RECENT ECONOMIC DEVELOPMENTS*, 104

Second Half of 2003

Main developments

In the second half of 2003 (the period reviewed) business-sector activity showed signs of recovery, based on a rise in exports and private consumption. The increase in demand seems to have gained strength in the fourth quarter, with most of the economic indicators available at this stage pointing to a faster rise in that quarter than in 2003:III. Nevertheless, despite signs of a turnaround, manufacturers' behavior showed their uncertainty regarding the strength and stability of the improvement. The GDP growth rate—1.2 percent in the whole of 2003, of which 0.8 percent was in the second half of the year—is below the growth that could have been achieved with the stock of capital and labor, so that the output gap (the gap between potential and actual GDP) widened. Per capita GDP fell for the third successive year.

The rise in demand derived from two sources: the first was GDP growth in the advanced economies after a long slump, that boosted world trade and also increased Israel's exports; the second was related to the reduction in economic uncertainty together with a certain improvement in the security situation during the year. These raised private consumption both directly, by increasing the public's welfare, and indirectly, via their effect on the financial markets, and in particular on the exchange rate, prices, real interest, and the public's wealth. The drop in economic uncertainty was the result of a decisive economic policy, which on the one hand acted to restore credibility to fiscal policy and enabled monetary restraint to be eased, but on the other may have prevented a faster rise in activity.

The trend change in business-sector activity was most clearly visible in the advanced and service industries, the first due to the rise in world demand, and the second to the increase in private consumption. In the course of the period some recovery in tourism was also evident, although activity remained at a low level, but against this the recession in the construction industry became even more severe. Companies' profitability improved in 2003, after two years of continual losses, particularly in those industries in which there were positive expectations regarding future activity. Manufacturers' behavior reflects uncertainty with regard to the strength and robustness of the recovery in activity. Hence, in the light of the economy's surplus production capacity and the high rate of real interest in most of the year, they reduced their investments in 2003:III too, although preliminary indicators (such as capital goods imports and machinery and equipment production) suggest that the trend in investments changed towards the end of the year, with a rise in 2003:IV. In addition, in 2003:III the decline in the number of hours worked and in the number of employed persons halted, and in 2003:IV they actually rose a little. Nonetheless, despite these first indications of growth, economic activity was at a low level, and the rate of unemployment remained high, 10.7 percent, in 2003:III.

In the period reviewed budgetary restraint was exercised as a result of the program to revitalize the economy adopted by the government immediately after its formation and updated several times in the course of the period (until the 2004 budget was passed). The economic program placed much emphasis on immediately reducing the deficit and on measures expected to lead to its permanent reduction, and it therefore boosted the credibility of the fiscal policy and placed the economy back onto a declining budget-deficit path. Despite fiscal restraint and the reduction of public consumption in the period reviewed, the public-sector debt for the whole of 2003 was high, 5.6 percent of GDP, mainly due to the sharp fall in tax revenue resulting from the low level of activity. A trend change was evident in this variable too, however, with tax revenue rising in the second half of the year.

Several public issues were subject to serious public debate in the period reviewed, most arising from the economic program. Some focused on the negative effects of the cuts in transfer payments on the situation of the weaker segments of the population, and some derived from the undermining of labor relations in the public sector due to the effect of the program on employment and wages in that sector and the new pension arrangements affecting members of the old Histadrut (Labour Federation) pension funds. It is relevant to observe that many labor-related decisions were made unilaterally by the government, leading to disruptions in economic activity and to tortuous negotiations with the Histadrut that dragged on until agreement was reached only at the beginning of 2004. The restoration of trust and calm in labor relations in the public sector is a prerequisite for stability and sustainable growth.

For diagrams (bilingual) please turn to Hebrew section.

Developments in the money and capital markets also indicated reduced uncertainty and increased confidence in economic policy. The CPI went down by 1.9 percent in 2003—with a reduction of 1.4 percent in the period reviewed—mainly due to the low level of demand and the appreciation of the NIS in 2003:II. The fall in the CPI and the stabilization of inflation expectations within the target range enabled the Bank of Israel to accelerate the pace of cuts in the interest rate in the second half of the year without adversely affecting the stability of the financial markets. The NIS/$ exchange rate remained steady for most of the period reviewed, reflecting the easing of geopolitical and economic uncertainty. The fall of bond yields and the flattening of the yield curves of unindexed bonds also reflected the easing of uncertainty and the lowering of both the short-term and the long-term risk premiums. The General Share Price Index rose by 11.2 percent in the second half of the year, and by about 50 percent over the year as a whole. This derived from the recovery of capital markets abroad, and from the revival of real activity (expressed by a rise in companies' profits), and was the main reason for the real rise of 13 percent in the public's financial assets portfolio.

The national accounts and the principal industries

GDP rose by 1.2 percent in 2003, after falling by 0.8 percent in 2002 and by 0.9 percent in 2001 (Table 1). The GDP growth rate increased gradually as the year progressed, from an annual rate of 1.2 percent in the first half to 1.7 percent[1] in the second (preliminary estimates.[2] The recovery in activity was based on the growth in the global economy, the pace of which increased during the year, and on the rise in private consumption against the background of the relative calm in the security situation. Economic policy in the second half of 2003 acted to restore fiscal credibility and enabled the gradual easing of monetary restraint, both of which supported the turnaround in activity. Nevertheless, in the light of the volatility of the capital markets in the past, the process of reducing the interest rate was a gradual one, with emphasis on the stability of the financial markets. The recovery of domestic demand may indeed have been relatively moderate due to this caution—as a result of which ex-post real interest[3] remained relatively high throughout the period reviewed—and also due to the restraining effect of the budgetary cuts.

The trend reversal of activity in the second half of the year was evident in other indices too: the composite state-of-the-economy index rose at a modest rate of 0.6 percent in 2003:III after falling continuously during the three previous years, and in 2003:IV it rose by 1.8 percent (Table 2 and Figure 1). The rise in this index was the result of a turnaround in most of the components of the index in the third quarter, especially manufacturing production, revenue in the commerce and services industries (which had already risen in the second quarter), imports, and goods exports (Figure 2; the development of these components is described in detail below). Despite the continued positive development shown by most of the indices in the last quarter of the year, and despite some acceleration in the rate of growth derived from them, the Bank of Israel Companies Survey indicates that total economic activity stabilized in 2003:IV after rising in the previous two quarters; the survey does, however, report positive expectations in nearly all industries that activity will rise again in 2004:I.

Domestic uses rose in 2003:II by 4.2 percent, and in 2003:III by 14.8 percent; this follows their contraction ever since the beginning of 2000. Their rise was spearheaded by a sharp increase in private consumption in the second and third quarters (of 12.9 percent and 7.5 percent respectively), while public consumption fell in those quarters due to the implementation of the government's economic recovery program (detailed below in the section on the public sector), and gross investment continued to decline (Table 1). Goods and services imports (excluding diamonds) rose considerably in 2003:III, by 11 percent similar, to the rise in 2003:II, and exports turned and rose sharply by 35.5 percent, mainly services exports.[4] (The development of imports and exports is described in detail in the section on the balance of payments.) Thus total uses rose by 9.6 percent in 2003:III, after declining by 2.9 percent in the first half of the year. The Companies Survey shows clearly that despite the increase in demand, its persistent low level continues to be the main constraint on the expansion of activity.

