RECENT ECONOMIC DEVELOPMENTS*

Main developments

Data on activity in the principal industries in the first half of 2000 (the period reviewed) point to the consolidation of the economic recovery that began in 1999:II, notably the rapid growth of GDP and business-sector product, the rise in the composite index, increase in imports of intermediates and capital goods, and expansion of labor inputs in the business sector. Concurrent with economic growth were structural changes which are consistent with sustainable growth—a change in the composition of employment (contraction of employment in the general government sector and expansion in the business sector), by-industry composition (rapid rise in the output of advanced industry, and of high-tech in particular), composition of uses (rapid increase in exports and moderate rise in private and public consumption), and continued reduction of the trade deficit. The rapid economic growth was accompanied by real local-currency appreciation, despite the slowing of domestic demand and the deterioration in Israel's terms of trade, and was led by exports, which soared. According to the trends that emerged in the period reviewed, progress was made towards attaining the long-term annual goals in the areas of prices and the reduction of the budget deficit.

In the period reviewed, as in 1999, macroeconomic developments in Israel were closely connected with global developments, and in 2000 were favorable to Israel. Estimates for 2000 indicate that world trade is expanding far beyond the original forecasts, making a significant contribution to the increase in Israel's exports, and thereby to the expansion of the output of the export industries which led its economic growth. Alongside these developments, estimates of inflation in advanced economies indicate that it will rise, that prices of oil-based goods will increase, and that Israel's terms of trade will deteriorate—all of which serve to raise the inflation rate. The increase in short-term interest rates in Europe and the US, as indicated by estimates for 2000 (Table 5), also has an adverse effect, as the interest-rate differential between Israel and abroad—mainly between interest on the dollar and the NIS—contracts. This could have caused capital inflow to dwindle, even though there was extensive capital inflow to Israel in 2000:I, in the wake of the surge in the prices of technology stocks in the US with large offerings there by Israeli firms.

The Consumer Price Index (CPI) rose in the period reviewed by 0.8 percent in annual terms, after declining in each month of 2000:I and rising in each month of 2000:II. According to various indicators, the inflation environment stabilized in the period reviewed in the region of the lower limit of the inflation target (3–4 percent); these include *inter alia* actual inflation, its variance, and inflation expectations. The reduction of the inflation rate at a time of rapid economic growth was made possible *inter alia* by the low level of potential GDP. The housing component of the CPI was the most notable, and although its rate of decline slowed during the period reviewed, it contributed about 0.7 percent to the overall reduction of the CPI. In the period reviewed nominal local-currency appreciation against the currency basket was 7.8 percent, expressed in real appreciation, and the index of retail prices rose by a relatively rapid 4.1 percent.

With regard to fiscal policy, there was a marked domestic budget surplus in the period reviewed; net government domestic financing exceeded its level in the equivalent period in 1999, giving rise to extensive absorption by the government, and thereby contributing *inter alia* to the disinflationary process. Tax receipts—chiefly income tax—exceeded their planned extent. Thus, it appears that for 2000 as a whole the budget deficit will be significantly below the target ceiling (up to 2.5 percent of GDP) set at the outset. General government consumption, as measured in the National Accounts, declined by 3 percent in 2000:I, due *inter alia* to the contraction of general government employment, after this had risen considerably in the previous three quarters (despite the increase in real wage payments), as well as to the decline in defense expenditure.

Increased economic activity was expressed in the relatively moderate rise in total employment, alongside its expansion in the business sector and contraction in

* *For diagrams (bilingual) please turn to Hebrew section.*

Table 1. Indicators of Business Activity, 1998–2000
(all data excluding construction are seasonally adjusted)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	3.0	3.1	1.5	15.3	–1.9	8.3	10.8	0.6	6.2	6
Large-scale retail trade	6.5	4.3	-4.1	12.6	-1.3	13.0	22.8	3.7	8.1	6
Manufacturing production (excl. diamonds)	2.7	1.3	2.0	19.8	2.7	14.5	10.5	–1.2	10.5	5
Business-sector consumption of electricity	2.5	2.7	–1.5	15.7	16.5	9.6	11.7	0.8	11.2	4
Index of revenue in commerce	0.8	4.6	7.4	20.3	11.9	3.0	15.2	–0.0	11.5	5
Index of total revenue	3.5	5.9	7.8	17.3	17.1	5.3	5.5	2.1	11.9	5
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	–5.7	16.4	3.7	9.0	4.0	6.6	–13.5	12.1	20.3	4
Immigrant arrivals	–15.4	35.5	9.9	47.8	9.7	–44.1	–3.6	16.0	–6.9	6
Residential starts	–21.2	–7.3	2.2	16.0	–10.5	16.3	–65.5	–8.9	–17.9	4
of which: Government-initiated	–44.4	3.0	13.9	38.0	–36.4	44.3	–55.2	–18.9	–2.3	4
Residential completions	–21.6	–13.4	–7.0	13.8	2.0	–2.1	–69.1	–21.9	–28.3	4
of which: Government-initiated	–22.7	–4.7	–23.2	7.6	–6.3	–40.3	–56.1	–4.1	–62.4	4
Survey of companies (percent)[b]										
Net output of manufacturing firms (original)	–8	9	7	18	20	4 [c]	25			6
Net output of manufacturing firms (adjusted)	–8	9	7	10	15	17	26			6
Net sales by commercial firms (original)	–13 [c]	12 [c]	8 [c]	26	9 [c]	5 [c]	17 [c]			6
Net sales by commercial firms (adjusted)	–14 [c]	12 [c]	6 [c]	5 [c]	24	6 [c]	24			6

