

RECENT ECONOMIC DEVELOPMENTS*

Main developments

Economic developments during October 2001–March 2002 (the period reviewed) attest to a continuation of the contraction of activity at the beginning of the period and some moderation of the slowdown towards the end, due in part to temporary factors (Table 1, Figure 1). Developments during the period were accompanied by shocks in the financial markets, which culminated in local-currency depreciation, a rise in the yield on bonds, the acceleration of inflation expectations, and a rise in prices in 2002:IV. All this occurred against the backdrop of the exacerbation of Israel's security situation, continued expansion of the budget deficit, and the sharp interest-rate cut in December *inter alia* on the basis of unfulfilled expectations of a return to fiscal restraint.

In 2001:IV the economic slowdown that had begun at the end of 2000 intensified due to a further sharp reduction in investment and, for the first time that year, the contraction of private consumption (Table 2). The latter was expected in view of the persistence and intensity of the recession and the adjustment of real wages and firms' activities to the slump and decline in profitability. The terrorist attacks on the US in September 2001 intensified the impact on activity in 2001:IV, constituting another blow to capital flows and incoming tourism to Israel. After this event, however, international markets and trade rallied—due *inter alia* to emergency economic measures adopted by the US government—so that towards the end of the year the decline in Israel's exports, especially of the high-tech industry, moderated (Figure 1).

Because of the important role of Israel's exports in explaining the wide swings in economic activity in recent years, the recovery of international markets at the end of 2001 could have paved the way for Israel's economic recovery and the expansion of its exports. According to the various indicators, however, the economic slowdown persisted in 2002:I, even though some of them show that it moderated. This appears to be due to the large share of the traditional industries in the recovery of the international market, whereas Israel's specialization is in the high-tech field. Domestic factors

were responsible for the persistence and even exacerbation of the recession—the fall in private consumption and domestic demand, and the deterioration of the security situation, culminating in Operation 'Defensive Shield,' which was launched at the end of March. The increasing relaxation of budgetary discipline could also impair the economy's ability to return to a growth path.

Following the intensification of the security incidents, the IDF embarked on Operation 'Defensive Shield' in March 2002, within Palestinian territory calling up tens of thousands of reservists in the process.¹ The exacerbation of the security situation and the ensuing military operation could have grave economic repercussions, including a fall in domestic demand, a rise in uncertainty, which affects investment and could adversely affect productive activity, and a further decline in exports of tourist services and nonresidents' investment in Israel. The deterioration in the security situation and its adverse effect on economic activity hamper the government's ability to attain the deficit target, increasing the need for fiscal adjustments.

The adjustment of the labor market in the business sector to the protracted recession continued in 2001:IV, and was expressed in the reduction of the real wage, rise in unemployment, which reached 10.3 percent (according to trend data) in March, and fall in labor input. In the public sector, by contrast, the real wage and employment continued to increase (Table 3, Figures 6 and 7).

The trends in the public sector, especially the fiscal deviation in 2001—most notably in 2001:IV—as well as the greater share of the deficit and the public debt in GDP serve to move the government away from its long-term targets and the norms accepted in the advanced economies. In view of the deepening recession, and in order to increase public confidence in the budget framework, the government decided in December to adjust the growth forecast underlying the 2002 budget from 4 percent to 2 percent. It also decided to make substantial budget cuts, determining a deficit target of 3 percent of GDP for 2002 and a return to a declining deficit path—to reach one percent in 2005. Nevertheless, the 2002 national budget approved at the beginning of February

¹ The data in this survey are updated to March at the latest, so do not yet incorporate the implications of the operation.

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

Table 1. Indicators of Business Activity, 2000–2002
(all data excluding construction are seasonally adjusted)

	2000	2001	2001				2002	Oct–Mar ^a		*
			I	II	III	IV		2001	2002	
Rates of change (annual averages, percent), compared with preceding quarter										
State-of-the-economy index	4.9	-5.1	-2.2	-8.8	-6.8	-2.5	1.2	4.8	-5.1	3
Large-scale retail trade	10.2	4.0	-3.2	4.9	0.9	1.2	-2.2	10.5	1.0	3
Manufacturing production (excl. diamonds)	9.8	-4.8	-3.5	-14.1	-9.3	-6.2	-1.8	5.8	-8.4	2
Business-sector consumption of electricity	7.4	2.4	9.4	-0.2	-6.0	21.1	5.9	1.9	5.5	1
Index of revenue in commerce	10.4	-0.6	1.0	-5.7	-1.8	-2.0	-4.4	5.9	-2.8	2
Index of total revenue	10.8	0.5	2.0	-7.3	-2.2	1.2	3.5	6.9	-1.7	2
Rates of change (percent), compared with preceding quarter										
Tourist arrivals	3.7	-50.1	-6.5	-12.9	-12.1	-15.6	-0.4	-45.3	-37.6	3
Immigrant arrivals	-21.6	-27.8	-32.3	-16.6	31.9	-11.6	-32.3	-30.7	-33.6	2
Residential starts	18.6	-31.3	-13.1	-20.8	5.4	7.6		3.1	-22.0	12
of which:										
Government-initiated	51.2	-52.3	-30.2	-43.3	34.6	12.9		45.0	-39.9	12
Residential completions	-6.5	-15.5	8.3	-20.9	44.7	12.7		-38.6	39.7	12
of which:										
Government-initiated	-38.1	-22.4	-31.7	-8.1	62.6	7.7		-42.9	10.0	12
Survey of companies (percent) ^b										
Net output of manufacturing firms (not adjusted)	11	-15	-6 **	-16	-20	-18	-12			3
Net output of manufacturing firms (adjusted)	11	-15	1 **	-19	-24	-18	-6 **			3
Net sales by commercial firms (not adjusted)	5 **	-24	-11 **	-33	-30	-23	-46			3
Net sales by commercial firms (adjusted)	5 **	-24	-5 **	-31	-37	-23	-43			3