[1] Henceforth all rates of change will be annual rates, unless stated otherwise.

[2] The quarterly and half-yearly National Accounts data are subject to wide volatility caused in part by security-related incidents, strikes and work sanctions during the year. In any event, these are preliminary estimates as stated, to be updated when final data are available.

[3] Short-term nominal interest *minus* the actual rate of price increases.

[4] The gap between the steep growth rate of services exports according to the National Accounts and their relatively moderate rise according to foreign trade data is unexplained at this stage, and will apparently only be clarified when final data are published.

Table 1. National Accounts,[a] 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[b] Jul–Dec	Last month for which data available
GDP	–0.8	1.2	–0.3	3.1	–1.2	2.8		1.1	9
Business-sector product	–2.8	1.5	–0.9	4.7	–0.8	3.1		1.5	9
Business-sector product excl. start-ups	–1.8		–0.3	6.2	–1.1	2.1		1.7	9
Private consumption	0.1	2.0	3.0	–4.9	12.9	7.5		4.4	9
Gross domestic investment	–12.4	–13.6	–23.5	–35.7	10.1	–2.4		–14.7	9
Gross domestic investment excl. start-ups	–9.4		–21.5	–31.7	22.7	–36.4		–19.6	9
Goods and services exports	–3.0	5.5	10.2	9.6	–11.9	35.5		9.6	9
Goods and services exports excl. start-ups and diamonds	–6.8		11.9	9.6	–12.5	36.5		10.0	9
Goods and services imports	–2.3	–1.9	3.4	–20.1	5.7	18.2		0.8	9
Goods and services imports excl. diamonds	–6.6		–4.7	–11.3	12.4	11.1		1.4	9
Public-sector consumption	5.7	–1.0	–0.9	1.2	–9.8	1.5		–2.1	9
Public-sector consumption excl. defense imports	5.1		1.7	–1.3	–4.4	2.6		–0.4	9

[a] Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.
[b] Compared with July-December 2002.
Source: Central Bureau of Statistics.

After remaining static in 2002, private consumption rose by 2 percent in 2003, reflecting as stated a sharp rise from the second quarter. Other indicators of private consumption present a similar picture: goods imports for current consumption were 8.2 percent higher in the second half of the year than in the second half of 2002 (Table 4), and the revenue of commerce and services industries rose (as detailed below).[5]

The rise in private consumption is apparently related to optimism prevailing in the economy, particularly in 2003:II, which was also expressed by consumers' conduct in the financial markets. It was also affected by the downward trend of real interest and by the 13 percent real increase in financial assets in the course of the year[6] (described more fully in the section on the capital and money markets). The upward trend in private consumption was supported by price reductions during the year that increased real purchasing power, and by the expectation that the reductions would continue for a long while. On the other hand, private consumption is also affected by disposable income, and this fell during the year due to the high unemployment rate, the erosion of wages and the cutbacks in transfer payments. The rise in private consumption was also expressed by a decline in the private savings rate during the year, a continuation of the monotonic decline in this rate since 1999.

Despite the signs of recovery in the period reviewed, the decline of gross investment, after four years of continuous contraction, continued and even intensified. In 2003:III investment also fell relative to its level in previous quarters (Table 1); investment in residential and nonresidential construction continued to go down (by 3.9 percent and 12.8 percent respectively), reflecting the persistent recession in the construction industry; investment in the principle industries fell by 13.6 percent in 2003:III, with a steep drop in stocks; and imports of capital goods also declined in that quarter, by 7.7 percent. It should be noted, however, that the reason for this sharp decline in capital goods imports was their exceptional rise (of 18 percent in monthly terms) in June, while in the

[5] A similar picture emerges from the "Index of the Population's Expectations" which indicates a rise in the public's expectations of an improvement in the economic situation from the second half of the year, following a continuous decline since the middle of 1999.

[6] A review of the factors influencing private consumption from 1968 to 2000 found that changes in disposable income explain about half of the fluctuations in private consumption, and the other half was explained by changes in the public's wealth and the short-term interest rate (Y. Lavi, Bank of Israel Economic Review 71, January 1999, and Israel Economic Review, Volume 1, No. 2, November 2003).

vegetables

Table 2. Indicators of Business Activity,[a] 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[b] Jul–Dec	Last month for which data available
State-of-the-economy index	–3.2	–2.2	–3.2	–2.8	–2.1	0.6	1.8	–1.3	12
Large-scale retail trade	–2.9	–2.6	–4.1	–7.6	–1.4	3.9	10.1	–0.7	12
Manufacturing production (excl. diamonds)	–2.3	–0.3	–0.3	–1.1	–2.7	1.6	12.4	0.7	11
Business-sector consumption of electricity	3.4	3.1	–1.0	0.1	10.2	5.2	–19.5	2.0	10
Index of revenue in commerce	–2.6	0.5	–4.8	–1.4	7.0	1.0	3.5	1.7	11
Index of total revenue	–1.2	–1.1	1.6	–9.2	5.9	6.3	1.4	1.8	11
Tourist arrivals	–27.9	22.1	8.7	22.8	39.0	20.8	5.8	38.9	12
Construction (change from equivalent period in previous year)									
Residential starts	1.9	–24.3	–18.7	–15.2	–14.0	–10.4		–11.4	10
of which: Government-initiated	5.6	–22.2	–18.5	17.8	–31.0	–2.3		–17.2	10
Residential completions	–0.7	–28.1	–33.8	–13.6	–12.5	–25.7		–23.8	10
of which: Government-initiated	22.0	–31.5	–22.6	–9.3	–10.6	–34.3		–35.9	10
Survey of companies (net balance, percent)[c]									
Output of manufacturing firms	–10	–5[d]	–16	–16	–9	2[d]	2[d]		12
Sales by commercial firms	–32[d]	2[d]	–20[d]	–24	31	12[d]	–10[d]		12

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

[b] Compared with July-December 2002.

[c] The net balance is defined as the difference between the number of firms reporting a rise and those reporting a decline, as a proportion of all reporting firms.

[d] Not significant at 5% level.

Source: Based on Central Bureau of Statistics and the Ministry of Construction and Housing.

last quarter of the year they remained steady, and based on trend data actually rose (Table 4).

The decline in investment over the whole of 2003, particularly in the second half of the year, is not surprising bearing in mind the surplus productive capacity in the economy and the high level of ex post real interest during most of the year. It was also due to the decline in domestic savings in both the private and the public sector as the deficit increased, and to the current-account surplus. At the same time the reduction of investments indicates the caution exercised by manufacturers due to the great uncertainty regarding the underlying strength of the recovery of activity.

Most of the indicators of the principle industries point to a change of direction in activity in the second half of the year. Manufacturing production, which contracted by 3 percent in the first half of the year, increased by 1.6 percent in the third quarter and by a further 12.4 percent in October and November (Table 2 and Figure 2). Manufacturers apparently increased production in a carefully controlled manner: output per hour of labor started rising monotonically as early as in 2003:I, partly as a result of companies' streamlining processes; hours worked per employee fell in the first half-year, stabilized in the third quarter, and rose slightly in the fourth, when the number of employees in manufacturing also increased to some extent. All three indicators—output per hour of labor, number of hours worked and number of employees—point to a change from the trend prevailing in the previous two years, but its strength and stability are as yet unclear.

