RECENT ECONOMIC DEVELOPMENTS, 108
July–December 2004

Main developments

In the second half of 2004 (the period reviewed) the trend of expansion in economic activity evident since the second half of 2003 continued. In the third quarter of 2004 GDP increased by 3.3 percent in annual terms, and business-sector product grew by 3.9 percent. The rise in economic activity was based on the expansion of business-sector activity, and in particular on increased exports. The composite state-of-the-economy index, the Bank of Israel Companies Survey and other economic indicators relating to the period reviewed point to continued growth in 2004:IV and to expectations that it would become more firmly based in 2005:I. This growth led to salary increases and to a drop in unemployment, although the latter is still very high.

The background to continued growth consisted in part of the following: (1) the continued process of world growth becoming more firmly established, and the expansion of world trade that led to increased demand for domestic production, particularly for high-tech products; (2) relative calm on the security front and changes in the Palestinian Authority; (3) a fiscal policy that was consistent with the achievement of the deficit target, that led to the stabilization of long-term interest rates at a relatively low level, while cutting expenditure and taxes; (4) an expansionary monetary policy that acted against the backdrop of stability of prices and in the financial markets.

The upward trend in exports compared with the equivalent period in 2003 persisted, with improved demand world wide; this was the result of the increase in world trade, real depreciation, and improved profitability in the traditional and mixed industries that helped boost the exports of those industries. Underlying the growth in exports in the period reviewed was the rise in goods exports. A rise in labor productivity coupled with streamlining in companies following years of recession resulted in a rise in total manufacturing exports, especially those of high-tech industries, which also benefited from a rise in worldwide demand for these goods. Private demand rose in 2004:III by 3.3 percent, reflecting a rise in expenditure on current consumption, particularly services, clothing and footwear. The improvement in the labor market apparently contributed to this rise—the decline in unemployment and the rise in the average wage per employee post—as did the relative calm regarding the security situation and more optimistic consumer expectations in the wake of the changes in the Palestinian leadership.

Developments in the labor market in the second half of 2004 are consistent with the picture of continued growth. They were affected mainly by the continued expansion of business-sector activity and the government's policy of cutting employment in the public sector. The number of employed Israelis rose again in the third quarter, albeit more slowly. The number of employed persons in the public sector contracted, while employment in the business sector continued to increase. As employment grew, so did the average wage per employee post, although it is still below its level in 2003. These developments, that derived from the process of economic growth, were also reflected by a further fall in the rate of unemployment.

In 2004:III the downward trend in the number of foreign workers halted, while the number of Palestinian workers, which had dipped temporarily in the second quarter, rose again to about 43,000, the level at which it had stabilized in mid-2003.

In the area of fiscal policy, the domestic deficit[1] (cash basis) in 2004 was 3.9 percent, just below the target ceiling. This can be attributed mainly to the under-performance of all components of budgeted expenditure, and a real rise of 6.5 percent in tax revenues despite the cuts in taxes on individuals and companies. In the second half of 2004 government expenditure was significantly below the seasonal path (except for an exceptional rise in December), continuing the under-performance of expenditure that started in the first half of the year. As a result, government domestic expenditure in 2004 was about NIS 3.4 billion below the budgeted amount.

The budget for 2005 as passed by the government is the first to relate to the new fiscal targets set by the government—a maximum deficit of 3 percent of GDP, and a real rise of 1 percent in expenditure. The budget, however, does not take into account the additional cost of the disengagement plan, the implementation of which would result in the deficit ceiling being exceeded. The forecast of revenue on which the budget is based assumes

[1] Figures for the domestic deficit are used because of the high volatility of the deficit abroad.

a real rise of 6.5 percent in government revenue. This may be an over-optimistic forecast. The budget reserve available to meet the expenditure target allows the government a certain deviation from forecast revenue, but if the deviation turns out to be significant, a measure of underperformance of expenditure will be necessary in order to meet the deficit target.

The Consumer Price Index (CPI) went down in the second half of 2004 by 0.2 percent, and the seasonally adjusted––i.e., excluding the housing, fruit and vegetables, and clothing and footwear components—rose by only 0.2 percent. Price stability, against the background of the appreciation of the NIS against the dollar, shows the absence of inflationary pressures. In the whole of 2004 the CPI rose by 1.2 percent, slightly above the lower limit of the inflation target of price stability. Gross inflation expectations in December for the short and medium terms (1–3 years) derived from the capital market were also within the price-stability target range.

Against the backdrop of price stability and the stabilization of long-term yields following their decline, monetary policy acted in an expansionary direction: the Bank of Israel key interest rate was kept at 4.1 percent in the third quarter, and was lowered to 3.9 percent in December (followed by further reductions to 3.7 percent and 3.5 percent in January and February 2005 respectively). In that period the interest rate in the US was raised by 1.25 percentage points, so that the differential between the central banks' interest rates in the two countries narrowed to 1.25 percentage points in February (1.45 percentage points in January). As the Bank of Israel's interest rate stabilized at its low level, and with expectations that any renewed increase, against the background of rises in the interest rate in the US, would be moderate and would not occur until later in 2005, yields on unindexed government bonds and on Treasury bills declined.

The money supply rose much faster in the period reviewed than in the last few years. Some of the rise may be explained by the low level of nominal interest and continued economic recovery.

The General Share Price Index rose by 1.7 percent in the half year under review, slightly slower than the rise in the Nasdaq. In 2004:III the Share Price Index went down by 9.7 percent and in 2004:IV it rose by 12.4 percent, with a marked surge in turnover to its highest level in the last ten years. The rise in the index in the fourth quarter apparently reflects the changes in the Palestinian Authority, optimistic expectations regarding continued expansion in economic activity, and the rise in Israel's credit rating by Moody's from negative to stable (see Events in July–December 2004, below).

The Tel-Tech index, which expresses expectations of growth in the information technology (IT) field, rose by 3.7 percent in the second half of 2004, after declining in the first half of the year. The rise, albeit modest, reflects investors' expectations of continued growth in that area.

Continued rapid growth depends on several factors: continued global recovery, calm in the security situation, and in the long term also a return of public debt to a downward path. Clouding the picture of rapid growth is the contraction of activity in the construction industry and the persistent decline in investment in it, as construction is a major demand component for the nontradables produced by the mixed and traditional industries. In the period reviewed the government strictly adhered to its fiscal policy of reducing expenditure together with tax cuts while maintaining the framework of the deficit. In doing so it boosted its credibility and helped keep Israel's risk premium in the international markets at its relatively low level.

The National Accounts and the principal industries

The National Accounts for 2004:III show that GDP continued to increase, rising by 3.3 percent, with business-sector product rising by 3.9 percent.[2] These results reflect the effect of the strike of the dock workers (see Events in July–December 2004, below). These figures indicate that growth continued to become more firmly established, based on the expansion of activity in the business sector and particularly of exports, while the rise in public consumption slowed. The composite state-of-the-economy index and the Companies Survey (Table 2) show that activity continued to expand rapidly also in the last quarter of 2004.

The backdrop to continued growth in the second half of 2004 was provided by the firmer basis of growth in the global economy, the expansion of world trade, and the relative calm in the security situation. These were joined by a credible fiscal policy that acted to achieve the deficit target while cutting taxes and an expansionary monetary policy. These supported Israel's relatively low risk premium and further lowering of the interest rate. Acting in the opposite direction, the rise in oil prices in

[2] All rates of change of the National Accounts are in annual terms.

Table 1. National Accounts,[a] 2003–2004

	2004	2003	2004				2004[b]	Last month for which
	Forecast	IV	I	II	III	IV	Jul–Dec	data available
GDP	4.2	1.5	3.8	4.0	3.3		3.1	Sep
Business-sector product	6.0	3.0	4.6	5.8	3.9		4.3	Sep
Business-sector product excl. start-ups	5.7	2.8	5.2	5.2	3.1		4.0	Sep
Private consumption	5.3	5.0	4.3	2.9	3.3		3.9	Sep
Gross domestic investment	11.2	–25.6	1.2	7.3	–3.0		–5.9	Sep
Fixed investment	–1.8	1.3	8.5	–12.2	–3.5		–1.8	Sep
Goods and services exports	14.0	4.1	25.2	11.6	17.2		14.3	Sep
Goods and services exports excl. start-ups and diamonds	16.2	4.1	34.0	12.8	11.2		15.0	Sep
Goods and services imports	12.5	–3.0	26.6	8.1	4.3		8.5	Sep
Goods and services imports excl. diamonds		–1.2	29.7	8.8	–4.8		7.3	Sep
Public-sector consumption	–2.3	–7.8	3.0	–1.8	–2.3		–2.3	Sep
Public-sector consumption excl. defense imports	–1.9	–7.0	4.3	–3.3	–5.4		–2.9	Sep

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

[b] Compared with July-December 2003.

SOURCE: Central Bureau of Statistics.

the third and fourth quarters of 2004 caused a slowdown in the rate of growth by raising the cost of inputs.

Growth in 2004:III was based on the increase of the business-sector product, with continued improvement in goods and services exports. Exports of the high-tech industries benefited from the rise in global demand, and exports of the traditional and mixed industries were supported by the real depreciation of the NIS and improved profitability. Private consumption continued to rise and also helped the expansion in manufacturing, commerce and service industries (Table 2). Investment in machinery and equipment fell in the third quarter, despite companies' expectations of continued expansion; this was partly due to the sanctions by the dock workers. In contrast, in 2004:IV capital goods imports, particularly machinery and equipment, rose steeply.

Israel's **goods and services exports** (excluding diamonds), continued to increase in 2004:III. The background was the increase in world trade, the rise in global demand for high-tech goods, in which Israel enjoys a relative advantage, and persistent real depreciation of the NIS. The real exchange rate, i.e., the ratio of export prices (excluding ships, aircraft and diamonds) to the prices of business-sector product, rose by 3 percent in 2004:III, following a rise of 4 percent in the first half of the year. The rise of manufacturing exports moderated, due to the deterioration of the terms of trade and the sanctions by the dock workers. This was reflected by the decline in exports of the traditional and mixed industries, and a slower rise of exports of the high-tech industries, which constitute about a third of manufacturing exports. Foreign-trade data (Table 4) for 2004:IV show an acceleration in the rise in exports in that quarter, especially in exports of the traditional and mixed industries. This may derive from the delays in exports of these industries caused by the labor dispute in the docks.