* Last month for which data available.
[a] Compared with same period in preceding year.
[b] Difference between the number of firms reporting a rise and those reporting a fall, as a percentage of all reporting firms.
[c] Denotes non-signifcant result at 5 percent level.

the general government sector. In the context of the exceptional developments in 1999:IV, it would seem that in 2000:I the labor market returned to the trend of gradual emergence from the slump that characterized it in 1999. Thus, the participation and employment rates declined, reflected by the fall in the unemployment rate from 8.9 percent in 1999:IV to 8.6 percent. The sectoral distribution of employment shows that the business-sector's demand for workers rose, expressed in the greater number of employees in it as well as in the number of hours worked per employee, and also that employment in the general government sector fell, alongside a reduction in the number of hours worked. Until April the real wage per employee post rose relatively rapidly in both sectors compared with the equivalent period in 1999, and in the business sector it rose twice as fast as in the general government sector.

Monetary policy operated during the period reviewed in the context of the relatively slow rise in prices and inflation expectations, alongside the greater budgetary absorption by the government, and strong indications that the economic recovery had been consolidated. Mainly in 2000:II, however, monetary policy operated in an environment of rising world interest rates—particularly in the US—shocks in global stock markets, and a falling rate of IPOs there by Israeli firms. The publication of the recommendations of the committee on the reform of the direct taxation of individuals, creating expectations that tax legislation would be changed, made investment abroad more attractive. Against the backdrop of these developments, the Bank of Israel reduced its key interest rate five times in succession. In June and July, in the wake of the rise in inflation expectations into the target range and in the context of the narrowing of the interest-rate differential between Israel and abroad to a relatively low rate. The bank did not reduce the interest rate, after which inflation expectations fell again. Towards the end of July the Bank again reduced its key interest rate by 0.2 percentage points. In the capital market, despite the shocks in world stock markets, prices of shares traded in Israel's stock market did not fluctuate widely, and both the General Share-Price Index and the rate of return on bonds, particularly unindexed bonds, rose.

The principal industries

Indicators used for assessing economic activity (Table 1) show that this continued to expand throughout the period reviewed—even exceeding the forecast—in most industries. Compared with the equivalent period in 1999, manufacturing production was up by 10.5 percent (until May), and the other indicators in the table (except those for construction, which were negative) rose relatively steeply. The increase in economic activity was borne out by the Survey of Companies for 2000:II conducted by the Bank of Israel. According to firms' reports, manufacturing activity continued to grow in this quarter, and even accelerated. In addition to the rise in exports, domestic sales also increased, as expressed in indices of revenues (Table 1). Transport and communications firms also reported expansion, as did hotels, business services, and commerce. The decline in construction activity persisted, albeit more slowly than in 2000:I.

National Accounts data for 2000:I (Table 2) indicate that the rapid growth of GDP, business-sector product, and per capita GDP persisted, although more moderately than in the previous three quarters. The relatively rapid rise of GDP began in 1999:II, and was concentrated mainly in the business sector. This development came in the context of the continued slowing of the rise in domestic uses (seasonally-adjusted data), which were up by less than one percent in 2000:I; although export growth slowed (to 17 percent) it still greatly outstripped GDP growth, serving as the engine of economic expansion. In 2000:I the rate of increase of investment was notable, exceeding that of the other components of domestic uses. A trend analysis shows that it went up by 6.8 percent in 2000:I, after increasing by 2.6 and 5.8 percent in 1999:III and 1999:IV respectively. In view of the considerable sensitivity of investment to expected economic developments, this may be an indication of continued expansion. Against the slowing of domestic demand in general, in 2000:I imports of goods and services slowed; adjusting for defense imports and imports of ships and aircraft, the extent of imports declined. Thus, the continued recovery signalled by the above indicators was indeed led by the rapid rise of exports.

Table 2. National Accounts, 1998–2000
(seasonally adjusted)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	2.2	2.2	8.3	5.2	5.8	4.5		0.5	5.9	3
Business-sector product	2.2	1.8	10.0	7.1	7.5	6.7		–0.7	7.8	3
Private consumption	3.6	3.3	1.0	11.5	1.5	0.5		3.3	3.6	3
Gross domestic investment	–8.0	9.8	33.8	–7.0	2.2	4.5		1.5	7.4	3
Goods and services exports	6.3	9.7	19.5	24.6	21.1	16.6		6.2	20.4	3
Goods and services imports	1.7	14.4	30.5	20.9	13.9	8.5		6.2	18.2	3
General government consumption	2.0	3.9	17.9	7.8	3.9	–3.0		–1.2	6.4	3

* Last month for which data available.
[a] Compared with same period in preceding year.