The rise of 6.9 percent in the index of manufacturing production from July to November reflected different trends in industries with different levels of technological intensity: in the advanced industries manufacturing production rose by 1.9 percent, in the mixed industries it remained steady, and in the traditional ones it rose by 2 percent. The impetus for the rise in production in this quarter came from the recovery in world demand, which led to a 7.1 percent increase in manufacturing exports in the second half of the year, with most of the rise occurring in the advanced industries in the last quarter (see the section on the balance of payments for details). As production and exports rose, the 1.4 percent rise in the number of hours worked in the advanced industries was also notable, while in the mixed industries the number of hours rose by a more modest 0.8 percent, and in the traditional ones it actually fell by 1.4 percent. The leveling of the decline of the number of employees was also most notable in the advanced industries.

The implications of the recovery in manufacturing are evident in companies' profitability, which rose in 2003 after two years of decline. Thus traded manufacturing companies reported profits in 2003 for the first time (and a return on equity of 6 percent), and these rose from quarter to quarter. In the Companies Survey, too, manufacturing companies reported a rise in output in 2003:III and stability in 2003:IV, and from the third quarter their net balance (i.e., the number of companies reporting a rise in output *minus* the number reporting a decrease) was positive for the first time in two years (Table 1).

The number of hotel bed nights rose in most months from March 2003 (after the end of the war in Iraq), giving a cumulative rate of increase of 47 percent during the period reviewed. Together with the rise in the number of bed nights, the number of tourist entries into Israel also rose (Table 2 and Figure 4), a development supported by the improvement in the feeling of security following the end of the war in Iraq in 2003:II and the drop in the number of terrorist attacks. In contrast to the rise in the number of tourists, the number of hotel bed nights of Israelis in the second half of the year declined by 2 percent from the number in the second half of 2002.[7] The level of foreign and Israeli tourism remained significantly lower than its pre-*intifada* level.

The revenue of the commerce and services industries rose by 3.8 percent from July to November, after declining by 3 percent in the first half of the year (Table 1).[8] In commerce, revenue rose by 4 percent in this period, while in the service industries it rose relatively fast, by 17 percent in business services against the background of the improvement in the capital markets and in the activity of banks and insurance companies, by 14 percent in hotels and catering and by 6 percent in personal services. These rises went hand in hand with a rise in companies' profits as reported to the stock exchange, and reflected mainly the significant effect of private consumption on activity.

In contrast to the recovery in the manufacturing, commerce, services and tourist industries, the recession in the construction industry persisted and became even more severe. The number of building starts and completions continued to fall steeply, extending the long-term trend evident since the mid-1990s (Table 2 and Figure 3). Following a temporary revival in sales in 2003:II, apparently due to the appreciation of the NIS reflected by a fall in dollar prices of apartments in that quarter, the number of new apartments sold in July to October was 13 percent lower than in the equivalent period in 2002. The number of apartments for sale continued falling in the period reviewed, in line with the trend of the last few years, and reached an unprecedented low. The steep fall in the stock of apartments is likely in the future to constitute a major cause of an increase in activity and of price rises in the industry. Despite the continued substitution of foreign workers in the industry by Israelis in the period reviewed, the average real wage in the industry fell by 5 percent during the year. A similar picture emerges from construction companies' reports to the Companies Survey, which mention the demand constraint and the shortage of skilled labor in the industry as the main constraints on the expansion of activity in the period reviewed.

The labor market

The low level of activity that characterized the economy in 2003 continued to be reflected in the labor market. Nevertheless, several indicators—such as the rise in the total number of employees, a certain decline in the depth of unemployment and an increase in the number of hours worked—indicate some recovery in the labor market, mainly towards the end of the year. This apart, the broad implications of the government's economic program undermined labor relations in the period reviewed, and the number of labor disputes grew, particularly in the public sector.

The rate of unemployment in 2003:III was 10.7 percent of the civilian labor force, similar to the rate in the first half of the year (Table 3). The rise in the rate of unemployment from 10.3 percent in 2002 to 10.7

[7] Data on internal tourism for December is expected show further deterioration due to the continued teachers' strike that led to the cancellation of all school trips.

[8] It is recommended that extra caution in exercised with regard to these data because of their great irregularity, arising from, among other things, the many strikes in the period that disrupted regular reporting.

Table 3. Indicators of Labor Market Developments,[a] 2002–2003

	2003		2002	2003					Last month
	III	IV	IV	I	II	III	IV	2003[b]	for which
	(000)		(per cent change from previous quarter)					Jul–Dec	data available
1. Civilian labor force	2,603		0.9	0.9	–0.1	0.4		2.3	9
2. Total employees	2,324		1.1	0.2	0.0	0.3		1.4	9
Of which: General government	732		0.9	–0.5	2.2	0.7		1.2	9
Business sector	1,599		1.6	0.0	–0.7	0.5		1.5	9
Of which: Israelis	1,620		0.1	–0.9	0.4	1.9		1.5	9
Non-Israelis[d]	216		1.2	–11.8	–7.5	–1.9		–19.5	9
3. Average hours worked weekly per employee	40.4		0.9	–1.3	–0.4	1.6		–0.4	9
4. Labor input in business sector (including foreign workers)	67,368		0.7	0.5	–1.3	0.1		–2.4	9
Of which: Israelis	65,399		0.6	0.7	–1.6	–0.2		1.4	9
5. Labor input in general government (Israelis)	20,758		–0.5	–0.1	–0.5	3.9		–1.5	9
6. Israeli employees	2,332		1.4	–0.3	0.4	0.6		1.4	9
7. Unemployed	279		–0.8	6.5	–1.6	1.5		10.0	9
8. Work seekers	219		–6.6	6.2	1.3	11.5		12.0	9
9. Claims for unemployment benefit	87		–12.9	–7.5	–6.9	2.3		–23.3	9
	Nominal NIS, unadjusted								
10. Wage per employee post[e]	6,962	6,722	–0.2	0.2	–2.9	2.9	0.6	0.9	10
General government	6,747	6,550	–0.5	–0.2	–6.6	5.1	2.5	–1.7	10
Business sector	6,951	6,687	–0.5	0.7	–0.5	1.3	–0.7	0.8	10
				Percent					
11. Participation rate			54.2	54.5	54.2	54.2		0.1	9
12. Employment rate			89.8	89.2	89.4	89.3		–33.8	9
13. Unemployment rate (1÷2)			10.2	10.8	10.6	10.7		4.2	9
14. Depth of unemployment[f] (1÷7)			31.6	35.1	39.9	35.6		12.3	9

[a] Seasonally adjusted.
[b] Compared with July-December 2002.
[c] Foreign workers and an estimate of foreign workers.
[d] Foreign workers and Palestinians.
[e] Excluding Palestinians.
[F] 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 National Accounts estimates.

percent[9] in 2003 occurred mainly in the first quarter, and reflected mainly the rise in women's participation rate in the labor force, the result of the persistent recession that boosted the number of families in need of another wage earner (the "added worker" effect). After a further rise in the depth of unemployment in the first half of the year, following the trend of the last few years, it seems that in 2003:III it moderated somewhat and it may even have improved: the share of the unemployed who had been seeking work for more than half a year went down, almost completely offsetting its sharp rise in the second quarter, and the share of those who had not worked at all in the previous year edged up a little, following its sharp increase in the second quarter.

