 will be an election year. The planned tax reductions will be implemented in full.

¹⁰ The Central Bureau of Statistics estimate is based on initial growth data for 2005, partial data for the third quarter, and projections of developments in the last quarter of 2005. According to the Bank of Israel's projection, the growth in gross domestic product in 2005 is expected to be half a percentage point lower. The major difference is a result of a lower growth of domestic public consumption and a higher growth of civilian imports.

- Real interest rates will increase as a result of local and international developments.
- The number of foreign workers will remain unchanged.

The growth projection of the gross domestic product in 2006 is 4.3 percent, and the projected growth rate of the business-sector gross product is 5.4 percent. The expected decrease in the rate of growth of the business-sector gross product is a result of the gradual closing of the output and unemployment gaps, which will lead to a growth in the demand directed toward imports. The closing of the GDP gap and the growth trends abroad are expected to cause an increase in real interest rates in Israel and abroad. The decrease in the expected growth rate of the business-sector gross product (relative to 2005) can be explained by the slow growth of public consumption expenditure, especially for domestic purchases, and the influence of negative income resulting from continued worsening in the external terms of trade.

Exports (excluding diamonds) in 2006 are expected to grow at a lower rate than in 2005, and slightly less than the projected growth of world trade. The reason for this is the freeze in exports during 2005: during 2006 exports are expected to grow at a relatively rapid pace. The relative contribution of exports to GDP is expected to continue to rise, thanks to the continuing growth in the export of services (including tourism services).

Private consumption, whose rate of growth was checked to some extent in the first half of 2005, is expected to grow

in 2006 at a similar rate to that of 2004. The relatively high rate of growth, more than two percent per capita each year, is supported by the tax reductions and the continuing improvement in the labor market—in salaries and in employment. The planned reduction of the direct tax will focus on the average income level in which the marginal propensity to consume is relatively high. We thus assumed that about half of the planned VAT decrease will be directed to a growth in private consumption. Taken together, these tax reductions will contribute to a growth in consumption of about half a percentage point. The continuing economic recovery and the decreasing unemployment rate contribute to stabilizing the growth trend in current consumption.

Until now the recovery process was accompanied by only a slight increase of investment in the different sectors of the economy, and investment in residential buildings even declined, as opposed to recovery processes in the past. These developments took place despite the fact that in 2005 the capital market offered a substantial volume of financing resources, and at a relatively low price. We assumed that a positive turnabout would already take place in investment during 2005, and especially in residential building. The rate of investment in economic branches in the GDP is very low, and the pace of residential building starts in 2005 is less than the projected (net) increase in households. It thus seems that the current investment is below its reasonable level. The

continuing recovery process will reduce the uncertainty in the economy and will also contribute to a significant change in investment.

The assumption underlying the projection regarding the development of domestic public consumption is that the rate of growth will be low relative to 2005, in line with the government's expenditure objective, despite the expense of the expected elections and payment arrears connected to the Disengagement Plan. The decline in per capita public consumption will continue, and the rate of growth in the number of employees in the public services will be less than the growth of the labor force.

The major assumption on which the projection is based is that the security situation will remain stable. A deviation from this assumption, as expressed in an increasing number of terror attacks and of people injured in these attacks, will have an immediate adverse effect on the tourism industry and thus on private consumption and on investments. In this situation, the growth projection for 2006 is liable to be about 2 percent lower than that presented here, depending on the intensity of the events. The reason for this is that per capita private consumption will grow at a very low rate, which will lead to a drop in the GDP by one percent, while the expected decline in tourism and in investment in the various branches of the economy (instead of the projected increases) will each cause a decline in GDP of about 0.5 percentage points.