The expansion of manufacturing, which constitutes 30 percent of the business sector, was similar (until May) to that of the business sector as a whole, encompassing the entire manufacturing industry with the exception of the traditional industries, which remained stable, and the mining and non-metallic mineral industries, whose output continued to fall (its persistent decline since 1999:I stemming *inter alia* from the ongoing contraction of the construction industry). The number of hours worked per employee in manufacturing was up by about 3 percent over the equivalent period in 1999, and output per hour worked (labor productivity) was up by 7 percent. Particularly noteworthy was the rise in the output of export industries, including the high-tech industry, especially electronic equipment, whose output grew by 18 percent relative to the equivalent period in 1999. The output of the textile, clothing and leather, and food, beverages, and tobacco industries remained stable, however—an expression of the continued long-term trend of the contraction of their share of manufacturing. According to the Survey of Companies, there was a marked rise in the output of the mixed and advanced industries in 2000:II, although output also grew in the traditional industries.

There was no clear shift in the slowdown in the construction industry, a trend that has been evident since 1995. Output, as expressed in building starts and completions, was down from the equivalent period in 1999 (Table 1), while there was a slight rally in sales of new apartments, reducing the stock of unsold new units. The increase in the sale of new units was apparent even though purchases had been brought forward at the end of 1999 due to expected changes in purchase and sales tax rates. Other indicators of activity in the industry also convey conflicting trends: private-sector construction rose by 16 percent in 2000:I; sales of land were up by 25 percent (excluding cancellations) over 1999; there was a 6 percent increase over the equivalent period in 1999 in mortgages taken up until May despite the high interest rate on them; there was a sharp turnaround in nonresidential construction, which was up by 54 percent, after contracting more rapidly than residential construction. On the other hand, purchase tax data indicate a slight decline in total transactions involving apartments, especially new ones; building time lengthened, and according to seasonally-adjusted National Accounts data for 2000:I the quarter-on-quarter decline in private-sector and government-initiated residential construction evident since 1997 persisted.

Activity expanded rapidly in all other industries, too. The index of revenue in commerce was up by 12 percent over the equivalent period in 1999, despite the moderate rise in consumption in 2000:I. The total index of revenue increased by a similar rate, and the number of tourist entries and bed-nights was up by 20 percent over the equivalent period in 1999, *inter alia* due to the Pope's pilgrimage in March.

The labor market

Labor input edged up in 2000:I over 1999:IV as a result of a rise in employment and in the number of hours worked in the business sector and a decline in both of these in the general government sector (Table 3). The fall in the number of persons unemployed in 2000:I is explained entirely by the reduction in the labor-force, reflecting a decline in the participation rate, which rose to an exceptional level in 1999:IV. The total number of persons employed (including foreign workers and Palestinians) grew by 0.3 percent, increasing by 1 percent in the business sector and declining by 1.9 percent in the general government; their distribution by employee posts shows that the rise in real wages in the business sector exceeded that in the general government. The development of wages and employment in both sectors indicates increased demand for workers in the business sector.

After rising continuously in the last two quarters of 1999, the rate of participation in the civilian labor force declined in 2000:I. This development, which is unexpected in a period of rapid economic growth (when the rate at which unemployed persons leave the labor force is particularly low), represents an adjustment of the sharp rise in the participation rate in 1999:IV, which brought this rate to a level not seen for many years—54.2 percent. The exceptional development in 1999:IV also explains the decline in the utilization rate of the labor force in 2000:I (expressed in the fall in the number of persons employed full-time, and increase in those employed part-time or temporarily absent from work). In 2000:I the labor supply declined by 7,000, and the number of persons employed remained stable, as did the number of hours worked per employee. The contribution to lower unemployment came from the business sector, which absorbed some 8,000 employees in 2000:I, mainly in commerce, while in the general government, as stated, employment contracted.

A trend analysis of monthly unemployment data, adjusted seasonally, indicates that the unemployment rate edged down slightly throughout the first five months of the period reviewed, reaching 8.8 percent in

Table 3. Indicators of Labor Market Developments, 1998–2000
(seasonally adjusted)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
	('000s)									
Civilian labor force	2,266	2,344	2,325	2,354	2,388	2,381		2.5	3.0	3
Israelis employed[b]	2,073	2,136	2,118	2,141	2,176	2,177		2.4	3.2	3
Business sector	1,444	1,491	1,478	1,490	1,521	1,529		2.3	3.7	3
General government	628	646	640	647	659	646		3.4	1.4	3
Average hours worked per employee[b]	37	37	37	38	38	38		–1.3	1.9	3
Business sector	40	40	40	40	40	41		–1.7	3.3	3
General government	31	31	31	32	32	31		–1.2	1.3	3
Labor input of Israelis employed	77,138	79,546	77,836	80,528	81,860	82,318		1.2	5.6	3
Business sector	57,770	59,394	58,387	59,771	61,436	62,129		0.1	7.1	3
General government	19,367	20,151	19,449	20,757	20,424	20,189		4.5	1.1	3
Claims for unemployment benefit	108	108	109	108	108	111	102	–0.1	–1.3	6
Work seekers	156	158	160	150	164	158	153	–0.1	–0.1	4
Real wage[c] per employee post (NIS)	4,206	4,304	4,290	4,268	4,460	4,524	4,527	0.1	7.2	4
of which: Business sector	4,262	4,409	4,382	4,403	4,553	4,682	4,680	1.1	8.3	4
Unemployment rate (%)	8.6	8.9	8.9	9.0	8.9	8.6				3

* Last month for which data available.