The number of Israelis employed in the business sector rose by 1.9 percent in 2003:III (Table 3 and Figure 5). The rise was evident in all principle industries, with the most marked increase occurring in construction, agriculture and

[9] Based on three quarters.

hotels and catering, and was due to Israelis replacing foreign workers (except for agriculture) and to seasonal factors (mainly in hotels and catering). The drop in the number of foreign workers in the third quarter, continuing the trend evident since the beginning of the year, was the outcome of vigorous steps taken by the government to reduce their number in order to encourage the employment of Israelis.[10] Thus total employment (including foreign workers) rose by a moderate 0.3 percent in 2003:III, and by 0.5 percent since the beginning of the year.

With the rise in the number of employed persons in the third quarter, the average number of hours worked per employee also rose, by 1.6 percent, after declining in the first half of the year. The rise in the number of hours worked may reflect a faster rate of increase in activity, or employers' expectations of such in the near future; such expectations are first expressed by an increase in the number of hours worked and thereafter by a rise in the number of employed persons.

The nominal wage in the business sector went down by 3.4 percent in the first ten months of 2003 from the level in 2002, and from July to October 2003 it was 0.8 percent higher than in the equivalent period in 2002 (Table 3). The trend change in wages in the second half of the year occurred mainly in industries in which activity and profitability rose in the third quarter, particularly in the manufacturing, wholesale and retail commerce and service industries (hotels and catering, banking and finance). The change probably reflects a rise in labor productivity and an increase in demand in those industries.

The number of employees in the public sector grew by 0.7 percent in 2003:III, and by 1.5 percent since the beginning of the year, slightly slower than the rate of population growth and slower than in previous years. The number rose despite the fact that many employees left the public sector, some as a result of dismissals, and some voluntarily in the expectation that the conditions of their retirement would be adversely affected by the government's economic program. It is noteworthy that many employees retired despite the uncertainty prevailing throughout the period reviewed—uncertainty regarding the extent to which the government's program would be implemented and regarding the details of the agreement that was eventually signed by the Ministry of Finance and the Histadrut.

The aim of the economic program was to cut wage costs in the public sector by reducing its manpower (by dismissals and the non-absorption of new employees) and wage cuts. This program, and another program of streamlining and dismissals formulated in the following months (after an agreement concerning the reduction of the public sector signed by the parties in May) led to a prolonged confrontation between the Ministry of Finance and the Histadrut throughout the period reviewed, in the course of which work in the public sector was disrupted intermittently by strikes, and some major services to the public were unavailable for a period of about 100 days. At the beginning of 2004 an agreement was reached that (in addition to the terms of the May agreement) postponed the dismissal of public-sector employees to 2005, deferred the changes making the terms of retirement less favorable, cancelled or limited some of the structural changes planned for certain sections of the public sector, and changed some of the principles underlying the program to rescue the long-established pension funds.

Despite the commendable objective of cutting wage costs in the public sector, involvement in labor relations should be undertaken by agreement and with as broad support as possible among those affected—the government, employers, and workers organizations. Such an agreement was reached in May 2003[11] and was the basis for dismissals and cuts in the nominal wage in the public sector. The far-reaching changes introduced unilaterally by the government in the second half of the year damaged the web of labor relations in the public sector, and economic activity was adversely affected due to the struggles that ensued. The restoration of trust and calm in labor relations is a *sine qua non* for the maintenance of stability and sustainable growth.

The public-sector wage in July to October was 1.7 percent lower than in the equivalent period in 2002, and over the year as a whole it fell by 2.8 percent. The decline was the outcome of a collective agreement signed in May by the government and the Histadrut that progressively reduced the wage from July and deferred payments (such as the Jubilee grant due in September). The changes in the structure of the public-sector labor force are also expected to lower the wage, mainly as a result of replacing veteran workers by new and younger ones. Nevertheless, rises in the nominal wage were evident in the period reviewed (Table 3 and Figure 6), partly related to the technical effect of the lowering of the wage in the second quarter as the result of the postponement of the payment of the vacation supplement due in that quarter, and apparently also partly due to the temporary effect of the changes in the structure of the public-sector labor force.

[10] The failure to include the expected levy on foreign workers in the Economic Arrangements Law (Supplementary to the Budget Law 2004) may be seen as some backtracking by the government on this issue.

[11] Following an attempt to introduce changes via legislation which aroused the opposition of the Histadrut.

Box 1
The crisis in the long established old pension funds

The rise in life expectancy and the fall in the birth rate resulted in a rise in the dependency ratio—the ratio of the number employees of pensionable age to the working age population—in most advanced economies. Over the last few years these developments led to the adjustment of pension plans in various countries (France, Germany, Japan, the US and others), because the assumption common in the twentieth century that each generation would be financed by the next generation was found to be inconsistent with reality.

The basis of the pension crisis in Israel, beyond the global trend, lay in the special structure of the pension funds: since the establishment of the State most of the pension funds were formed under the auspices of the Histadrut, which currently manages more than 75 percent of Israelis' pension assets (excluding unfunded pensions). Fundamental decisions taken in the first decades of Statehood—such as the decision to grant every new immigrant a minimum subsistence grant, which was expressed in the accumulation of broad pension rights in a relatively short period of time[a]—and which were based on the assumption that the younger generation would finance the needs of the older one, sowed the seeds of the crisis, while specially favorable pension rights granted to large groups of workers increased the actuarial deficit. It is relevant to note that in the first decades following Israel's independence, government policy[b] made the pension funds into a source for financing the budget, until in 1995 ninety-three percent of the funds' capital was invested in earmarked nontradable bonds issued by the government that guaranteed a high, subsidized yield determined in various agreements.

With the awareness that some of the pension funds would be unable to meet their commitments to their members in the long term, reform of the pension system has been debated and in the process of formulation for about twenty years, incorporating changes in the funds' articles of association and in their operational rules. One significant change was introduced in 1995, when it was decided that the established funds would accept no new members, and new employees could only join new, actuarially balanced funds. The share of funds' investment in earmarked bonds was reduced (to 70 percent), and their yield reduced. Another important aspect of the 1995 reform was the agreement that new public-sector employees would join funded pensions and not unfunded ones, and funds operating according to principles of actuarial balance. Most aspects of this agreement were implemented in the early 2000s.

Despite the fact that the old funds were not accepting new members, and despite the efforts of the government, by legislation (in 1995) and by agreement (in 1996) to restrict the exceptional rights of the members of the pension funds and to reduce the deficit of those funds, the deficit continued to grow. The Knesset therefore approved a new arrangement for the established pension funds in May 2003 that affected about a million employees.

The arrangement was intended to balance the funds actuarially to enable them to pay their members' pensions. The actuarial change was achieved by implementing several measures: 1) reducing members' rights; 2) a gradual increase in the contributions to the funds by employees and employers; 3) a gradual raising of the retirement age to 67 for men and 64 for women; 4) a government commitment to provide NIS 73 billion for this purpose over 35 years. The arrangement also incorporated changes in the funds' management structure (their management was transferred to management teams appointed by the Ministry of Finance), and the standard articles of association were applied to all the funds including a mechanism for balancing the funds such that if a fund cannot meet its commitments to its members, their rights would be adjusted in accordance with the actuarial position. Another change was the redirection of the funds' assets into the capital market until their holdings of earmarked bonds would be reduced to 30 percent. Some of the above aspects were not finalized until the agreement between the government and the Histadrut at the beginning of 2004, and some (such as the extent of the redirection of the funds into the capital market, the investment safety net, and the future actuarial balancing mechanism) have still not been finally agreed.