Goods and services imports (excluding diamond) fell by 4.8 percent (annual rate) in 2004:III, following their steep rise in the first and second quarters. Foreign-trade data for 2004:III show the drop in goods imports was and temporary one and was due to the dock strike, and during the second half of the year goods imports were 21.2 percent higher than in the second half of 2003. Goods imports in 2004:III fell by 2.8 percent, but rose by a marked 10.5 percent in the fourth quarter. Imports of intermediates and of capital goods significantly exceeded those in the second half of 2003.

Table 2. Indicators of Business Activity,[a] 2003–2004

		2003	2004				2004[b]	Last month for which data available
	2004	IV	I	II	III	IV	Jul–Dec	
Composite state-of-the-economy index	4.6	4.5	7.2	5.6	3.8	3.8	5.2	Dec
Large-scale retail trade	4.2	10.5	–0.5	3.2	9.1	0.5	4.2	Dec
Manufacturing production (excl. diamonds)	7.2	10.3	10.9	4.4	7.4	12.0	8.4	Nov
Business-sector consumption of electricity	3.0	–4.3	13.0	–12.2	22.5	–8.9	3.7	Nov
Index of revenue in commerce	7.2	8.4	13.1	1.4	1.4	12.2	6.7	Nov
Index of commerce and services revenue	8.3	11.1	9.9	4.5	5.3	7.4	8.0	Nov
Tourist arrivals	41.2	11.2	3.3	9.9	4.6	–2.6	23.5	Dec
Construction (average change from equivalent period in previous year)								
Residential starts	–26.3	6.9	–11.1	–12.6	–17.2		–12.7	Oct
of which: Government-initiated	–48.1	–11.4	–45.9	–44.4	–43.6		–26.2	Oct
Residential completions	–29.0	0.6	–13.9	–14.1	–21.1		–18.5	Oct
of which: Government-initiated	–21.2	–1.5	–17.9	0.5	–9.9		–1.0	Oct
Survey of companies (net balance, percent)[c]								
Output of manufacturing firms		9	29	20	23	29		Dec
Sales by commercial firms		11[d]	53	14[d]	16[d]	35		Dec

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

[b] Compared with July-December 2003.

[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 10% level.

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

Private consumption rose by 3.3 percent in 2004:III, outstripping the increase in disposable income. The rise reflects an increase in expenditure on current consumption, particularly on services, clothing and footwear. The relative quiet in the security situation and the changes in the Palestinian Authority led to more optimistic expectations of future activity, as can be seen from indices of consumer confidence, and thus contributed to a rise in private consumption. The rise in the share-price index in 2003, and then again in 2004, together with the improved employment situation and the rise in the average wage per employee post also helped to boost private consumption by increasing disposable income and the value of individuals' property/assets. Sales revenue indices of commerce and service industries (Table 2), which are used as indicators of private consumption, rose considerably in October and November.

Public consumption was 2.3 percent lower in 2004:III than in the previous quarter. The decline in civilian consumption was due to fiscal policy that acted to reduce government ministries' expenditure beyond the budget cutbacks by means of underperformance of the budget. On the other hand, defense imports increased.

Gross domestic investment fell by 3 percent in 2004:III after rising in the first two quarters of the year. **Fixed investment** also fell in the third quarter, by 3.5 percent, although the decline was more modest than that in the previous quarter. The decline in fixed investment reflects a contraction of investment in the principle industries and in residential construction: in the third quarter investment in investment in machinery and equipment slumped by 25.6 percent, and in transport equipment by 10.5 percent. Residential investment fell by 3.4 percent in 2004:III, having declined also in the two previous quarters. Foreign-trade data show that in the fourth quarter import of capital goods increased by 4.4 percent, possibly correcting for the delays caused by the action taken by the dock workers.

The rise in economic activity during the period reviewed, and especially in the last quarter of the year, was also expressed by the **state-of-the-economy index**, which

Figure 1

State-of-the-economy index, 1998-2004
(Average 1994=100)

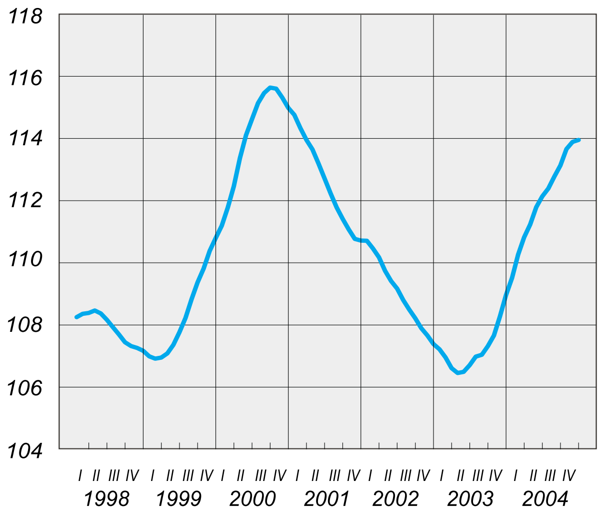
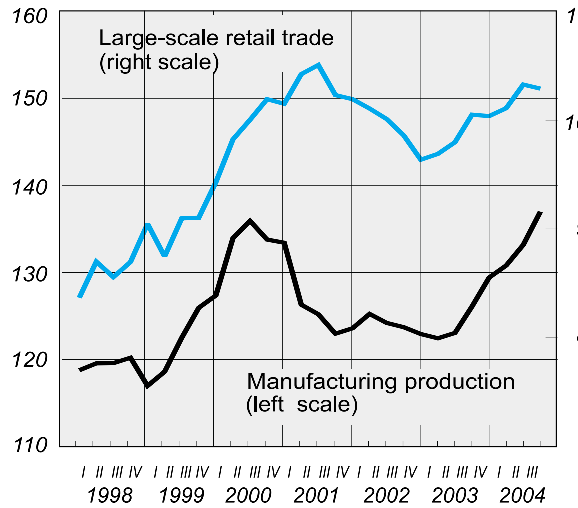


Figure 2

Manufacturing production* (index, average 1994=100) and large-scale retail trade (index, average 2002=100), 1998-2004



* Manufacturing production data to November 2004.

also reflects deviations from the trend of the rise in activity (Table 2). The index was 5.2 percent higher than in the second half of 2003; the rise was due to the increase in manufacturing production and in world trade and the rise in sales revenue index in the commerce and services industries. The level of the index (including its long-term trend) rose by 5.9 percent in 2004, similar to the rise in business-sector product.

The **Companies Survey** for the fourth quarter conducted by the Bank of Israel Research Department paints a similar picture to that obtained from the other indicators, according to which the trend of increased activity was similar to that in the third quarter (excluding the construction, transport and communications industries). In most industries companies expected activity to expand, both for the domestic market and for exports. In the construction industry the downward trend in activity both in buildings and in infrastructure intensified, and the decline was expected to continue in the first quarter of 2005. Companies in the transport and communications industries reported reduced activity, after a long period of growth. The reduction was attributable to the sharp drop in sales of services to the domestic market.

Manufacturing production (excluding diamonds) was 7.7 percent higher than in the equivalent period in 2003. It rose considerably in 2004:III, and in 2004:IV (partial data) it expanded even faster, by 8.9 percent (Figure 2).

Manufacturing production of the high-tech industries rose at an annual rate of 9 percent in the third quarter, and even more strongly in the fourth quarter. Production in the industries of mixed technological intensity (high-tech and traditional) grew by about 4.9 percent in 2004:III, and at a similar rate in the fourth quarter. In contrast, the traditional industries showed stable manufacturing production, and a decline of half a percent in the number of employees.

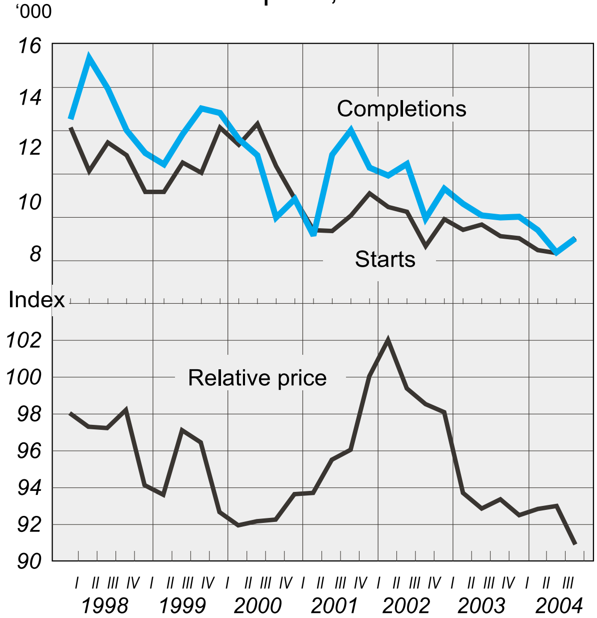
The rise in manufacturing production was a reflection of a marked increase in manufacturing exports, and in particular those of the electronics industries, and stability in production for the domestic market, despite the continued rise in private consumption. The reasons for this were the continued contraction during the period reviewed of the construction industry, a major consumer of products of the mixed and traditional industries, and the sustained rise in the share of imported substitutes at the expense of domestically manufactured items.

The number of hours worked per employee in manufacturing was 2.8 percent higher in 2004:III than in 2003:III, and 0.6 percent higher than in 2004:II. The number of employees in manufacturing was 2.3 percent and 0.7 percent higher over the same periods. The rise in employment, in contrast to the trend evident in the last few years, indicates a rise in demand for labor following the recession.

Activity in the **construction industry** continued to decline in 2004:III (Table 2). Demand eased after improving in

Figure 3

Housing units: starts and completions,* and relative price,** 1998-2004



* Original data, to October 2004, interpolated.

** Relative to CPI, 2002=100.

the first half of the year, and this was reflected in a fall in sales of new apartments. The number of employees in construction (Israelis, foreign workers, and Palestinians) was 7 percent lower than the number in the third quarter of 2003, the decline due mainly to the deportation of illegal foreign workers. According to the Companies Survey in the last quarter of 2004, contractors' expectations regarding future activity in the industry are pessimistic.