[a] Percent change compared with same period in preceding year.

[b] Not seasonally adjusted.

[c] January 1995 prices.

May. Claims for unemployment benefit, which rose in 2000:I, dropped appreciably in 2000:II, possibly due to the sanctions which disrupted the work of the Employment Service.

The real wage per employee post was up by 7 percent in the period reviewed over the equivalent period in 1999; in the business sector it rose by 8.3 percent, and in the general government by 4.6 percent. Particularly prominent was the real wage rise in business services, which include software development (up by 16 percent until April), while wages in transport, storage, and communications remained unchanged.

The pattern of labor disputes did not alter in the period reviewed, and three categories were evident: organizations that had not yet signed wage agreements for 1997–98, employees who were demanding special increments, and employees who were trying to avert privatization or competition from elements not covered by collective agreements (e.g., employed via subcontractors). On July 13, 2000, after a labor dispute lasting over 120 days, a wage agreement was signed with the physicians, based on two interlocking agreements: a. a collective agreement for the period from July 1998 to the end of 2001; b. a collective arbitration agreement for ten years from the day the agreement was signed, with the establishment of a committee to examine the public health system. The overall cost of the wage agreement was 13.2 percent, excluding items connected mainly with the subject of pensions (allocations against the transition from non-contributory to contributory pension plans, and improvement of the pensions of senior physicians), and also improves the working conditions of interns. The principal purpose of the collective arbitration agreement is to prevent strikes for ten years.

The increase in the population of immigrants of working age in 2000:I outstripped that of the general population, but whereas in the latter the labor force participation rate declined to 53.7 percent, among immigrants it remained steady at 55.6 percent. The unemployment rate of immigrants (data not seasonally adjusted) fell to 10.6 percent, and their share in total employment remained at the high level evident in 1999:IV—17.2 percent, the highest since the influx of immigrants began in 1990.

There were 204,000 persons unemployed (seasonally-adjusted data) In 2000:I, down by 8,000 from 1999:IV, with similar rates for both men and women. According to the statistics generally used to examine hard-core unemployment, there are clear signs of a deterioration: the share of young people among the jobless was significantly lower than indicated by the quarterly rates of previous years, the share of married people rose, and the period of the search for work and unemployment grew longer (the number of persons refusing to work, as recorded by the Employment Service, declined, apparently due to sanctions in the Service). The increased proportion of chronically unemployed persons is normal at a time of declining unemployment, however.

The balance of payments

In 2000:I the current-account deficit fell to $ 0.5 billion, lower than in any quarter of 1999. The deficit consists of the sum of the goods and services account, whose deficit is similar to that of 1999:I—about $ 1 billion; the deficit on the factor inputs income account—about $ 1.1 billion, with a slight rise in wage payments to nonresidents since the beginning of 1999; and the unilateral transfers account—some $ 1.5 billion, compared with about $ 1 billion in 1999:I.

Goods exports, the rise in which had slowed in the previous two years, began to accelerate in the period reviewed compared with the second half of 1999, and in annual terms was about 11 percent—twice the 1999 rate, and 22 percent above its level in the equivalent period in 1999. The development of exports is in line with the marked acceleration in the rate of expansion of world exports in general, and especially to the US and Europe. By June 2000 manufacturing exports had

Table 4. Balance of Payments, Foreign Trade, and the Reserves, 1998–2000

($ million, current prices)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
Monthly averages										
Trade deficit	352	373	371	368	357	321	241	383	281	6
Goods imports	1,769	1,855	1,823	1,906	1,923	1,977	2,035	1,796	2,006	6
Consumer goods	323	331	318	344	331	363	360	324	361	6
Capital goods	378	446	434	471	471	489	480	422	484	6
Intermediates	1,067	1,078	1,071	1,091	1,122	1,125	1,196	1,050	1,161	6
Goods exports	1,416	1,482	1,452	1,538	1,566	1,656	1,795	1,413	1,726	6
Manufacturing	1,347	1,415	1,383	1,471	1,497	1,594	1,724	1,346	1,659	6
Quarterly averages										
Net current account	–241	–470	–653	–1,081	701	–546		–751		3
Financial account (excl. foreign-currency balances)	300	746	984	283	1,252	1,045		724		3
Nonresidents' direct and portfolio investments	561	954	1,050	744	990	2,229		1,041		3
Israeli residents' direct and portfolio investments	247	315	128	301	400	–13		279		3
Net foreign debt (% of GNP)	13.03	10.95	11.58	11.97	10.55	9.67		12.13		3
End-period Bank of Israel reserves	21,828	22,071	21,931	21,854	22,515	22,677		21,958		3

* Last month for which data available.

[a] Foreign trade data are seasonally adjusted monthly averages (excluding ships, aircraft, diamonds, and fuel).

expanded continually for fifteen consecutive months. Exports of electronic components for computers (mainly by Intel) were up by 117 percent over the same period in 1999, and exports of communications, medical and scientific equipment increased by 35 percent. These two high-tech industries, which accounted for a third of manufacturing exports in January 1998, amounted to half of these exports in the period reviewed. Almost all the other manufacturing export industries, including the traditional ones, displayed positive and high growth figures relative to previous periods, albeit significantly below the level of the high-tech industry.