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[1] These benefits were cancelled in 1985.

[2] This started when the government took a loan in 1954.

Harsh reality made necessary the changes in the established pension funds in the light of the risk that they might be unable to meet their commitments. Imposing uniformity on members' pension rights and on the articles of association leads to a fairer distribution of the pension burden, greater flexibility in the labor market due to a member's ability to move from one job to another without affecting his pension rights, and to a deepening of the capital market. A solution still needs to be found for the population engaged in very demanding jobs (such as manual laborers), for whom raising the retirement age harms their welfare, and changes in the arrangement must not have seriously adverse implications on the rights of members in distress (invalidity, survivors' pensions) and their ability to grow old honorably.

The balance of payments

Israel's trade deficit remained steady in the second half of 2003, and for the whole year it totaled $ 6 billion, its lowest level since 1991. The stability of the trade deficit in the period reviewed reflects a rise in goods imports offset by an acceleration of goods exports (Table 4 and Figure 7). The level of imports and exports in this period were affected by industrial action taken by customs personnel and dock workers, so that the trends derived from the data should be treated with caution.

Goods imports in the second half of 2003 were 4.1 percent higher than those in the second half of 2002, with a notable 8.2 percent surge in the imports of consumer goods that resulted from the sharp rise in private consumption in the period. Raw material imports (excluding diamonds and fuel) rose by 7.5 percent, with most of the increase, taking place in the fourth quarter and consisting of raw materials intended for the advanced and chemical industries. Capital goods imports declined steeply in the third quarter, partly offsetting the exceptional increase in June; in 2002:IV they steadied, and the trend data show that the decline in capital goods imports moderated during the period reviewed, and even that they rose in the November and December.

Exports rose rapidly, by 7 percent, in the period reviewed, with the whole of the rise occurring in the last quarter (Table 4). In the third quarter exports of the mixed and traditional industries increased sharply, while exports of high-tech industries stood still, whereas in the fourth quarter it was the advanced industries that prompted the rise in exports. The growth of exports of the mixed industries slowed somewhat in 2003:IV, but still stayed high, and exports of the traditional industries actually fell in that quarter. The trend data also indicate a strengthening of exports of the advanced and mixed-advanced industries.

The services account showed a surplus for 2003:III, partly due to the increase in exports of software from $ 1.8 billion in 2003:II to $ 2 billion in 2003:III and a 0.5 percent rise in income from tourism, following a similar rise in 2003:II. (A large part of the increase in services exports is as yet unexplained.) Exports of tourist services rose despite the reduction in the number of foreign workers whose expenditure constitutes part of this item. The surplus in the services account offset the deficit in the balance of trade, resulting in a surplus of $ 0.2 billion in the current account in the third quarter.

The flow of nonresidents' capital to Israel were affected by domestic developments and by global trends. Against the background of the ending of the war in Iraq, the increase in the yield differential between the US and Israel, and the lowering of the assessment of Israel's country risk, the second quarter saw a large capital flow into Israel (Table 4). In contrast, in the second half of the year expectations of recovery in the international markets strengthened, yields on US government bonds rose, and concurrently Israel's interest rate went down. These developments had the combined effect of causing a significant decline in the extent of nonresidents' direct investments, from NIS 1.7 billion in 2003:II to NIS 0.5 billion in 2003:III, which was partly offset by their investments ($ 1.3 billion) in Israeli securities, mainly in government bonds. Israelis meanwhile reduced their direct investments and their deposits abroad in 2003:III.

In July the US government approved an Israeli government bond issue of $ 3 billion a year for three years, guaranteed by the US government, and under this arrangement Israel's government issued $ 1.6 billion and $ 0.75 billion of bonds in September and December respectively. The government used about $ 1 billion of the guarantees to finance the domestic deficit by converting foreign currency at the Bank of Israel. The surplus in the current account and the utilization of the guarantees to finance the domestic deficit were partly offset by the reduction of Israel's net capital inflow and boosted the foreign exchange reserves in the central bank by about $ 1.2 billion to a new record level of $ 25.6 billion.

Table 4. Foreign Trade, the Balance of Payments, and the Reserves,[a] 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[b] Jul–Dec	Last month for which data available
			(percent change from previous period)						
Goods imports	–6.0	0.4	–2.1	–2.4	5.6	0.1	4.0	1.4	12
Of which: Consumer goods	–6.6	–1.8	–5.4	–3.4	7.2	6.2	2.4	8.2	12
Capital goods	–8.5	–4.1	11.1	–10.9	7.9	–7.7	0.1	–6.6	12
Intermediates	–4.7	3.0	–6.3	2.0	4.2	1.5	6.0	7.5	12
Goods exports	–6.8	6.1	3.3	6.0	–3.1	–0.1	5.3	7.0	12
Manufacturing	–6.9	5.7	3.5	5.3	–2.8	0.1	5.5	7.1	12
High-tech	–13.0	1.8	7.4	4.4	–7.3	2.0	6.4	5.4	12
			Quarterly averages						
Trade deficit	307	220	246	107	259	262	250	256	12
Current account, net	–257	148	–232	122	153	168			9
Financial account (excl. foreign exchange reserves)	–435	48	–1,952	–896	105	937			9
Nonresidents' direct investment	412	1,005	391	805	1,732	479			9
Nonresidents' portfolio investment	193	346	–323	–229	–70	1,339			9
Residents	993	289	462	–38	422	483			9
Net foreign debt (% of GDP)	–2.94		–2.90	–4.15	–4.74	–5.22			9
Bank of Israel reserves, end-period	23,670	25,675	23,670	23,486	24,089	24,767	25,780	25,780	12

[a] $ million, current prices, seasonally adjusted. Foreign trade data do not include ships, aircraft, diamonds, and fuel.
[b] Compared with July-December 2002.
Source: Central Bureau of Statistics.

Global developments

Data published in the second half of the year indicate a turnaround in economic activity in most of the advanced economies. In the US preliminary estimates were published in October according to which the US growth rate in the third quarter was 8.2 percent, compared with 3.3 percent in the second quarter, due to the considerable increases of 6.4 percent in private consumption and 18.2 percent in private-sector investments. The rise in demand in the US was affected by the tax-cutting policy, by the feeling of confidence in the administration after the war in Iraq, and the low interest rate that among other things boosted housing sales. In the US the ISM (Institute of Supply Management) index of manufacturing activity rose significantly in November, by six percent to its highest level for twenty years, and there were indications of improvement in manufacturing production and new orders.

The rise in activity in the US prompted growth in the eurozone, and accelerated the expansion of exports in European countries, so that their export surplus increased by 4 percent. Thus, despite weak domestic demand in Europe, the eurozone countries recorded a 1.6 percent increase in GDP in 2003III, following negative growth in the two previous quarters.[12] Japan also showed signs of growth: manufacturing production rose by a cumulative 5 percent in September and October, and the estimate for the whole of 2003 is 2.2 percent.