According to the National Accounts data for 2004:III, construction investment declined by 3.4 percent from its level in the previous quarter, with the fall encompassing both residential and nonresidential investment. At the same time the decrease in building starts and completions continued, so that the supply of area under active construction at the end of the third quarter was smaller than that at the end of the third quarter of 2003.

On the demand side, the downward trend of sales of new apartments continued persisted in 2004:III, after rising by 13 percent in January–July 2004. The relatively low interest rates in the mortgage market did not manage to bring about an increase in demand for new apartments.

In the second half of 2004 the number of government-initiated building starts went down by 43.6 percent from the number in the second half of 2003. This decline, concurrent with the abolition of grants and cutting back on eligibility, led to a standstill in construction in outlying areas, although the stock of unsold apartments is still high. The Companies Survey shows that the extent of activity, both residential and infrastructure, continued falling in the fourth quarter too.

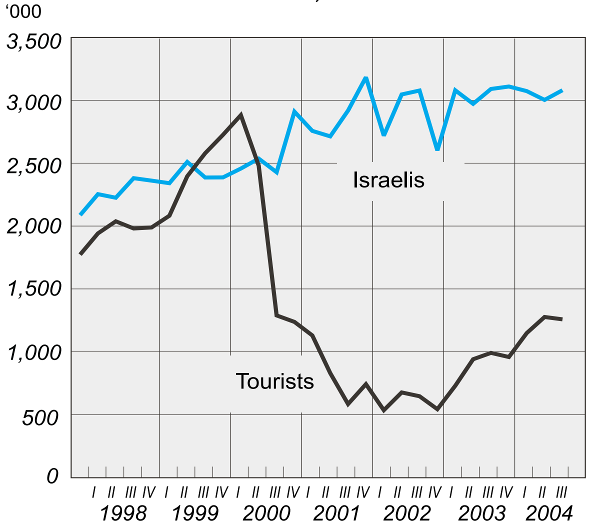
The above developments resulted in a fall of 2.3 percent in housing prices in 2004:III, following a rise of 4.5 percent in the first half of the year. On the other hand prices of second-hand apartments rose by 0.5 percent from the second quarter to the third. The decline in housing prices incorporates a rise in prices of large apartments (3.5 to 4 rooms) and a fall in prices of small ones (1.5 to 2 rooms).

The number of persons employed in the construction industry remained unchanged in 2004:III. This stability, against the background of the relative calm in the security situation and the more lenient granting of entry permits to Palestinians, reflects the substitution of about 7,000 Israelis employed in construction by 1,000 foreign workers and 6,000 Palestinians. The number of (legal and illegal) foreign workers employed in the industry reached 49,000 in the third quarter, about 26 percent of the total number of construction employees, similar to the number in 2004:I. As the wage costs of foreign workers are significantly lower than those of Israeli workers, the substitution of Israelis by foreign workers, contrary to government's declared policy, contributed to the lowering of wage costs in the construction industry. This is reflected in the index of construction inputs: the wages component is the only one that declined in the period reviewed.

The tourist industry rose considerably in the second half of the year, due to the improved security situation which resulted in a 25.5 percent increase in the number of incoming tourists from the number in the second half of 2003. Tourists' bed nights increased by 10.7 percent in the third quarter of the year, and by a further 2.5 percent in October and November. The faster rise in the number of tourists from abroad increased their share in total hotel bed nights to 30 percent, compared to 20 percent in 2003. Concurrently, the rise in private consumption was reflected in an increase in hotel bed nights of Israelis: these went up by 1.5 percent in 2004:III and by another 0.5 percent in the last quarter.

Figure 4

The hotel industry: bed nights of tourists and Israelis,* 1998-2004



* Seasonally adjusted.

The rise in the number of bed nights and of tourist arrivals resulted in increased activity in the industry. The increase in demand led to a 4.3 percent rise in the number of people employed,[3] but their wage remained stable. Tourist companies expressed optimistic expectations regarding future activity, mainly because of the number of tourist bed nights, but also due to the number of bed nights of Israelis, and expected a continued increase in 2005:I.

The labor market

Developments in the labor market during the second half of the year reflected the continued expansion of economic activity and were primarily influenced by the continuing turnaround in the business sector and the government policy of reducing employment in the government sector. The total number of employed grew in 2004:III in comparison to the preceding quarter although the rate of increase slowed (Table 3 and Figure 5). These developments translated into a decline in the rate of unemployment during 2004:III. The number of foreign and Palestinian workers rose during 2004:III in spite of the declared policy of the government.

During 2004:III, the upward trend continued in **employment** with the number of employed growing by 2.7 percent in comparison to the same period in 2003. During that same period, the number of workers in the government sector declined, apparently due to the government policy of reducing the size of the government sector and the early retirement of veteran workers. On the other hand, the number of Israelis employed in the business sector rose (Table 3).

The strengthening of growth during the period reviewed and the policy of reducing the number of foreign workers during the previous six months, led to the absorption of new workers in community services, business services and the automotive repair sector, as well as household services provided by individuals. The increase in the number of Israeli workers was the result of a significant increase in the number of part-time workers (an increase of 4.1 percent in comparison to the previous quarter). In contrast, the number of full-time workers continued to decline (by 0.5 percent in comparison to the previous quarter).

The increase in employment in 2004:III was accompanied by a sharp increase in the number of non-Israelis employed in the business sector (Table 3): The downward trend in the number of foreign workers halted,[4] while the number of Palestinian workers, which had dipped temporarily in the second quarter, rose again to about 43,000, the level at which it had stabilized in mid-2003.

The expansion in employment was accompanied by an increase in the **average wage employee post** of 1.6 percent in the third quarter relative to the previous quarter (Figure 6), although it remains low relative to the same period in the previous year. The increase in wages in the business sector was smaller than in the government sector so that in comparison to the same period in 2003, wages declined by one percent. The decline in wages in the business sector relative to the same period in 2003 was a result of the increase in the supply of civilian labor and in the proportion of part-time positions.

The **participation rate** during the period reviewed was higher by 1.1 percent than in the same period in 2003.

[3] Excluding hotel staff employed by manpower companies.

[4] According to estimates of the Central Bureau of Statistics.

Table 3. Indicators of Labor Market Developments, 2003–2004

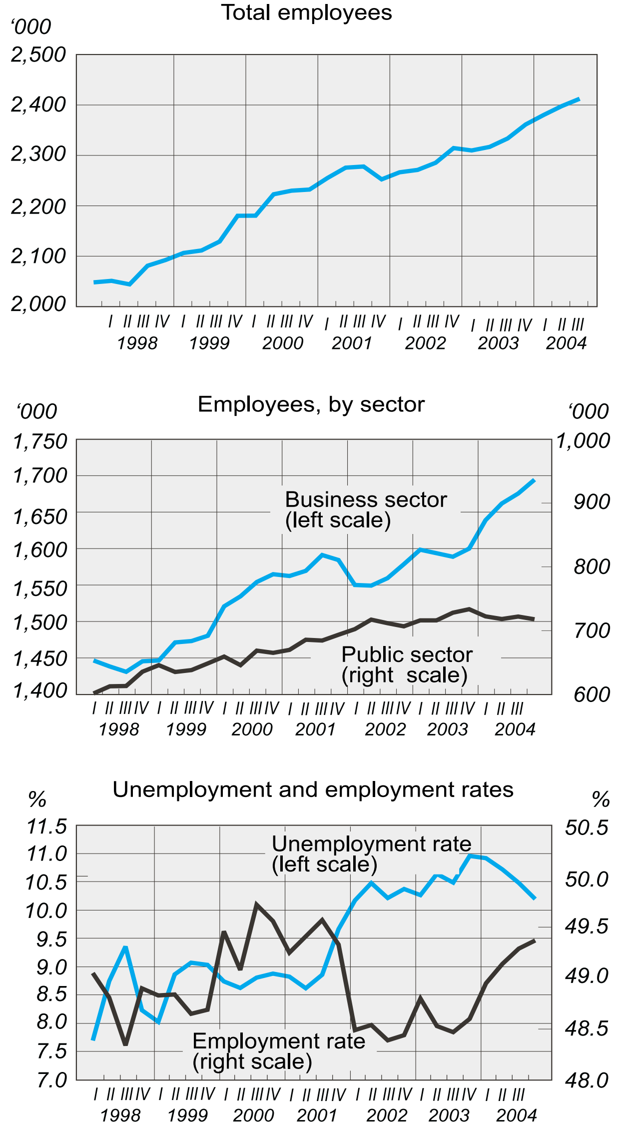
	2004		2003	2004					Last month
	III	IV	IV	I	II	III	IV	2004[a]	for which
	('000s)		(percent change from previous quarter)					Jul–Dec	data available
Civilian labor force	2,685		1.4	0.7	0.6	0.1		2.6	Sep
Israeli employees	2,411		1.4	1.0	0.8	0.4		2.7	Sep
Of which: In general government	718		–1.5	–0.6	0.5	–0.6		–0.7	Sep
In business sector	1,695		2.4	1.4	0.8	1.1		4.2	Sep
Foreign workers and Palestinians (unadjusted)	227		–2.8	–5.3	–6.1	6.0		–8.4	Sep
Of which: in business sector (unadjusted)	221		–2.9	–5.4	–6.3	6.1		–8.6	Sep
Average hours worked weekly per employee	37		–0.3	0.5	–0.8	–0.3		–3.6	Sep
Labor input in business sector (including foreign workers and Palestinians)	81,025		2.0	1.4	–0.3	–0.1		2.1	Sep
Of which: Israelis	70,341		2.8	2.3	–1.2	0.1		0.2	Sep
Labor input in general government (Israelis)	17,751		–3.0	–0.4	0.0	–0.7		–5.6	Sep
Unemployed	274		1.0	–1.1	–1.7	–2.7		1.7	Sep
Work seekers	236	229	6.4	–0.7	–1.5	3.0	–2.9	27.6	Dec
Claims for unemployment benefit	73	70	–0.4	–3.6	–11.4	–2.6	–3.8	–10.9	Dec
	Nominal NIS, unadjusted								
Real wage per employee post[b]	6,575	6,422	–0.4	2.8	–3.7	1.4	0.9	1.9	Oct
In general government	6,326	6,156	1.2	8.3	–13.4	4.9	1.9	2.5	Oct
In business sector	6,688	6,544	–0.4	1.3	–1.0	0.6	1.0	1.6	Oct
Nominal wage per employee post[b]	6,992	6,825	–0.3	2.7	–3.3	1.6	0.9	–0.7	Oct
In general government	6,727	6,542	0.9	6.8	–10.8	4.3	1.4	–0.1	Oct
In business sector	7,112	6,955	–0.3	0.9	–0.1	0.6	0.7	–1.0	Oct
				percent					
Participation rate			54.9	55.1	55.2	54.9		1.1	Sep
Employment rate			48.9	49.2	49.4	49.3		1.2	Sep
Unemployment rate			10.9	10.7	10.5	10.2		–0.5	Sep
Depth of unemployment[c]			35.2	38.7	42.6	39.7		11.6	Sep

[a] Compared with July-December 2003 (unadjusted).
[b] Including foreign workers and Palestinians.
[c] 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.