Imports of production intermediates, serving as a partial indicator of current activity, were up by 11 percent over the equivalent period in 1999; in 2000:I they remained at the same level as in 1999:IV, while in 2000:II they rose by 6 percent. Imports of capital goods, serving as an indicator of future activity, were 15 percent higher in the period reviewed than in the same period in 1999; consumer goods imports rose by 11.4 percent, with fluctuations during the period and a steep increase in vehicle imports in 2000:I. A trend analysis of developments in imports indicates that the slowdown that began at the end of 1998 continued until 2000:I, and that the level steadied in 2000:II. Prominent among the import categories were energy products (raw fuel, refined oil, and coal) the level of which (not seasonally adjusted) rose to $ 1.6 billion in the first half of 2000—up from $ 1.3 billion in the second half of 1999 and $ 819 million in the first half of 1999—due chiefly to the rise in prices.

In 2000:I Israel's terms of trade deteriorated by 4 percent, with export prices falling and import prices remaining stable. Had it not been for this deterioration, the trade deficit in nominal terms would have been still lower.

Net capital inflow (the financial account in the balance of payments *less* the change in the foreign-exchange reserves) was some $ 0.5 billion higher in 2000:I than in 1999:I, and up by about $ 0.25 billion over the quarterly average for 1999 as a whole. The sharp increase in IPOs abroad by Israeli firms in 2000:I is particularly noteworthy, and brought the level of investment in the assets portfolio to its highest quarterly level in the last few years—$ 3.5 billion. Data provided by the Controller of Foreign Exchange indicates that in the first half of 2000 direct investment abroad by the nonbanking private sector was some $ 1.4 billion, compared with an average annual rise of $ 600 million in the five previous years. Most of the investments were in the electronics industry. In 2000:II the level of IPOs abroad fell markedly, while direct and portfolio investment in Israel by nonresidents rose, and the increase in residents' financial assets abroad exceeded that in their liabilities. In 2000:I Israel's net outstanding liabilities declined by $ 0.8 billion, continuing the trend evident since 1996.

Since July 1997 (and throughout the period reviewed) the Bank of Israel has not intervened in the foreign-currency market; thus, as net purchases of local-currency assets by nonresidents rose from the beginning of the year until mid-March, there was local-currency appreciation of 5 percent against the currency basket, and the NIS exchange rate was only 4 percent above the lower limit of the band (Figure 12). Capital inflow in 2000:I was chiefly long and medium term (primarily purchases of high-tech companies traded abroad),and its increase contributed to the continuation of the trend of appreciation that had begun in October 1999. In April, with the rise in net purchases of foreign-currency assets by residents, this trend reversed, and until the end of the period reviewed there was local-currency depreciation of 4 percent against the currency basket. Among the factors explaining the trend shift in the foreign-currency market are the narrowing of the interest-rate differential between short-term interest rates in Israel and abroad—especially vis-à-vis the US—throughout the period (see section on the money and capital markets, below), and the publication at the beginning of May of the recommendations of the committee on tax reform, with a recommendation to tax the capital market; these two factors acted to reduce the yield on local-currency assets relative to foreign-currency ones.

The Bank of Israel's foreign-exchange reserves were $ 22.2 billion at the end of the period reviewed, after declining by $ 329 million during the period. Total interest receipts on the foreign-exchange reserves, and the Bank of Israel's capital gains were similar in extent to the decline in the reserves stemming from the activities of the private and general government sectors—$ 580 million—and the decline in the reserves was equivalen to the revaluation differential resulting from shifts in cross rates.

World developments and their implications for Israel

The rapid emergence from the financial crisis that affected the global economy (see issue no. 89 of this publication) took forecasters by surprise. In contrast to

Table 5. Indicators of Economic Development in Advanced and Developing Countries,[a] and Estimate for 1998–2000

	1998	1999	Estimate 2000	Estimate 2001
Annual rate of change[b]				
World GDP				
Total	2.5	3.3	4.2	3.9
Advanced countries	2.4	3.1	3.6	3.0
Developing countries	3.2	3.8	5.4	5.3
World trade				
Total	4.2	4.6	7.9	7.2
Advanced countries				
Imports	5.5	7.4	7.8	7.1
Exports	3.7	4.4	7.2	6.8
Developing countries				
Imports	0.4	–0.3	9.8	8.5
Exports	4.5	1.7	9.7	8.3
Inflation (CPI)				
Advanced countries	1.5	1.4	1.9	2.0
Advanced countries–OECD		1.1	1.6	1.9
Developing countries	10.1	6.5	5.7	4.7
Prices of unprocessed goods (US$)				
Oil	–32.1	38.7	35.1	–19.2
Other	–14.7	–6.9	4.9	3.2
Short-term interest[c] (%)				
Dollar deposits	5.6	5.5	6.8	7.1
Yen deposits	0.7	0.2	0.2	0.4
DM deposits	3.7	3.0	4.1	4.9
Unemployment rate				
OECD countries	7.4	6.6	6.3	6.1

[a] According to "World Economic Outlook," Israel is classified as an advanced country.
[b] Apart from interest and unemployment rates, which are shown as percentages.
[c] 3-month Libor rate.
SOURCE: "World Economic Outlook," (IMF), and OECD "Economic Outlook."

the forecasts for 1999–2000 that were made in 1999, various updated estimates, including those of the IMF and the OECD, indicate a dramatic improvement in global macroeconomic and financial conditions. In all the advanced economies, with the exception of Japan, estimated GDP significantly surpassed the forecast.