Despite growth in the advanced economies, the trend change in activity remains very fragile. Unemployment stayed high—6.7 percent in the advanced economies (Table 5), with 5.9 percent in the US and 8.8 percent in Europe—which is likely moderate the level of demand in the future. The deepening of the "twin deficits" (i.e., the budget deficit and the balance-of-payments deficit) also casts a cloud over the US economy, as despite the publication of positive economic indices it acts to weaken the dollar, mainly against the euro (it depreciated by 9.1 percent in the third quarter and by 36 percent in the fourth), but also against many other currencies. The US government's declared policy and the public's avoidance of purchasing US government bonds in the light of the ballooning deficits also serve to weaken the dollar.

[12] In the third quarter GDP "grew" by –0.2 percent in Germany, by 0.5 percent in Italy, and by 0.4 percent in France.

Table 5. Indicators of Economic Development in Advanced and Developing Countries,[a]

	2001	2002	2003	Forecast 2004
World GNP	2.4	3.0	3.2	4.1
Advanced countries	1.0	1.8	1.8	2.9
Developing countries	4.1	4.6	5.0	5.6
World trade				
Advanced countries	0.1	3.2	2.9	5.5
Imports	–0.1	2.2	2.8	4.8
Exports	–0.8	2.2	1.6	5.2
Developing countries				
Imports	1.6	6.0	5.1	7.8
Exports	2.7	6.5	4.3	6.9
Inflation (CPI)				
Advanced countries	2.2	1.5	1.8	1.3
Developing countries	5.8	5.3	5.9	4.9
Countries in transition	16.2	11.1	9.7	9.1
Prices of unprocessed goods (US$)				
Oil[b]	–14.0	2.8	14.2	–10.5
Other	–4.0	0.6	5.0	2.4
Short-term interest[c] (percent)				
Dollar deposits	3.7	1.9	1.3	2.0
Euro deposits	4.2	3.3	2.2	2.4
Unemployment rate in advanced countries (percent)	5.9	6.4	6.7	6.6

[a] Annual change, percent. According to "World Economic Outlook," Israel is classified as an advanced country.
[b] The average price of oil was $24.96 per barrel in 2002; the estimated price for 2003 is $28.5, and for 2004, $25.5.
[d] 6-month Libor rate.
SOURCE: "World Economic Outlook" (IMF), updated September 2003.

The sharp depreciation of the dollar against the euro, if it continues, is likely to have an adverse effect on Europe's trade balance and continued growth. Also, it is doubtful whether the Japanese economy will be able to continue buying massive quantities of foreign currency to prevent appreciation of the Yen, that would make it more difficult for that country's business sector to recover. These developments are likely to halt growth in developing countries in its very early stages, and could even cause a financial crisis on a global scale.

The general government sector

Fiscal restraint in the second half of the year was the natural outcome of the economic program to revive the economy adopted by the government immediately following its formation and updated several times in the period reviewed (until the approval of the 2004 budget). In the program, great importance was attached to the steps introduced to cut the deficit in the short term and the steps expected to reduce it on a permanent basis, and it therefore boosted the credibility of fiscal policy and placed the economy back onto a downward budget-deficit path. Fiscal restraint together with a rise in tax revenues in the second half of the year reduced the deficit from 7 percent of GDP in the first half of the year to less than 4 percent of GDP in the second. The deficit for the whole of 2003, 5.6 percent of GDP, nevertheless remained very high compared to its level in the past and compared to the target specified in the budget of 3 percent of GDP, and higher than the norm in advanced economies (Table 6 and Figure 9).

The essential aspects of the program for revitalizing the economy were budgetary cuts, changes in the system of National Insurance benefits, a gradual lowering of the tax burden, progressive wage cuts and streamlining in the general government sector, the unification of municipalities (most of which was deferred in the agreement between the government and the Histadrut signed at the beginning of 2004), and the program to rescue the Histadrut pension funds (see Box above).

The sharp increase in the budget deficit during the year, contrasting with the target of 3 percent of GDP, was caused by a shortfall of about NIS 15 billion in actual tax revenues relative to the assumption underlying the budget[13] and by the rise in interest costs (Table 6 and Figure 9). Nevertheless a trend change was evident in the second half of the year: following a continuous decline in tax revenues, they rose in the second half by 1 percent of GDP, reverting to their end-2002 level.

Government expenditure was lower in the second half of 2003 than in the first half, and for the year as a whole was NIS 5.1 billion lower than the expenditure path consistent with the budget. The cut in expenditure took place mainly in the non-defense government ministries—the defense budget was utilized to the full—and it reflects the effect of the across-the-board cuts decided on by the government, the postponement of the payment of the vacation supplement due in June and the Jubilee grant due in September, and the postponement of expenditure due to industrial action.

Total National Insurance allowances in July to November were 6 percent lower than in the equivalent period in 2002, with most of the fall occurring in October and November (Table 6). Unemployment payments slumped by 25.1 percent, income support payments by 22.7 percent, and child allowances by 14.1 percent. The reduction in National Insurance payments despite the rise in the unemployment rate in 2003 was the result of the economic packages of 2002 and 2003 which cut the allowances and made the eligibility criteria more stringent. In the period reviewed disability allowances were raised by 13 percent, and pensions for work accidents and to terror victims by 12 percent, the result of the struggle by the disabled and the continued confrontation with terrorism.

The 2004 budget sets the deficit target at 4 percent of GDP, far lower than the actual deficit in 2003. The contraction of the deficit is expected to be based on a significant increase in revenue (by a real 7.5 percent), together with a more moderate rise in expenditure (by a real 2.8 percent). The return to a downward budget deficit path inherent in the 2004 budget is a prerequisite to bolstering fiscal credibility. However, the utilization of the entire general reserve in the budget,[14] the financial straits of the municipalities and the disagreements regarding the defense budget right at the beginning of the year give cause for concern as to the government's ability to meet the target deficit should unexpected expenditure be incurred during the year.

Several bitter struggles were waged in the period reviewed: the first was the long strike by single mothers over the cut in their allowances, in which they were joined by other sociologically weak groups as a protest at the reduction of transfer payments. Dock workers struck intermittently in opposition to the privatization of the ports, and public-sector employees were on strike for a long time because of the effect of the economic program on employment, wages and pension rights in that sector (see section on the labor market).

The government recently privatized several important areas of the infrastructure: in January 2004 the government holding in Zim shipping line was sold; this followed the sale of 5.25 percent of the shares of the Bezeq Telecommunication Corporation in November 2003, reducing the government's holding in it so that it ceased being a government corporation. This, together with the sale of 13 percent of the shares of El Al Israel Airlines in the first half of 2003,[15] yielded proceeds of NIS 1.7 billion in 2003 (compared with NIS 118 million in 2002, and indicates the government's policy of reducing its involvement in the markets.