However, in 2004:III, it declined somewhat following five continuous quarters of increase. The decline in the participation rate in 2004:III reflected the decrease in the participation rate among women (to 49.6 percent) and the slight decrease among men (to 60.6 percent). These changes were influenced, among other things, by

Figure 5

The Labor Market,* 1998-2004



* To September 2004. Seasonally adjusted.

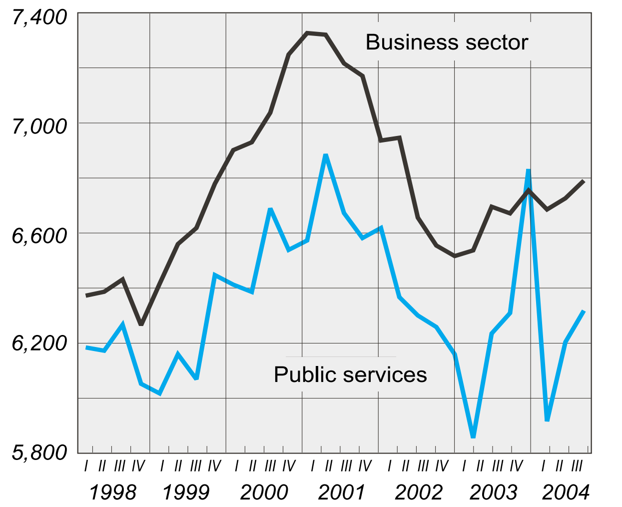
statutory changes, i.e. the reduction in guaranteed income supplements and the tightening of criteria for unemployment benefits.

The **unemployment rate** had declined to 10.2 percent by the end of 2004:III which was a continuation of the process which began in 2004:I. This decline, despite the increase in the participation rate, reflected the increase in the number of employed. The depth of unemployment

Figure 6

Real wage per employee post,* 1998-2004

(NIS, 2001 prices)



* To October 2004. Seasonally adjusted.

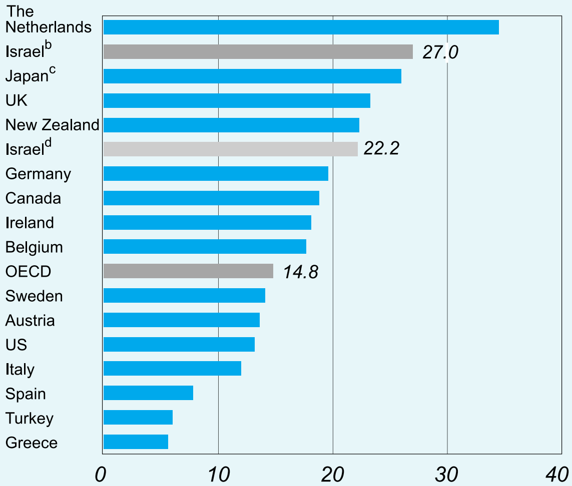
remained high – the proportion of unemployed who have been looking for employment for more than six months reached 39.7 percent in 2004:III. This represents an increase of 11.6 percent compared to the same period in 2003. In 2004:III, there was a slight decrease in the depth of unemployment which may indicate a change in trend following a long period of increase. Comparing the unemployment rates by gender shows that the decline in the unemployment rate among women was larger than among men. These developments reflect, for both genders, the decrease in the participation rate together with an increase in the number of employed.

The period reviewed was characterized by numerous work disputes arising from the government's plan to privatize government corporations in order to increase their efficiency and to reduce the size of the government sector. The intention to implement structural changes without the prior agreement of the unions and without ensuring workers' rights led to prolonged strikes (in the municipalities, religious councils, Bezek, Discount Bank and the seaports, as well as a one-day general strike) which harmed economic activity and foreign trade.

Part-Time Workers

The proportion of part-time workers (who worked less than 35 hours per week) in 2004 stood at 29 percent of the total number of employed as compared to a relatively stable rate of 27.5 percent during the previous three quarters. The increase in this proportion took place entirely in the second and third quarters of the year.[1] It is worth mentioning that during this period some 18 percent of the employed who generally worked less than 35 hours (for example, teachers and nurses) were considered to be full-time workers. Nonetheless, the number of part-time workers in Israel was higher than the average for OECD countries (Box Figure 1).

Part-Time Employees, International Comparison, 2003[a] (percent of total number of employees)

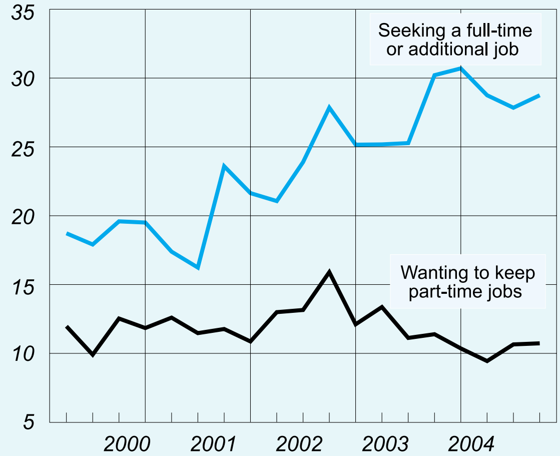


[a] In most of the countries shown, part-time employment is less than 30 hours a week.
[b] In Israel, employment for less than 35 hours a week is considered part time.
[c] Less than 35 hours actual work.
[d] Using the international definition of part time as less than 30 hours a week. This rate was also obtained with regard to employees working less than 35 hours a week, excluding those whose jobs were considered to be full time.

SOURCE: OECD Employment Outlook, 2004; the Central Bureau of Statistics Labor Force Survey, 2003.

The proportion of part-time workers among women is significantly higher than among men—40 percent as compared to 17 percent––with women accounting for some 65 percent of total part-time workers. This is due to the fact that part-time work allows women to more easily integrate into the labor market while maintaining a household and, in particular, bringing up small children. The proportion of part-time workers varies widely between the various sectors: part-time work is most common in the hotel and catering sector, education, health and personal and community services (with proportions varying from one third to one half of total employment in each sector) and least common in commerce and agriculture (about one quarter of the total employment in each sector). The tendency to work in a part-time job varies little between the primary age groups that participate in the workforce (ranging from 25-54), increases in the 55-64 age group and reaches a peak after retirement age.

Rate of Those Unsuccessfully Seeking a Full-Time or Additional Job vis-a-vis Those Wanting to Keep Their Part-Time Jobs,[a] 2000–2004



[a] Of employees and members of corporations who are generally employed in part-time jobs.
[b] To September 2004.

SOURCE: Central Bureau of Statistics.

[1] The calculations for 2004 are based on seasonalized data for the first three quarters of the year and the comparison was made to previous years accordingly. It is worth mentioning that a position of less than 35 hours does not necessarily represent a part-time position. Thus, for example, full-time teaching positions involve less than 35 hours; however, this distinction cannot be made for 2004 at this stage.

The proportion of part-time workers is also influenced by the business cycle. Thus, during a change in the trend of economic activity, employers tend to first adjust labor input by altering the hours of work per employee rather than changing the number of employees. This decision is a result of the employers' uncertainty as to the reliability and strength of the change in trend and the high cost of hiring and firing workers. In contrast, during an economic slowdown, it is expected that before firing workers, employers will reduce the number of hours worked by increasing the number of part-time workers. Indeed, in the past there has been a high correlation between changes in the rate of unemployment and changes in the proportion of part-time positions.[2] During the last business cycle, the economic slowdown in 2001 and 2002 was accompanied by an increase n the proportion of part-time positions in the total number of employed – from 25.8 percent in 2001 to 27.5 percent in 2002. In OECD countries as well, there was a significant increase in the number of part-time positions during those years which was a period of global economic slowdown.

Despite the theory which links the end of a recession to a reduction in the number of part-time workers and in contrast to the global trend (of stability and even a slight decline in the number of part-time workers at the end of the recession in 2003), the upturn in economic activity in Israel was characterized, as mentioned above, by the continuing increase in the proportion of part-time workers. Thus, the expansion of the number of employed in 2004 by 80,000 reflects an increase of some 60,000 part-time workers and only 20,000 full-time workers and as a result the proportion of part-time workers increased, as mentioned above, to 29 percent.

It is worth mentioning that the increase in the number of part-time positions resulted from the increase in the demand by employers for part-time workers rather than a scarce supply of full-time workers. Proof of this can be found in the increase of the proportion of part-time workers due to the difficulty in finding part-time jobs during the first half of 2004 as compared to the same period in 2003 (Box Figure 2).

The increase in the number of part-time workers during 2004 cannot be explained by a change in the relative size of the sectors of the economy. Thus, the sectors which expanded at more than the average rate were not those which are characterized by a high proportion of part-time positions. Similarly, the expansion of part-time positions cannot be explained by the gender breakdown of employment. In fact, this variable should have worked in the opposite direction due to the relatively large increase in employment among men who are characterized by a low proportion of part-time workers.

The increase in the number of part-time positions in 2004 was accompanied by a slight increase in the proportion of workers who earn less than half of the average wage to 27 percent which is similar to the proportion of part-time workers (during the first eight months of 2004 as compared to the same period in 2003). In addition, the distribution of these workers among the various sectors is similar to the distribution of part-time workers and thus the link between the two phenomena is evident. Furthermore, the proportion of low-salaried workers rose primarily in agriculture and community/social and personal services as well as hotels and catering, all of which are sectors which have a high proportion of part-time and non-Israeli workers. It appears that simultaneously with the upturn in the economy, the relative demand for part-time Israeli workers increased in these sectors. However, with the partial data that we currently possess (which lacks a breakdown of part-time positions according to sector), it is not possible to provide a full explanation of this phenomenon.