In the OECD countries estimated GDP for 2000 was up by 4 percent, the fastest growth rate for a decade; the US has been enjoying the most protracted growth surge for a century, and in 2000 this will reach 4.4 percent. Estimates of world trade for 2000 have also been adjusted upwards, and its rate of expansion is currently 8 percent, the highest for two years. The imports and exports of both the advanced and the developing economies are also growing relatively rapidly.

According to the global macroeconomic forecast for 2001, global macroeconomic conditions appear to be favorable for Israel's economic expansion. The rapid rise in GDP and foreign trade will slow only slightly, inflation in the advanced economies will remain about 2 percent, and in the developing countries it will continue declining to 4.7 percent. Oil prices, which soared in 2000, are expected to fall in 2001 to a level similar to that of 1998. Prices of unprocessed goods are expected to rise, after plummeting in 1998 and 1999, and this will have an adverse effect on Israel's terms of trade and inflation rate. Short-term interest rates, which declined in the last three years, are expected to rise slightly, requiring caution in the reduction of Israel's interest rate. During the period reviewed there was local-currency appreciation of 2 percent against the dollar, and of 6 percent against the euro.

Prices

During the period reviewed the development of the various price indices appeared to be similar to that in the same period in 1999; in both periods they declined steadily in the first quarter and rose in the second. In both periods the rate at which prices rose (a rise of 0.8 percent in the period reviewed and a decline of 0.7 percent in the equivalent period in 1999, in annual terms) was considerably below the annual inflation target (3–4 percent for 2000 and 2001). Nevertheless, the background to the development of the price indices was different in each case; in 1999 it was the slowing of the rapid rise in prices of October 1998, and in 2000 it was a long period of calm—a difference that is expressed in the level of inflation expectations and the policy of reducing interest derived from them. Throughout the equivalent period in 1999 inflation expectations—both derived from the capital market and on the basis of the Bank of Israel's Survey of Companies—were above the inflation target, whereas in the period reviewed they were below its upper limit, and sometimes even below its lower one. This appears to indicate growing public trust in the policy of disinflation. According to indicators of the inflation environment, which also include inflation expectations, this stabilized around the lower limit of the target in the period reviewed.

Among the components of the CPI the development of housing, which accounts for about a fifth of it, was outstanding. Its gradual decline began in October 1999, accelerated in December, slowed from then until April, and rose in the last two months of the period reviewed. The short-term trend of housing prices is consistent to a great extent with that of the dollar exchange rate, as most housing prices are denominated in dollars, and the more moderate decline in prices in this market than in the exchange rate may signify a rally in the real estate market. During the period reviewed the index of housing prices fell by 3.4 percent—the result of a 17 percent fall, in annuala terms, in 2000:I and a 12.3 percent rise in 2000:II.

During the period reviewed there was nominal local-currency appreciation of 7.8 percent against the currency basket in annual terms, and of 4.1 percent against the dollar; in both cases there was local-currency appreciation in 2000:I and depreciation in 2000:II. Prices of exports fell relative to those of GDP in 2000:I, a development that reinforces the hypothesis regarding real appreciation in the period reviewed. On the other hand, prices of tradable goods rose by about 1 percent vis-à-vis those of nontradable goods, and prices of imports rose by about half a percent beyond those of GDP—indicating slight real depreciation.

Table 6. Selected Price Indices, 1998–2000
(annual rates of change during period, percent)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
CPI	8.6	1.3	4.3	5.1	1.9	–4.8	6.6	–0.7	0.8	6
CPI excl. housing, fruit and vegetables	8.5	1.7	2.7	1.1	4.6	–0.4	6.5	0.6	3.0	6
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	8.8	2.4	2.2	3.7	0.7	1.6	4.6	2.6	3.1	6
Index of housing prices	8.8	–0.9	8.3	23.5	–12.1	–17.0	12.3	–5.7	–3.4	6
Wholesale price index	8.2	3.5	4.1	7.3	6.3	–1.1	9.7	0.3	4.1	6
NIS/$ exchange rate	18.2	0.4	5.9	16.3	–5.0	–16.8	10.7	–4.1	–4.1	6
NIS/currency-basket rate	20.6	–2.5	0.6	21.5	–7.4	–21.4	8.2	–10.4	–7.8	6

* Last month for which data available.