Against the background of the restraint with regard to government expenditure, the rise in infrastructure investment by the general government sector is all the more noteworthy, with several decisions taken in the second half of 2003 likely to lead to further acceleration in this area. In November NIS 24 billion was allocated to Israel Railways—partly against a share issue by the corporation, partly as a loan (NIS 2.4 billion), and partly as a subsidy (NIS 10.5 billion)—to complete the national railway network by 2008. In the period reviewed an agreement was signed by the government and several entrepreneurs to erect water desalination plants, although after the closure of the tenders the entrepreneurs asked for more favorable terms mainly due to new conditions imposed by the financing banks. Progress was also made with regard to the actual supply of natural gas and plans for its development, and a BOT (Build–Operate–Transfer) tender was approved for the erection of the Tel Aviv metropolitan light railway system. The parties involved in the Jerusalem light rail project, which is making progress, have encountered difficulties in the final financial arrangement.

[13] The shortfall is made up of NIS 8.2 billion in income tax revenues and NIS 4.1 billion in receipts from customs and levies. The amount transferred to the government by the National Insurance Institute was NIS 4.5 billion short of the amount consistent with the annual forecast.

[14] The reserve for meeting the deficit target remains intact.

[15] All the budgetary revenue from the sale was used to cover the government's debt to El Al.

Prices, monetary policy and the money and capital markets

The behavior of the financial markets in the second half of the year should be reviewed in the light of the various events and the signs of recovery evident in the first half which affected many of the financial indices throughout the year. The formation of the new government at the end of February and its immediate adoption of an economic program that indicated its commitment to fiscal discipline, the ending of the Iraq war in February, the fall in the number of terrorist incidents, and the approval of Israel's loan guarantees by the US government in March—all these led to a lessening of the degree of economic uncertainty and to positive trends in the financial markets in the second quarter. Following the moderation of some indices in 2003:III, and against the background of signs of recovery of activity and the easing of monetary restraint, the positive trends were renewed in 2003:IV.

The CPI went down in the second half of the year by 1.4 percent[16] and from the beginning of the year by 1.9 percent (Table 7 and Figure 10). The adjusted indices (housing, seasonal items and controlled-price goods) that provide an indication of the inflation environment declined in the period reviewed at an average rate of 1.5 percent, and since the beginning of the year at a rate of 0.5 percent. The fall in prices reflects the recession in domestic demand, the high rates of unemployment, the heavy erosion of the real wage, and companies' rationalization, expressed by increased productivity and lower hourly labor costs. The fall in prices in the period reviewed was also affected by the steep appreciation of the NIS in 2003:II—8.4 percent against the dollar and 6.4 percent against the currency basket—which acted via the transmission mechanisms both immediately and with a lag to slow down the rate of price increases. The 2 percent depreciation of the NIS against the dollar and the rise in dollar prices of imports in the third quarter were relatively modest, and did not counteract the moderating effect on prices of the appreciation in the second quarter.

Table 6. Performance of the Government's Budget vis-a-vis the Deficit Target, 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[a] Jul–Dec	Last month for which data available
Domestic deficit as percent of GDP	4.2	5.7	8.6	4.6	8.6	3.4	6.4	4.4	12
Deviation from path[b] (NIS billion)									
Government revenue	–3.9	–19.5	–1.5	–5.0	–7.5	–5.0	–2.7	–7.7	12
Government expenditure	–5.1	–5.1	–1.1	0.6	–0.3	–2.5	–2.9	–5.4	12
Domestic deficit	1.3	–14.3	–0.4	–5.5	–7.2	–2.5	0.2	–2.3	12
Total government deficit (excluding credit granted)	–18.7	–21.1	–9.9	–4.4	–9.9	–5.4	–8.0	–13.4	12
	Percent change from previous period								
Government tax revenue	–0.7	–1.4	–9.2	8.3	–8.4	9.4	–6.8	–0.3	12
Of which: Income tax, gross	–5.1	–3.6	–10.6	7.6	–6.2	8.6	–8.0	–0.6	12
VAT, gross	5.2	1.8	–9.3	10.8	–11.9	10.9	–5.4	0.1	12
Government expenditure	4.6	–8.9	10.4	–5.7	0.0	–1.6	6.3	0.4	12
National Insurance allowances	3.8	–12.7	2.7	–1.7	–3.8	–0.9	–37.3	–6.0	11
Of which: Unemployment benefit	0.6	–36.3	–10.4	–6.0	–8.8	–2.2	–41.2	–25.1	11
Income support	14.4	–24.9	–3.1	3.5	–1.9	–18.9	–41.8	–22.7	11
National Insurance contributions received from the public	5.8	3.5	1.0	–3.8	0.5	1.9	–2.6	–2.2	12

[a] Compared with July-December 2002.
[b] The path was determined on the basis of a deficit of 3 percent of GDP as specified in the budget for 2003.
Source: Ministry of Finance.

[16] In this section the rates of change of prices and the exchange rate relate to annual rates, not the period in question.

Table 7. Selected Price Indices,[a] 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[b] Jul–Dec	Last month for which data available
CPI	6.5	–1.9	–1.8	3.2	–5.0	–3.9	–1.6	–2.8	12
CPI excl. housing, fruit and vegetables	6.3	–0.6	0.4	2.7	0.8	–5.0	–0.8	–2.9	12
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	6.9	–0.4	–0.4	4.2	–0.2	–1.0	–4.2	–2.6	12
Index of housing prices	8.2	–6.7	–5.7	3.8	–26.2	5.3	–5.8	–0.4	12
Wholesale price index	6.9	3.3	0.8	15.4	–7.9	2.3	4.9	3.6	12
NIS/$ exchange rate	9.8	–6.4	–6.6	7.6	–29.7	8.2	–6.3	0.7	12
NIS/currency-basket rate	14.2	–0.5	–2.8	15.0	–23.2	3.6	7.3	5.4	12

[a] Annual rates of change during period, percent.
[b] Compared with July-December 2002.
Source: Central Bureau of Statistics.

The housing prices index remained steady in the period reviewed. Over the year as a whole, however, housing prices fell by 5.7 percent, reflecting the persistent recession in the construction industry and the appreciation of the NIS exchange rate against the dollar. The wholesale price index rose by 1.8 percent during the period reviewed. A point of interest is that prices of production inputs for the advanced industries rose, whereas production inputs for the traditional industries fell; this probably indicates a rise in demand for the former, but may adversely affect their profitability.

Following a sharp drop in inflation expectations in the first half of 2003 that brought the one-year (gross) expectations derived from the capital market at the end of the first half year to less than 1 percent, the expectations stabilized in most months of the second half to between 1.5 percent and 2 percent, with a slight upward trend in the third quarter that was offset by a small fall in the last quarter. The stabilization of inflation expectations at this low level and within the inflation target range derives from actual price developments, the stability of the foreign currency market, and greater confidence in the economic program. Inflation expectations for one year forward and for longer terms (up to nine years) declined in the second half of the year, pointing to a greater feeling of security regarding the ability of economic policy to achieve the inflation target in the short as well as longer term.

Despite price falls in the period reviewed and during the whole year, inflation expectations show that the economy is not in a deflationary environment, and that the deviation from the inflation target (of 1–3 percent) is only temporary (Figure 11). This claim is supported by the steep increase in private consumption, as it shows that consumers are not postponing purchases in the expectation that prices will fall further.

In the second half of 2003, against the background of the fall in prices and the stabilization of inflation expectations within the lower part of the target inflation range, the Bank of Israel increased the pace of its reductions in the interest rate to about 0.5 percentage points each month, so that its marginal interest rate went down by a cumulative 2.8 percentage points in the course of the second half of the year, and reached 4.8 percent at the end of the year. The process of lowering the rate was a gradual one, and it supported the trend change in the real markets while emphasizing the stability of the financial markets. As the Bank of Israel reduced its key interest rate, other nominal rates, the long-term (5- and 10-year) real interest rates, and the implicit real interest rate all declined (Table 9 and Figure 11).