In summary, the increase in employment in 2004 primarily reflected an increase in the number of workers in part-time positions due to the difficulty in finding full-time jobs. This increase was also reflected in the increased proportion of workers earning less than half of the average wage in the economy. These trends raise the concern that this is temporary employment which will not provide long term income for these workers. This further emphasizes the need for policy measures that will encourage the creation of stable and reasonably paid employment.

[2] For more details, see Yanon Cohen, Haya Shteir and Ronit Nadiv, 2000 "Part-Time Work as the Only Option and Unemployment in Israel 1997-1979," *Economic Quarterly* (Hebrew), 47 (3).

Table 4. Balance of Payments, Foreign Trade, and the Reserves,[a] 2003–2004

	2004	2003 IV	2004 I	2004 II	2004 III	2004 IV	2004[b] Jul–Dec	Last month for which data available
		(percent change from previous period)						
Goods imports	21.6	2.9	10.4	5.9	–2.8	10.5	21.2	Dec
Of which: Consumer goods	19.3	0.7	8.6	1.8	–1.7	14.0	16.7	Dec
Capital goods	16.6	1.4	12.6	6.0	–3.3	4.4	18.8	Dec
Intermediates	24.3	4.2	10.1	7.1	–3.0	11.9	23.6	Dec
Goods exports	20.4	5.9	10.1	3.2	0.2	8.4	21.9	Dec
Of which: Manufacturing	20.3	5.8	9.1	4.2	0.6	7.5	22.1	Dec
Of which: High-tech	20.9	6.9	11.2	5.6	1.0	3.3	24.7	Dec
		quarterly averages, $ million						
Trade deficit	249	192	217	283	215	280	247	Dec
Current account, net		31	92	203	272			Sep
Financial account (excl. foreign exchange reserves)[c]	–848	–8	–672	–748	–1,126			Sep
Nonresidents' direct investment[c]	185	719	467	628	–541			Sep
Nonresidents' portfolio investment[c]	1,262	1,598	2,152	1,159	477			Sep
Residents' direct and portfolio investment abroad[c]	1,356	2,226	3,299	462	306			Sep
Net foreign debt (% of GDP)[c]		–4.3	–6.9	–7.9	–8.3			Sep
Bank of Israel reserves, end-period[c]	26,629	25,788	26,162	25,712	25,839	26,629		Dec

[a] Seasonally adjusted. Foreign trade data do not include ships, aircraft, diamonds, or fuel.
[b] Compared with July-December 2003.
[c] Unadjusted data.
SOURCE: Central Bureau of Statistics.

The balance of payments

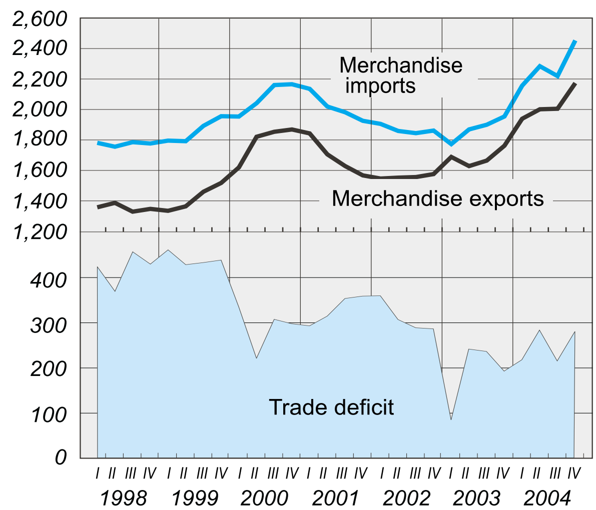
The accelerated increase in exports led to a larger surplus in the (net) current account in 2004:III totaling $272 million (Table 4) as compared to a surplus of $140 million in the same quarter in 2003. The deficit in the goods and services account declined relative to the same period in 2003 as did the deficit in the revenues account. The surplus in the current transfers account declined somewhat.

As a result of the expansion in exports, Israel's trade deficit was lower in the third quarter of 2004 than in the same period in 2003 (Figure 7). The data on the composition of trade during the period reviewed as compared to 2003 shows stability in the proportion of trade with the EU, a slight decrease in the proportion of trade with the US and an increase in the proportion of trade with Asia, especially trade with India and China which grew by some 50 percent.

The export of goods, excluding ships, planes and diamonds, during the period reviewed was some 20 percent higher than during the same period in 2003.

Figure 7

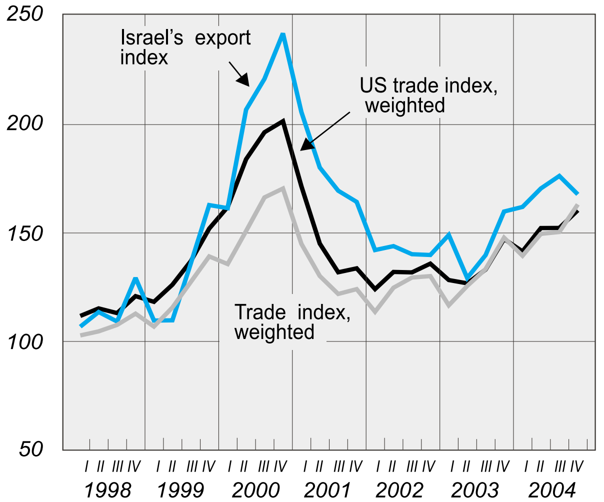
Foreign trade,* 1998-2004
($ million per month)



* Excluding ships, aircraft, diamonds and fuel.
Seasonally adjusted.

Figure 8

Israel's exports and US Trade: electronic components, electronic communications equipment, and scientific and monitoring equipment,* 1998-2004



* To November 2004, interpolated.

Industrial exports of all technological intensities grew relative to the same period in the previous year although most of the increase was concentrated in the hi-tech industries. This increase resulted from the expansion in global trade and the increase in demand for hi-tech products, in which Israel has a relative advantage, simultaneous with a 4.4 percent increase in the price of exports relative to 2003:III. The increase in exports of the hi-tech industries moderated in the third quarter and again accelerated in the fourth. This slowdown reflected the changes in the volume of trade of Israel's trading partners (Figure 8) and was possibly influenced by the work slowdown in the ports.

The import of goods, excluding ships, planes and diamonds, during the period reviewed was significantly higher than in the same period in 2003. The increase in imports encompassed all categories – raw materials, investment goods and consumption goods. The import of fuel rose in 2004:III by 28 percent following the increase in world fuel prices. The increase in the import of raw materials and investment goods reflected an increase in the Industrial Output Index while the increase in the import of consumption goods reflected an increase in consumption. During October and November the import of goods increased significantly, especially consumption goods and production inputs, following a decrease in the third quarter. This increase reflected the conclusion of the work slowdown in the ports.

The increase in energy prices in 2004:III contributed to the worsening of the terms of trade (excluding ships, planes, diamonds and energy products) which was reflected in an increase of 3.9 percent in the Terms of Trade Index relative to the same period in 2003. Export prices increased by 3 percent following smaller increases during the first half of the year. This increase reflected a significant rise in export prices in the mixed sectors and a smaller rise in export prices in the traditional sectors as opposed to a decline in the hi-tech sectors. Import prices increased in 2004:III by 4 percent following a cumulative increase of 5.5 percent in the first half of the year. These increases reflected a steep increase in the price of energy products, a moderate increase in the price of consumption goods and an increase in the price of raw materials (excluding ships, planes and diamonds).

The surplus in the net services account increased in the third quarter, apparently as a result of the increase in the export of software and R&D services[5] and incoming tourist and transportation services which continued to expand during the period reviewed. During 2004:III, the export of software and R&D services grew by 12 percent relative to the same quarter in the previous year. This was the result of an increase in demand for these services in the US and EU. The export of tourist and transportation services grew during 2004:III relative to 2003:III as a result of the relative quiet in the security situation. During the same period the import of services from abroad grew by 9 percent which primarily reflected the sharp rise in the import of transportation services as a result of increases in the price of port services and import fees.

The investments of Israeli residents abroad declined during 2004:III by 30 percent compared to the same quarter in the previous year to a total of some $400 million. Most of the decrease resulted from a decline in investment in tradable securities that reflected the strengthening of the shekel and the reduction in the interest rate gap. On the other hand, direct investment abroad by Israel residents grew by $300 million which was primarily the result of investment in the equity capital of construction companies building abroad and the exceptionally large transaction at the beginning of the year involving the purchase of the Sicor corporation by Teva, an Israeli corporation. At the same time, the drop in Israel's risk premium and the weakening of the dollar against the shekel led to a large drop in the investment of Israelis in foreign bonds and notes and in the holdings

[5] We do not possess detailed information on the export of software and R&D services which are included in other services, however, the principal source of the increase in the export of other services is the export of software and R&D services.

of foreign currency abroad as compared to the same period in the previous year.

Foreign investment in Israel declined significantly during the period reviewed (Table 4) and a negative investment of $757 million was recorded in 2004:III as compared to investment of $1.75 billion in the third quarter of the previous year. This decline reflected the sale of Israeli securities by foreign residents, the issue of shares in Bezek and the sale of government bonds. In November, $750 million was raised within the framework of the US guarantees. The Bank of Israel's foreign currency reserves stood at $26.5 billion at the end of the period reviewed, representing an increase of 2.8 percent relative to the level at the beginning of the period.

General government

During the period reviewed, the Government continued to apply an expansionary policy on the tax side (by cutting taxes) and a contractionary policy on the expenditure side (by underperforming the budget, which was contractionary to begin with). Despite the cuts in personal and corporate taxes, the domestic deficit ended 2004 at 3.9 percent of GDP, slightly under the target—mainly due to the underperformance of expenditure and a real 6.5 percent increase in revenues abetted by economic expansion. In 2004, the general-government deficit fell to 4.3 percent of GDP as against 5 percent on average in the previous two years. The cycle-deflated general-government deficit decreased by 0.9 percent during this time.