Table 7. The Budget and its Financing, 1998–2000
(cash flows, as percent of GDP)

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
1. Government domestic expenditure	38.8	37.9	36.5	36.8	39.2	39.6	37.9	37.7	37.2	7
2. Government receipts	35.5	34.9	32.6	34.9	34.8	41.3	38.6	35.3	35.8	7
3. Domestic budget deficit (1 – 2)	3.2	3.0	3.9	1.9	4.4	–1.7	–0.7	2.4	1.5	7
4. Public-sector domestic deficit[a] (5 + 6)	3.6	3.6	3.3	1.2	7.1	–3.7	–2.7	2.9	–3.2	6
5. Government net borrowing from the public	2.7	2.1	2.8	2.3	2.4	2.1	2.2	1.8	2.1	6
6. Public-sector injection (9 – 8 – 7)	0.9	1.5	0.5	–1.1	4.7	–5.8	–4.9	1.1	–5.3	6
7. Bank of Israel injection	–1.1	–0.4	–2.3	0.4	–1.4	5.1	6.3	–0.3	5.7	6
8. Private-sector foreign-currency conversions	0.3	–0.1	0.1	–0.1	–0.0	–0.3	–0.1	–0.1	–0.2	6
9. Change in monetary base	0.1	1.0	–1.7	–0.8	3.3	–1.0	1.4	0.7	0.2	6

* Last month for which data available.
[a] Budget deficit, plus Jewish Agency injection, plus non-budgetary injection.

The retail price index of manufacturing output for the domestic market went up by 4.1 percent in the period reviewed, largely due to the rise in the price of refined oil and its products.

The general government

In the period reviewed there was a surplus of NIS 2.5 billion in the domestic budget (excluding net credit extended), leading to the extensive absorption of sources from the public. The path of the budget deficit in previous years indicates that the surplus in the period reviewed exceeds by far (NIS 6.4 billion) the deficit as calculated on the basis of its seasonal path, and that according to expected trends the budget deficit should be significantly below the ceiling set in the Budget Deficit Reduction Law (NIS 12.4 billion). More detailed analysis shows that in the period reviewed tax revenues outstripped the calculated level by NIS 7.5 billion (11.6 percent of tax receipts in the period reviewed), most of the deviation (some NIS 7 billion) deriving from income tax, while other government revenues lagged slightly behind the calculated level. Government expenditure, on the other hand, exceeded the calculated path by about NIS 1 billion, being higher by 5.6 percent in real terms than in the equivalent period in 1999. Note that estimated expenditure is based on cash data, it does not include retroactive wage payments arising from the wage agreements that were signed recently.

According to National Accounts data (accrual basis), general government consumption was 3 percent lower (seasonally adjusted and in annual terms) in the period reviewed than in the equivalent period in 1999, with a real rise in wages, purchases, and amortization, and a steep drop in defense imports.

The transition to a budget surplus occurred after a marked increase in the government's current income (Table 7) and slower rise in its expenditure. The domestic deficit, which includes, in addition to the budget deficit, the 'deficit' of the Bank of Israel and the Jewish Agency, became a surplus in the period reviewed, reaching 3.2 percent of GDP, compared with a deficit of 2.9 percent of GDP in the equivalent period in 1999. Alongside the surplus, the government continued its net borrowing from the public via issues of unindexed securities and by means of privatization, expressed in the sale of bank shares. Thus, there was considerable government absorption, exceeding the aforementioned current surplus, in the first two quarters of 2000 and reaching an extent unprecedented in recent years.

According to data (accrual basis) from the State Revenue Administration, total tax receipts of the government were 18 percent higher in real terms than in the same period in 1999. Their development throughout the period, as measured by not seasonally adjusted data (in real terms), indicates that after a significant rise in 2000:I they remained high in 2000:II. Most of the increase in the period reviewed was in direct taxes (including national insurance payments), which rose by about 20 percent in 2000:I, while indirect taxes on domestic production and imports went up at only half this rate (in real terms)—due mainly to the surge in economic activity. Notwithstanding, transfer payments to households were higher (until May) by 9 percent in real terms in the period reviewed than in the equivalent period in 1999; children's allowances were unchanged, and unemployment benefits rose only slightly (by 2.9 percent), *inter alia* due to the stable unemployment trend; income assurance payments rose steeply (by 17 percent), on the other hand, apparently expressing the rise in hard-core unemployment.

The money and capital markets

In the period reviewed, as a result of the decline in inflation expectations for a one-year and two-year horizon, as well as of appropriate background conditions, it was possible to gradually and continuously reduce the nominal interest rate on the auction of banks' deposits in the Bank of Israel's key interest rate by a cumulative 1.9 percentage points—from 11.3 percent in December 1999 to 9.4 percent in May 2000. In June and July, as expected inflation for a one- and two-year horizon remained within the range of the inflation target, the nominal interest rate was left unchanged, and at the end of July the Bank of Israel announced a further 0.2 percentage-point reduction for August. The interest rate was also reduced in December 1999, bringing the number of consecutive reductions to six, and the cumulative reduction to 2.2 percentage points. Monetary policy acted to consolidate the inflation environment for a one-year and two-year horizon within the target range, in view of the rise in interest rates abroad, shocks in world stock markets, expectations that the capital market would be taxed in the wake of the recommendations of the committee set up to review the direct taxation of individuals, and the large government absorption. Real short-term interest. which affects the level of real economic activity, declined significantly—from 8.8 percent in December, to 5.4 percent in May; in June, as inflation expectations fell, the real interest rate increased gradually, and stood at 6.4 percent.