The NIS/$ exchange rate was stable at around NIS 4.4 per $ for most of the period reviewed, after sharp appreciation of the NIS by 8.5 percent in 2003:II (Table 7 and Figure 12). The NIS depreciated by 5.4 percent against the currency basket during the period reviewed due to the strengthening of the euro worldwide and particularly in Israel. Over the whole of 2003 the NIS appreciated by 6.4 percent against the dollar and by 0.5 percent against the currency basket due to the activity of nonresidents, to the easing of economic uncertainty, the improvement in the current account, the high rates of interest, and the worldwide weakening of the dollar.

The downward trend of real and nominal yields that had started in February/March with the lowering of Israel's government debt risk persisted in the second half of 2003. The decline in yields reflects the improved credibility of

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2002–2003
(annual terms, percent)

Rates of change	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	Cumulative change over previous 12 months	2003 Jul–Dec change During period	Last month for which data available
	Average		Percent change from previous period							
M1[a]	15.6	0.5	–14.7	13.2	–1.6	9.7	11.2	7.9	17.2	12
M2[b]	2.2	1.7	5.6	–0.1	–4.0	6.0	8.4	2.1	8.0	12
M3[c]	6.1	2.2	2.4	6.3	–5.2	3.2	5.0	2.3	5.5	12
Nondirected bank credit	10.5	1.7	5.9	1.0	–5.9	–3.7	–0.4	–2.5	–1.2	12
Unindexed local-currency credit	6.5	7.1	17.2	–1.3	10.0	3.0	–2.3	2.6	–0.4	12
CPI-indexed credit	7.6	–1.1	–0.9	–3.8	–2.9	–7.8	–5.5	–5.7	–6.0	12
Foreign-currency-indexed and denominated credit	20.5	–1.0	2.7	11.0	–26.1	–6.4	10.1	–4.5	5.0	12

[a] Compared with July-December 2002.
[b] Narrow money supply (cash in the hands of the public and demand deposits).
[c] M1 plus unindexed time deposits (up to one year) plus self-renewing overnight deposits.
[d] M2 plus deposits in and indexed to foreign-currency, and deposits indexed to the CPI (up to one year).
Source: Bank of Israel.

fiscal policy and the expectation of reduced domestic borrowing following the receipt of the US government loan guarantees. It was reflected in a gradual reduction of the yield curves along their entire lengths (Figure 14). The decline in yields halted temporarily in August, in reaction to the disappointment over the breakdown of the peace process and the rise in interest rates abroad, but was renewed thereafter. The slope of the nominal yield curve flattened, expressing the drop in uncertainty over inflation and in the long-term risk premium, partly due to the lowering of the risk premium on investments in developing countries, while the real yield curve, which was negative at the beginning of the period, flattened towards the end of the year as a result of the sharp fall in short-term real yields, and possibly also due to expectations that real interest would continue to fall.

The increase in the M1 money supply accelerated to 17.2 percent in the half-year reviewed (Table 8). Most of this can be explained by the diversion of foreign-currency-indexed deposits to local-currency deposits resulting from the steep appreciation of the NIS in the first half of the year and the liquidation of financial assets that occurred throughout the year. The M3 aggregate rose by 5.5 percent in the period reviewed, and by 2.2 percent over the year as a whole, due to the low level of economic activity during the year and the signs of recovery towards the end of the year.

The total amount of nondirected credit went down by 1.2 percent during the second half of the year, reflecting the fall in local-currency, mainly CPI-indexed, credit and the increase in foreign-currency credit (Table 8 and Figure 12). The fall in CPI-indexed local-currency credit partly reflects the fall in the CPI during the period, while the increase in foreign-currency credit reflects the depreciation of the dollar and the consequent increase in foreign-currency and foreign-currency-indexed credit. The real contraction in nondirected credit was greater than that consistent with the change in activity (since as stated business-sector product rose by 1.5 percent), but reflected also the reduction in the supply of credit due to the rise in borrowers' risk premium evident from several indicators: loan-loss provisions increased, payment delinquency increased, the number of checks without cover grew, and arrears in mortgage payments increased. Credit declined in the household sector, and more steeply in the private sector, where risk exposure is higher because of the recession.

The General Share Price Index rose by 11.2 percent in the second half of 2003, having risen by 38.8 percent in the second quarter. In July and August the index went down by 2.5 percent and from September to December rose again, by 20.7 percent. The rapid rise of the index during the year was also expressed by the increased level of involvement of the public in the stock exchange

Table 9. Interest Rates, Yields, and the Share-Price Index,[a] 2002–2003

	2002	2003	2002 IV	2003 I	2003 II	2003 III	2003 IV	2003[b] Jul–Dec	Last month for which data available
Nominal interest on:									
Marginal interest on monetary loan	7.2	7.8	9.6	9.4	8.7	7.3	5.8	6.5	12
SRO deposits	5.8	6.4	7.9	7.7	7.1	5.7	4.6	5.3	11
Nondirected local-currency credit	9.9	10.8	11.8	12.0	11.4	10.2	9.2	9.8	11
3-month Eurodollar	1.7	1.1	1.4	1.2	1.1	1.0	1.0	1.0	12
Yield to maturity on: Treasury bills	7.4	7.0	8.7	8.5	7.6	6.5	5.4	5.9	12
10-year bonds	5.2	4.9	5.8	5.8	4.8	4.6	4.2	4.4	12
5-year bonds	4.8	4.9	5.9	5.6	5.2	4.5	4.2	4.4	12
Expected inflation (gross)	3.3	2.7	3.5	3.8	1.9	2.7	2.2	2.5	12
Interest derived from expected inflation (gross)	4.1	4.1	1.8	4.5	5.2	3.7	3.0	3.4	12
General Share-Price Index (change)	–20.2	55.7	–5.1	–2.3	38.8	2.5	20.7	14.1	12

[a] Pecentage change from previous period, in annual terms.

[b] Compared with July-December 2002.

Source: Bank of Israel.

towards the end of the year, encouraging the issue of commercial bonds. If this trend continues, companies will be faced with another source of capital.

The rise in share indices mainly reflects the public's confidence in the economic policy and the rise in share prices in stock markets world wide. The latter have a direct effect (via dual-listed shares and via Israeli companies' holdings in companies traded in the US) and an indirect effect (due to the very close links between the world's capital markets) on domestic share prices. The rise in share prices also reflects the decline in alternative yields and the recovery in activity expressed by the increase in companies' profitability (the average return on equity in the first three quarters of the year was 5.5 percent, and it rose constantly during the year), and possibly also the public's expectations regarding the effect of entry of the pension funds into the capital markets. The most prominent rises in share prices and profits occurred in companies in the electronics, insurance and banking industries.

The rise in share prices, the fall in the CPI, and the appreciation of the NIS during the year led to a change in the composition of the public's assets portfolio: shares assumed a greater weight at the expense of indexed assets, and the total portfolio increased by 7.6 percent in the second half of 2003 and by 13 percent in real terms over the whole year.