The **domestic deficit (cash basis),**[6] excluding issue of credit, was NIS 17.4 billion in 2004 as against NIS 26.5 billion in 2003. During the half-year reviewed, the deficit ballooned to NIS 11.3 billion as against NIS 6.1 billion in the first half. The deficit increased steeply in 2004:IV due to an aberrant upturn in expenditure—NIS 4.6 billion over the seasonal trajectory—in December, a larger increase than that resulting from advance payment of vacation bonuses.

Government tax revenues were 5.8 percent greater in 2004 than in 2003. The economic upturn in the first half of 2004 and the steep increase of durable-goods imports during this time boosted income-tax revenues by 7.7

[6] The examination focuses on the domestic deficit due to the seasonal volatility of the external deficit.

Table 5. Government Budget Performance vis-à-vis Deficit Target, 2003–2004

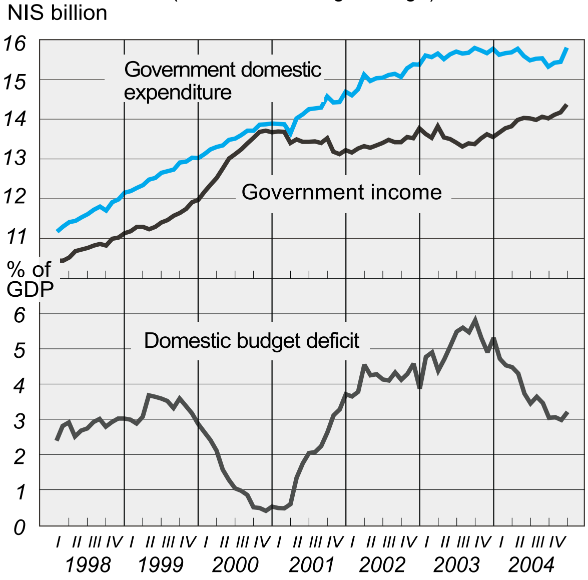
		2003	2004				2004[a]	Last month
	2004	IV	I	II	III	IV	Jul–Dec	for which data available
Domestic deficit as percent of GDP	1.2	2.1	0.3	1.4	0.6	2.5	5.9	Dec
			deviation from path[b] (excl. credit extended, NIS billion)					
Government revenue	–1.5	–2.7	0.5	–2.5	2.3	–1.9	6.4	Dec
Government expenditure	–3.4	–2.9	0.1	–2.2	3.2	–4.6	0.5	Dec
Domestic deficit	–1.9	–0.2	–0.4	0.3	–0.7	–1.1	–34.1	Dec
Total government deficit	20.4	–8.0	0.1	–7.4	–3.1	–9.8	–27.7	Dec
			percent change from previous period					
Government tax revenue	4.9	0.9	8.5	6.2	0.3	4.9	0.9	Dec
Of which: Income tax, net	3.1	–2.3	10.1	1.6	–0.9	1.5	–2.3	Dec
VAT, gross	4.6	3.0	3.4	6.1	4.1	4.8	3.0	Dec
Government expenditure	0.2	–0.6	–2.1	–5.2	–4.4	11.7	–0.6	Dec
National Insurance allowances	–4.8	–11.2	–6.5	–7.6	–4.6	–0.6	–9.3	Nov
Of which: Unemployment benefit	–12.2	–25.9	–7.8	–16.2	–18.3	–9.5	–25.5	Nov
Income support	–9.4	–25.8	–15.9	–19.8	–4.4	7.3	–26.6	Nov
National Insurance contributions received from the public	1.5	–4.4	2.7	0.0	–0.7	4.0	–4.4	Dec

[a] Compared with July-December 2003.
[b] The path was determined on the basis of a deficit of 3 percent of GDP in 2003, and 4 percent of GDP in 2004.
SOURCE: Ministry of Finance.

Figure 9

Government cash flows, 1998-2004

(12-month moving average)



percent and import-tax revenues by 25 percent. The acceleration of tax revenues slowed in the second half of 2004 to only 3.6 percent more than during the year-earlier period. The slowdown traced to tax cuts for low- and middle-income earners in 2004:III, a perceptible increase in the proportion of persons earning less than the average wage and paying very little income tax—for reasons including a proportional increase in part-time employment in total employment (see box)—and a slowdown in imports of tax-intensive goods during the period reviewed. Non-tax revenues (excl. National Insurance) were low throughout the period reviewed, at about half the level foreseen in the budget.

In the second half of 2004, government expenditure fell far short of the seasonal trajectory (except in December) pursuant to the expenditure underperformance that began in the first half of the year. Thus, government domestic outlays in 2004 were NIS 3.4 billion smaller than the budgeted level and only 0.5 percent higher, in real terms, than in 2003, notwithstanding a spike in December due to early performance of 2005 expenditures.

Payouts of National Insurance benefits continued to contract significantly during the period reviewed due to the toughening of criteria for unemployment compensation and a cut in child allowances. In July–November, benefit outlays decreased by 3.1 percent in real terms as against the year-earlier period. The decline reflected decreases in all benefit payouts and, especially, a 15.8 percent fall in unemployment compensation and a 16.4 percent real decrease in child allowances. Child allowances are expected to decline again in 2005 due to an adjustment of benefit sums in January. (See "Events in July 2004–January 2005.")

The 2005 budget is the first that addresses itself to the Government's new fiscal targets—a deficit ceiling of 3 percent of GDP and a real increase of 1 percent in expenditure. According to the budget, real expenditure will expand by 3.2 percent over actual expenditure in 2004. The budget that the Government approved assumes that real government revenues will increase by 6.5 percent even though the policy of cutting taxes on labor and corporations will continue, lowering the maximum marginal personal tax rate (income tax, National Insurance contributions, and health tax) to 49 percent as of January 2005 and reducing the rate of corporate tax to 34 percent.

The Government is expected to meet the 3 percent deficit target, albeit only if added expenditure for the disengagement is not taken into account. This expectation is based on estimated increases of 6.2 percent in tax revenues and 8.5 percent in other revenues. The tax-revenue estimate may be overly optimistic. The NIS 1.1 billion reserve for meeting the expenditure target will allow the Government to accommodate some deviation from the revenue forecast. If a larger deviation occurs, however, some underperformance will be necessary in order to stay under the deficit ceiling. Due to the deficit cuts and the acceleration of growth, the public debt/GDP ratio is expected to edge downward.

Global developments

The global recovery became more firmly based during the period reviewed. The IMF global growth outlook for 2004 was 5 percent in September as against 3.9 percent in 2003 (Table 6). The increase traces to 3.6 percent growth in developed countries, which generate more than 75 percent of global GDP, and 6.6 percent growth in developing countries. The global growth powered an increase in global trade (Table 6) and, in particular, an upturn in demand for unprocessed goods and raw materials—causing their prices to rise. Oil prices surged in particular, due to a confluence of greater demand—especially from 2004:II—and supply problems in several oil-exporting countries.

Table 6. Indicators of Economic Development in Advanced and Developing Countries,[a] and Forecast for 2005,[b]

	2002	2003	Estimate 2004	Forecast 2005
World GDP	3.0	3.9	5.0	4.3
Advanced countries	1.6	2.1	3.6	2.9
Developing countries	4.8	6.1	6.6	5.9
World trade	3.3	5.1	8.8	7.2
Advanced countries				
Imports	2.6	3.7	7.6	5.6
Exports	2.2	2.6	8.1	6.3
Developing countries				
Imports	6.0	11.1	12.8	11.9
Exports	6.6	10.9	10.8	10.6
Inflation (CPI)				
Advanced countries	1.5	1.8	2.1	2.1
Developing countries	6.0	6.1	6.0	5.5
Prices of unprocessed goods (US$)				
Oil[c]	2.5	15.8	28.9	
Other	0.6	7.1	16.8	–3.9
Short-term interest[d] (percent)				
Dollar deposits	1.9	1.2	1.6	3.4
Euro deposits	3.3	2.4	2.4	3.1
Unemployment rate in advanced countries (percent)	6.4	6.6	6.3	6.1

[a] According to "World Economic Outlook," Israel is classified as an advanced country.
[b] Annual rate of change, percent, except for unemployment and interest rate.
[c] Average price per barrel in 2003 was $28.89.
[d] 6-month Libor rate.
SOURCE: "World Economic Outlook" (IMF), updated September 2004.

The US continued to drive growth in developed countries. According to data for the first three quarters of 2004, the growth rate of US GDP is heading for 4.0 percent, slightly under the initial IMF outlooks, as against 3.6 percent in the industrialized countries at large. American GDP grew at a 4 percent annual pace in 2004:III after a slight slowdown in the previous quarter, reflecting a decrease in imports that was partly offset by a decline in general-government expenditure. During the survey period, growth in the US was led by rising productivity—up 1.8 percent in 2004:III—and a stable 5.4 percent unemployment rate. The growth was accompanied by a (foreseen) 5.6 percent balance-of-payments deficit, a large trade deficit due mainly to a steep increase in imports of goods, and an expected budget deficit of 4 percent of GDP, burdened by massive defense outlays related to the rehabilitation of Iraq. Due to concern about inflation pressure, the Federal Reserve raised the federal funds rate by 1.25 percentage point, nevertheless leaving the rate relatively low.

The EU, in contrast, is expected (IMF outlook) to end 2004 with a rather sluggish growth rate of 2.2 percent, reflecting an increase in investment and a less vigorous upturn in private consumption. The unemployment rate edged downward, leveling off at 8.9 percent in 2004:III as against 9.1 percent in 2003. The 12.7 percent appreciation of the euro during the period reviewed—to $1.36 to the dollar—hindered the export industries of European countries, especially Germany and France, which experienced growth of only 0.4 percent in 2004:III.

In Japan, the impressive recovery trend is continuing; growth is projected at 4.4 percent, the highest rate in the past decade. China continued to grow impressively at 9.5 percent in 2004,[7] despite a 0.27 percentage-point rate increase and regulatory restrictions that slowed the rates of growth and inflation.

[7] According to initial estimates of the Chinese central bureau of statistics, released on January 25, 2005.

The increase in global demand, especially in China, elevated oil prices by 13.2 percent during the half-year reviewed on the heels of an 18.1 percent upturn in the first half. The global increase in oil prices was uneven during the period reviewed. Prices surged by 30 percent upturn in 2004:III relative to 2004:II, peaking at $56.2 per barrel (North Sea oil) in October, thereby denting global growth and raising prices in developing countries. In 2004:IV, as OPEC came under global pressure to boost production, per-barrel oil prices fell by 13.3 percent.