During the period reviewed several factors had an impact on the market, affecting the direction and volume of capital flows to and from Israel. First, the interest-rate differential vis-à-vis abroad narrowed since, as stated, the Bank of Israel lowered its key interest rate, and world interest rates—especially in the US—rose. The differential between the interest rate on the NIS and the dollar, which was 5.7 percent at the beginning of the period reviewed, contracted to 2.8 percent by May, remaining at that level in June and July. (In view of the budget surplus in the US, which led to lower yields there while yields on Israel government bonds did not decline, Israel's financial risk premium rose, ranging from 1.4 to 1.8 percent in August, compared with a range of 1 to 1.5 percent previously.) Second, in April preliminary publication of the recommendations of the committee on direct tax reform began, and it transpired

Table 8. Monetary Indicators and Nondirected Bank Credit, 1998–2000
(annual terms, percent)

	1998	1999	1999 II	1999 III	1999 IV	2000 I	2000 II	Jan–June[a] 1999	Jan–June[a] 2000	*
Rates of change	(average)		(compared with preceding quarter)					(during period)		
M1[a]	12.0	9.5	8.7	28.7	5.3	8.0	11.2	4.0	2.1	6
M2[b]	22.6	21.0	22.5	17.8	19.6	29.1	12.9	27.7	17.2	6
M3[c]	22.1	21.8	19.6	19.2	20.4	27.3	12.6	22.4	16.9	6
Nondirected bank credit	15.9	17.9	11.9	15.1	20.5	14.3	12.2	11.3	11.9	6
Unindexed local-currency	16.3	18.0	13.8	5.3	20.2	52.9	24.4	12.9	31.3	6
CPI-indexed	14.1	18.3	10.2	18.4	17.8	–2.2	5.3	14.9	4.1	6
Foreign-currency-indexed and denominated	17.9	17.3	11.6	23.7	24.4	–3.8	5.5	5.0	–0.2	6

* Last month for which data available.

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

[b] M1 plus short-term local-currency deposits.

[c] M2 plus foreign-currency-indexed and denominated deposits.

Table 9. Interest Rates, Yields, and the Share-Price Index, 1998–2000

			1999			2000		Jan–June[a]		
	1998	1999	II	III	IV	I	II	1999	2000	*
Nominal interest rate										
Nondirected local-currency credit	16.2	16.4	16.5	15.9	15.5	14.1	13.1	17.1	13.7	5
Average monetary loan	12.0	12.4	12.5	12.0	11.5	10.4	9.5	13.1	9.9	6
SRO deposits	10.2	10.7	10.7	10.2	10.1	9.0	8.1	11.5	8.6	5
3-month Eurodollar	5.4	5.3	4.9	5.3	6.0	6.1	6.5	4.9	6.2	6
Yield to maturity on Treasury bills	11.3	11.4	11.5	11.3	10.9	9.1	9.0	11.8	9.1	6
10-year government bonds	4.9	5.2	5.1	5.2	5.3	5.3	5.2	5.2	5.3	6
5-year government bonds	5.1	5.6	5.4	5.6	5.9	5.8	5.7	5.5	5.8	6
General Share-Price Index (points)	137.7	181.4	181.2	187.7	210.4	254.8	251.0	163.7	252.9	6
Expected inflation (gross)	6.2	5.3	6.1	5.4	3.9	2.6	3.4	5.9	3.0	6
Interest derived from expected inflation (gross)	4.7	5.7	5.0	5.7	6.4	6.1	5.5	5.4	5.8	6

* Last month for which data available.

that the tax rate on investment abroad would be reduced, and a capital gains tax would be imposed on domestic investments, so that the effective net interest-rate differential would decline, making financial investment abroad less attractive to residents. Third, IPOs abroad by Israeli firms plummeted that month, in view of the fall in share prices in US stock markets (although nonresidents' investment in untraded Israeli securities reached their highest level since the beginning of the year—apparently due to long-term trends). Against the backdrop of these developments, there was long- and medium-term capital outflow in April. Thus, April was the first month in the period reviewed when there was local-currency depreciation against the dollar, and inflation expectations, which had declined continually for four months till then, began to rise and reached the lower limit of the inflation target. In May local-currency depreciation persisted and inflation expectations continued to rise within the target range, reaching 3.8 percent; in June the exchange rate stabilized against the dollar at NIS 4.10, and expectations declined accordingly.

The monetary base grew by only 5.1 percent in annual terms during the period reviewed, after a significant government absorption that was unprecedented in recent years (NIS 11 billion). The narrow money supply (M1) expanded even more slowly, by 2.1 percent, even though its growth rate in the preceding twelve months was higher than that of nominal GDP. The other monetary aggregates rose relatively rapidly: the increase in local-currency deposits (primarily for shorter terms) and Treasury bills outstripped that in M1, and M2 grew by 17 percent. The extent of banks' deposits (at auction) in the Bank of Israel fell by NIS 8.7 million during the period reviewed, to stand at NIS 40 million at the end of it.

In the first five months of the year the General Share-Price Index rose by 11 percent, with wide fluctuations. Share prices in real estate and the mortgage banks fell by 6 percent, while in manufacturing they rose by 18 percent. At the same time the index of high-tech shares rose by 17 percent, after a 150 percent increase in 1999. In the first two months of the period reviewed this index went up by 70 percent, and fell subsequently. During the period reviewed turnover increased, and although activity was affected by volatility in world stock markets (especially the Nasdaq), the shock to Israel's stock market was more moderate. In the first five months of 2000 the yield on government bonds of all indexation types and for all terms was positive, the highest yield being on unindexed bonds.