Events from January–June 2005

Month	Date	Event	Details
May	2	Prof. Stanley Fischer, eighth governor of the Bank of Israel, takes up his position.	
	16	The Prime Minister approves the draft of the main recommendations of the “Gadish Committee” for reforming the Israel Lands Administration.	<p>The committee’s main recommendations:</p> <ul style="list-style-type: none"> - To transfer urban residential land rights to the owners of apartments and private homes. - To expedite arrangements and registration procedures regarding land rights. - To institute a uniform land policy over the Administration’s lands. - To increase transparency and to simplify land policy. <p>The decision to transfer rights to apartment and home owners has to be approved by the government and by the Israel Lands Administration Council in order for it to be implemented.</p>
	17	Implementation commences of the licensing system for employing foreign workers in the building sector.	38 corporations have obtained licenses to operate as labor contractors for employing up to 400 foreign workers (for each corporation).
	23	The Deputy Prime Minister, the Minister of Finance, and the Minister of Housing and Construction decide on a campaign to assist home buyers in the Negev and the Galilee.	<p>The assistance will be given to people eligible for assistance to enable them to purchase housing in settlements in the Negev and the Galilee that are included in national preferential areas A and B.</p> <p>The campaign will commence on June 1, 2005 and terminate on October 31, 2005.</p> <p>The assistance will take the form of a grant to families purchasing apartments in multi-storey buildings: NIS 25 thousand in Area A, and NIS 20 thousand in Area B.</p>
	24	A framework agreement was signed for promoting joint R&D ventures between Israeli and Chinese companies.	As part of the agreement signed in Beijing between the Office of the Chief Scientist of the Ministry of Industry and Trade and the Scientific-Technological Parks Authority of Tsinghua University, it is stated that joint projects will enjoy the support of both parties.
June	9	The exchange-rate band against the basket of currencies was cancelled.	<p>The Governor of the Bank of Israel, the Minister of Finance, and the Prime Minister decided to cancel the exchange-rate band.</p> <p>Since 1997 the Bank of Israel has not been required to intervene in order to protect the band, whose boundaries have been ineffective for years.</p>
	22	The Ministerial Disengagement Committee approved the granting of bridging loans for businesses that will transfer their operations from the vacated area.	The Disengagement Authority (SELA), through the Investments Center of the Ministry of Industry, Trade and Labor, will provide bridging loans for transferring the activities of businesses from the areas to be vacated to within Israel.

Month	Date	Event	Details
June	26	An agreement was signed between the state and the fuel companies for the privatization of the “Pi Glilot” company.	According to the agreement, the activity in the company’s three installations—in Jerusalem, Ashdod, and Be’er Sheva—will be sold through a tender process. This will enable bidders to present proposals for purchasing each installation separately or all together. The highest proposed amount will determine the nature of the sale—jointly or separately.
	29	The Minister of Finance directed the Accountant General to initiate preparations for issuing a tender for selling the controlling interest in Bank Leumi.	
July	14	An order was issued for freezing proceedings and for drawing up a restructuring program for the “Clubmarket” chain.	The collapse of the chain, because of heavy debts to suppliers, could have ramifications for the wholesale food market, and for the chain’s approximately 3,500 employees.
	25	“Teva” announced the purchase of the American company “IVAX” for 7.4 billion dollars.	As a result of the purchase, “Teva” becomes the largest generic company in the world, with sales of 7 billion dollars and 25 thousand employees.
	26	The Knesset approves the “Bachar Report” for bank reform.	The major aspects of the report are: 1. The gradual sale of all the banks’ holdings in provident funds and mutual funds according to the size of the bank. 2. Allowing the banks to charge distribution fees on provident funds, mutual funds and pension funds. 3. Allowing the banks to distribute life insurance and pension insurance.
	26	The Knesset approved the Tax Reform Bill.	The essence of which is: 1. Gradually reducing the tax rate on individuals from 49 percent in 2006 to 44 percent in 2010. 2. Reducing the rate of company tax from 34 percent in 2006 to 25 percent in 2010. 3. Reducing VAT from 17 percent to 16.5 percent on September 1, 2005. 4. Raising taxes on individuals in the capital market on January 1, 2006 from 15 percent to 20 percent, as well as additional tax benefits, among which a tax exemption on the purchase of an apartment up to the sum of NIS 550,000, accelerated depreciation on machines and equipment, and an increase in old-age allowances.
	26	3.5 percent of Bank Leumi shares were sold for NIS 611 million.	In the wake of the sale, the state’s holdings in Bank Leumi fell to 20 percent.
August	7	The Minister of Finance, Binyamin Netanyahu resigned, and Minister Olmert was appointed as Acting Minister of Finance.	

Month	Date	Event	Details
August	15.8- 12.9	The process of disengagement from the Gaza Strip was implemented and the area transferred to Palestinian control	
	30	Hurricane "Katrina" strikes southern states of the United States in the Gulf of Mexico	The hurricane causes many casualties and damage to property, as well as inflicting damage on the oil industry in the region.
September	1	VAT is reduced by 0.5 percent to 16.5 percent.	As part of the tax reform, financial institutions and NGOs will continue to pay VAT of 17 percent.
	29	750 million Euro was raised through a government bond issue in England.	The amount raised was almost double the planned amount, and was executed at a relatively low interest rate of 3.78 percent.