Prices, monetary policy, and the money and capital markets

During the half-year reviewed, the **Consumer Price Index** slipped by 0.2 percentage point (Table 6) after rising by 1.4 percentage point in the first half (mainly in April). Several components of the index fell (foremost housing); others rose. The fruit-and-vegetable component increased aberrantly. The CPI net of seasonal factors—housing, fruit and vegetables, and clothing and footwear—climbed gently during this time. For the year all told, the CPI rose by 1.2 percent, slightly below the lower bound of the price-stability target range. The index rose by 1 percent net of fruit and vegetables and by 2.3 percent net of housing.

Two contributory factors abetted price stability. First, although the economy emerged from the recession and activity expanded during the year, inflation pressures were absent due to surplus production capacity that was reflected in under-utilization of factor inputs. Second, the NIS appreciation against the dollar in the second half of the year, especially in view of the dollar depreciation around the globe (even though the NIS/dollar interest spread narrowed), had a downward effect on prices—especially in 2004:IV—due to the mechanisms that index domestic housing prices to the dollar. The CPI increase was fueled in part by the prices of imported intermediates, which climbed during the year mainly due to the hefty upturn in oil prices. In the estimation of the Research Department, the increase in oil prices raised the CPI by 0.5 percentage point. It also affected the index of wholesale prices of industrial output, which climbed by 8 percent during the year, mostly due to higher prices for oil and for goods that are oil-intensive in their production processes.

Gross **inflation expectations** to twelve months ahead, as derived from the capital market, were 1.6 percent during the period reviewed—within the inflation target range (Figure 11). Expectations fell in 2004:IV and came to 0.9 percent on average in December, apparently in view of the low CPIs and the steep appreciation of the NIS against the dollar (Table 6). Inflation expectations to a medium term ahead (2–3 years) also fluctuated within the target range and dipped to 2.3 percent in 2004:IV. Average expectations to longer terms ahead (4–10 years) remained above the upper bound of the target at 3.6 percent in December.

In view of stability in the markets and the leveling off of long-term yields after a downtrend, monetary policy took expansionary action. The key rate was left at 4.1 percent

Figure 10

Inflation in previous 12 months and the inflation target, 1998-2004

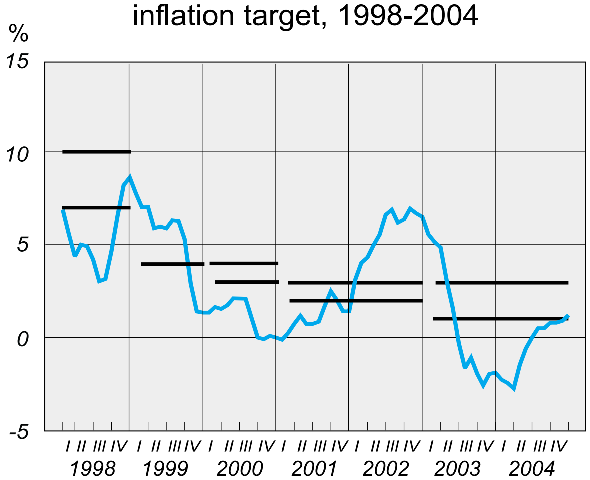


Figure 11

Interest, and inflation expectations, 1998-2004

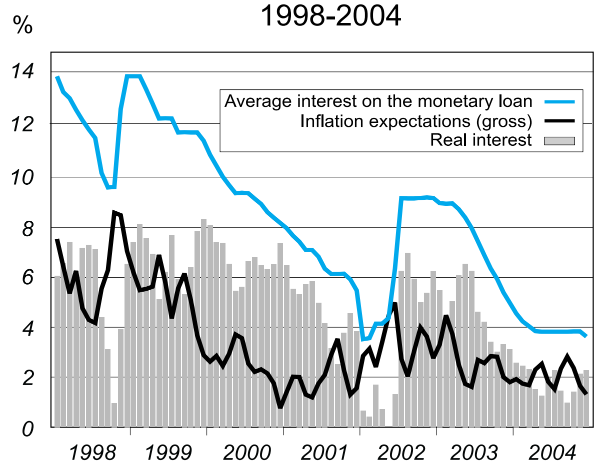


Table 7. Selected Price Indices,[a] 2003–2004

	2004	2003 IV	2004 I	2004 II	2004 III	2004 IV	2004[b] Jul–Dec	Last month for which data available
CPI	1.2	–1.6	–0.4	6.2	–0.8	0.0	–0.4	Dec
CPI excl. housing, fruit and vegetables	2.1	–0.8	0.0	8.5	–1.9	2.0	0.0	Dec
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.5	–4.2	2.6	7.2	0.7	–0.3	0.2	Dec
Index of housing prices	–2.5	–5.8	0.0	5.8	0.4	–14.9	–7.5	Dec
Wholesale price index	7.6	4.9	9.2	11.1	2.4	7.7	5.0	Dec
NIS/$ exchange rate	–1.2	–6.3	10.4	1.2	–1.7	–13.1	–7.6	Dec
NIS/currency-basket rate	1.8	7.3	11.5	–0.5	–1.7	–1.4	–1.6	Dec

[a] Annual rates of change during period, compared with previous period, percent.
[b] Compared with July-December 2003.
SOURCE: Central Bureau of Statistics.

in 2004:IV and lowered to 3.9 percent in December (and to 3.5 percent in February 2005). Consequently, the average real expected short-term interest rate sank to 2.5 percent, the lowest level in several years. Interest was kept low even though the US federal funds rate was raised by 1.25 percentage point during the period reviewed. Thus, the interest spread between the countries' central banks narrowed to a mere 1.65 percentage points in December and to 1.45 percentage points in January 2005.

The downtrend in **yields on one-year Treasury bills** halted in 2004:II when the rate-cutting process ended but resumed in 2004:III, albeit moderately and mainly in longer-term instruments. Later on, as the key rate for December and January was lowered, the curve declined along its full length by 0.5 percentage point and its slope remained positive. The positive slope of the curve during the half-year reviewed, relative to the beginning of the year, reflected expectations of a modest rate increase during the year ahead that was postponed each month.

Table 8. Monetary Aggregates and Nondirected Bank Credit, 2003–2004
(annual terms, percent)

	2004	2003 IV	2004 I	2004 II	2004 III	2004 IV	2004 Jan-Dec	2004 Jul-Dec	Last month for which data available
Rates of change	Average	Percent change from previous period					During period		
M1[a]	18.1	10.5	32.1	24.2	21.4	2.2	18.7	12.2	Dec
M2[b]	4.1	8.4	3.6	–0.4	7.6	5.3	5.4	7.7	Dec
M3[c]	4.5	5.0	7.0	4.2	5.7	4.9	6.7	6.9	Dec
Nondirected bank credit	1.2	0.1	7.4	1.8	–0.5	–0.6	1.6	–1.5	Dec
Unindexed local-currency credit	5.4	–1.6	8.5	7.0	6.6	8.8	6.9	6.5	Dec
CPI-indexed credit	0.0	–5.1	16.4	–3.4	–3.7	–6.7	0.4	–6.6	Dec
Foreign-currency-indexed and denominated credit	–2.9	10.5	–5.7	2.5	–5.4	–4.4	–3.7	–4.8	Dec

[a] Narrow money supply (cash in the hands of the public and demand deposits).
[b] M1 plus short-term local-currency unindexed deposits.
[c] M2 plus short-term CPI-indexed deposits.
SOURCE: Bank of Israel.

Figure 12

Monetary aggregates and credit, 1998-2004
(real change in last 12 months)

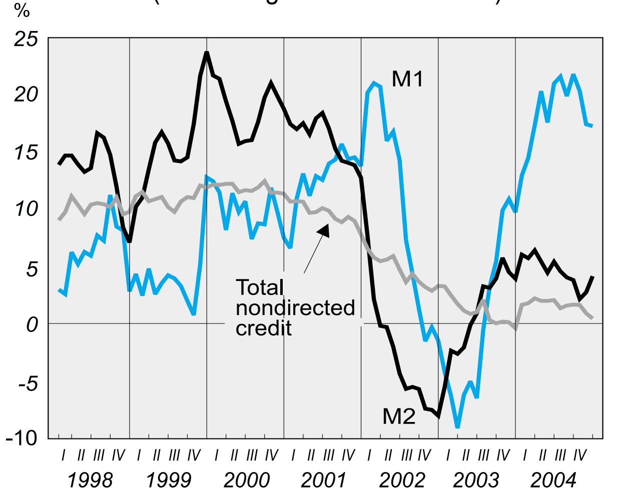


Figure 13

The NIS exchange rate against the currency basket and the dollar, 1998-2004

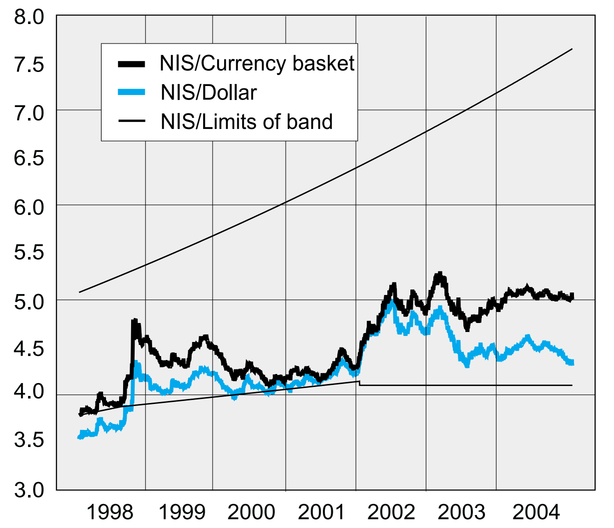
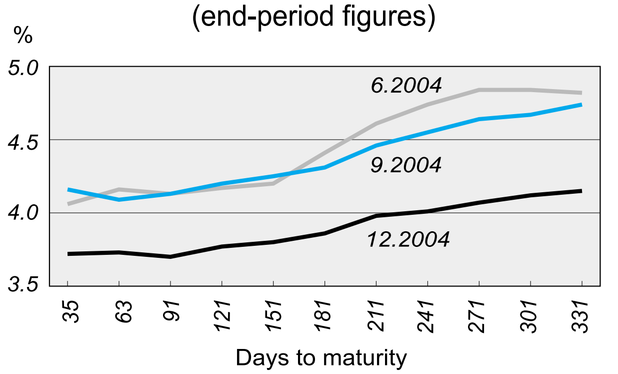
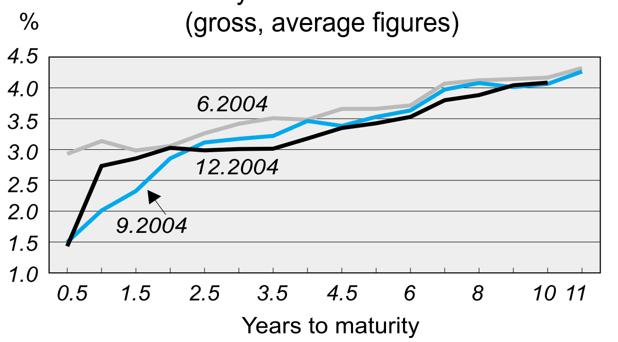


Figure 14

Treasury bills yield curve, July-December 2004
(end-period figures)



Yield on CPI-indexed Treasury bonds,
July-December 2004
(gross, average figures)



This change in the slope exceeds the country risk premium, which compensates for future uncertainty, and parallels expectations of a rate increase in the US. T-bill yields for December showed that in view of the narrowing of the NIS–dollar interest spread, the capital market expects no rate increase until the second half of 2005 (Figure 14).

Real future yields on CPI-indexed bonds decreased during the half-year reviewed relative to the high level observed in May. The shorter the term to maturity, the steeper the decline was. Thus, the curve sloped more steeply (Figure 13), reflecting monetary expansion and the recovery of real activity.

The share of liquid assets increased perceptibly during the half-year reviewed (Table 8). The **money supply** (M1) expanded at an 18 percent annual pace. The current-account component of M1 accounted for most of the increase, growing by 19 percent, as the cash component increased by a more modest 8 percent. This rate of increase, the fastest in recent years by far, is partly explained by the low nominal interest rate and the continued economic recovery. The imposition of capital-gains tax made investment less advisable and for this reason, among others, M1 growth outpaced the increase in nonindexed NIS deposits by 2.2 percent (Figure 12). M2 expanded in tandem with M1 and SROs. Despite the increase in current deposits, the share of short-term deposits fell during the year to 77.3 percent and that of

Table 9. Interest Rates, Yields, and the Share-Price Index, 2003–2004
(annual terms, percent)

		2003	2004				2004[a]	Last month for which data available
	2004	IV	I	II	III	IV	Jul–Dec	
Nominal interest							average	
Effective interest on monetary loan	3.9	5.4	4.3	3.8	3.8	3.8	3.8	Dec
SRO deposits	3.2	4.4	3.4	3.1	3.1	3.1	3.1	Nov
Nondirected local-currency credit	7.5	8.9	7.9	7.4	7.3	7.3	7.3	Nov
3-month Eurodollar	1.5	1.0	1.0	1.2	1.6	2.2	1.9	Dec
Yield to maturity on: Treasury bills	4.8	5.4	4.8	5.0	4.8	4.6	4.7	Dec
Real yield on 10-year bonds	4.2	4.2	4.1	4.3	4.3	4.2	4.2	Dec
Real yield on 5-year bonds	3.8	4.2	3.8	3.9	3.8	3.6	3.7	Dec
Expected inflation	2.0	2.2	1.8	2.2	2.2	1.8	2.0	Dec
General Share-Price Index (change)	17.4	18.2	9.2	5.8	–9.7	12.5	1.6	Dec

[a] Compared with July-December 2003.
SOURCE: Bank of Israel.

long-term deposits climbed to 14 percent. Although the term of NIS deposits has been lengthening in the past two years, short-term deposits still account for the largest proportion of the aggregate.

Unrestricted credit decreased during the half-year reviewed by 1.5 percent (Table 8) after an increase in the first half. The moderate decrease in unrestricted credit despite the recovery of economic activity traces in part to a decrease in bank credit supply in view of regulatory restrictions on borrowers and an increase in the supply of nonbanking credit sources as the low interest rates prompted investors to seek attractive opportunities. These developments were reflected in an increase in capital raising by firms in the past two years, especially in the form of corporate bond issues.

The **General Share Price Index** rose by 1.7 percent during the period reviewed, falling slightly behind the American share indices (NASDAQ and S&P 500) after outpacing them in the first half of the year. The General Share Price Index behaved unevenly, falling by 9.7 percent in 2004:III and gaining 12.4 percent in 2004:IV (Table 9). Trading volumes climbed perceptibly and daily turnover in December was NIS 1 billion, the highest level in the past ten years. The rise of the index during the period reviewed seems to reflect investors' trust in fiscal and monetary policies, which marched in tandem to support a confluence of heightened economic expansion, price stability, and lowering of the risk premium. Positive indicators about the state of the economy, optimistic expectations for 2005:I, relative calm on the security front, and changes that the Palestinian Authority underwent in early November also abetted market optimism.

The Teltech index, an indicator of expectations of IT growth, climbed by 3.7 percent during the period reviewed after dipping in the first half of the year. This increase, although quite moderate, reflected investors' expectations of continued growth in this field. The Maof and bank-share indexes rose more vigorously, by 10.8 percent and 25.4 percent, respectively, suggesting that investors expect overall economic activity to continue to expand.

As part of the advancement of the tax reform, **tax discrimination** against investments in foreign securities was abolished in January 2005. The tax rate, set at 35 percent until then, was aligned with the rate on investments in domestic securities. This action may have two clashing effects. First, it will enhance the wellbeing of Israeli investors and their ability to spread risks; this may boost the value of the total portfolio. However, the relative increase in advisability of investing in foreign securities may result in a capital outflow that will cause the NIS to depreciate, since the main intended effect of the elimination of tax discrimination is make investing in foreign bonds more worthwhile. Since Israeli investors, like counterparts in many countries, have a strong "home bias" for domestic shares, and since the reform had long been foreseen and some investors probably already took it into account, no immediate effect on the forex market is expected.

Events in July 2004–January 2005

Month	Date	Event	Details
Jan 2004	16	Moody's Investor Service upgrades its outlook on the Israeli banking system from "Negative" to "Stable".	
	25	The Government authorizes the entry of market makers in the bond market.	
Aug	1	The Credit Data Law goes into effect.	The law makes more information available to lenders and allows them to inspect customers' credit history, thereby facilitating their decisions about giving credit and setting credit terms.
	4	The Knesset (parliament) passes a law concerning gradual competitivization of postal services starting in 2006.	By 2009, 70 percent of the market is to be competitive. The Postal Authority will become a government corporation.
	5	The port strike ends as the State and the port workers conclude an agreement of principles.	
	15	The Government approves the 2005 budget.	
Sep	2–3	The new Histadrut-owed pension funds (opened after 1995) are sold to private investors—New Mivtahim to Menorah Insurance, New Makefet to Migdal Insurance, and Meitavit to Clal Insurance.	The proceeds of the sale of these funds (NIS 1.05 billion in all) will be used to reduce the deficits of the old pension funds. This completes another phase in the pension-industry reform that began a year ago, including the passage of a Pension Law, appointment of special managers for the funds, and introduction of a standard code of rules.
	8	The Committee for Enhancement of Competition in Banking and the Capital Market presents its recommendations (the "Bachar Report") to the Minister of Finance.	
	21	Wage arrears in municipal authorities set off a one-day general strike. Ruling by Labor Court links wage payments to recovery plans and demands an end to the strike.	
	22	The State concludes an agreement of understandings with CityPass for financing of the Jerusalem light-rail project.	
Oct	18	The Knesset approves on first reading an amendment to the Income Tax Code that equalizes the tax rates on externally and domestically traded securities. The amendment will go into effect on Jan. 1, 2005.	Since the tax reform went into effect in early 2003, gains from the sale of domestically traded securities have been taxed at 15% and those traded elsewhere at 25%. The amendment moves up the implementation of the original reform.

Month	Date	Event	Details
Oct	19	OPC wins tender for construction of NIS 1.23 billion independent power plant at Rotem Plain.	The dual fired combined cycle gas turbine plant will be a B.O.T. project—designed, financed, operated, and maintained by the franchiser for 25 years and then transferred to the state.
	28	Israel raises $750m in 20-year bonds guaranteed by the US Government.	
	29	Eight bidders vie for controlling equity in Bezeq.	The State intends to sell 30% of Bezeq share equity plus warrants for another 10.6%. Today, the State has a 46.4% share in Bezeq share equity.
Nov	11	An administrative order concerning bank loans to municipal authorities is signed.	The order defines municipal authorities' interest payments on the bank loans as a "crucial expenditure," thus allowing authorities to meet payrolls without risking garnishment of their funds.
	14	To stimulate construction, the number of credit days given by contractors to general government is reduced to 5.	
	22	After eight months without change, the Bank of Israel lowers the key rate by 0.2 of a percentage point, setting it at 3.9 percent for December.	The NIS–$ interest- rate differential narrows to 1.65 percentage points.
	25	Israel and China conclude their second financial cooperation accord.	The accord promotes bilateral trade by allowing Chinese companies to take long-term loans to do business with Israeli exporters in the fields of capital products and infrastructure.
Dec	14	Israel, Egypt, and the US conclude a QIZ (Qualified Investment Zone) agreement.	The agreement creates FTA terms, a customs exemption, and a quota exemption for Israel-Egypt joint manufacturing in preferred industrial areas for the purpose of free export to the US.
	16	The contractors' association and the Government conclude an accord that, from May 2005, replaces the allocation of permits for employment of foreign workers in construction with the issuance of employment licenses for companies.	As part of the agreement, the quota of foreign construction workers is lowered from 20,000 today to 17,500 in 2005 and 15,000 in 2006. The license fee will be raised from NIS 4,000 per worker per year to NIS 10,000 from 2005 on.
	22	The Knesset Finance Committee approves the government bond-market reform.	The reform is expected to lower the cost of capital to the government and, in turn, to firms and households, and to broaden the investor base in government bonds, including foreign financial institutions.

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