* 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-significant result at 5 percent level.

was based on unrealistic macroeconomic assumptions, primarily the view that revenue would rise by 5 percent in real terms. Actual developments in 2002:I, with the continued decline in revenue and expected rise in expenditure, especially defense expenditure, also indicate that without a significant spending cut there will be a marked deviation of the deficit from the target in 2002, too. These developments led the S&P international rating agency to reduce Israel's rating outlook from 'stable' to 'negative.' At the end of April the government approved a package of measures intended to limit the deviation from the deficit target—reducing expenditure, imposing new taxes, and raising the deficit target to 3.9 percent of GDP in 2002 and 3.5 percent in

2003. These measures still lack the necessary spending cut, and could adversely affect the return to sustainable growth in view of the increase in the tax burden and the public debt.

The security incidents and the global economic slowdown also explain most of the changes in the current account during 2001, especially in 2001:IV (see the section on the balance of payments below). Despite the recovery of trade in international markets and the rise in exports at the beginning of the period reviewed, the latest monthly data indicate that the export trend is continuing to decline. Trend data for goods imports show that stability is being maintained at a low level,

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however (Table 4, Figure 1). After the terrorist attacks in the US, which aggravated economic and security uncertainty in Israel and the rest of the world, the decline in foreign direct investment in Israel exacerbated in 2001:IV, and nonresidents' financial investment ceased almost entirely. The aggravation of the security situation at the beginning of 2002 reinforced the adverse effect on nonresidents' investment, while investment abroad by residents rose—apparently because of the recovery in the global economy and pessimism as regards investment in Israel.

The development of prices and inflation expectations was not uniform during the period. In 2001:IV, because of the recession, the rise in the unemployment rate, the fall in the real wage, and the decline in international trade prices, prices declined by 0.6 percent, and their rate of increase in 2001 as a whole was 1.4 percent (Table 6, Figure 10). In 2002:I, on the other hand, as local-currency depreciation accelerated, the rate of price increases followed suit, rising to 2.4 percent during the quarter, representing an annual rate of 9.8 percent—significantly above the inflation target for 2002 (see section on prices, and the money and capital markets below).

Monetary policy in 2001 focused on attaining the inflation target while maintaining economic stability. Consequently, the Bank of Israel reduced the nominal interest rate gradually and steadily, so that real short-term

interest declined from 7 percent at the beginning of the year to 4 percent in December (Table 6, Figure 10). Against the backdrop of the deep economic recession and the moderation of the rate of price increases, at the beginning of December it was decided to introduce a series of measures, the main one being a cut in the budget on the basis of the revised growth forecast, alongside renewed commitment to a declining deficit path, reduction of the Bank of Israel's key interest rate by an exceptional 2 percentage points, and several structural reforms of the money and capital markets.

At the beginning of 2002 the money and capital markets were unsettled, expressed in the accelerated 9.1 percent local-currency depreciation, an increase in the rate of price rises—to 2.4 percent—and a rise in both inflation expectations and the yield on bonds in 2002:I. All this came against the backdrop of the exacerbation of the security situation, continued budgetary deviation and the reduction of the interest rate at the end of 2001. This state of affairs obliged the central bank to raise the interest rate by 0.6 percentage points in March. Nonetheless, the further deterioration in the security situation in March intensifies concerns of a further impairment of economic activity. In the context of the persistent budgetary deviation, these apprehensions led to further local-currency depreciation in April—by 4.6 percent—as well as to continued expectations of higher inflation and bond yields, and a decline in share prices.

Table 2. National Accounts, 2000–2002
(seasonally adjusted)

	2000	2001	2001				2002		*	
			I	II	III	IV	I	Oct–Mar ^a		
Rates of change (annual averages, percent, constant prices), compared with preceding quarter										
GDP	6.4	-0.6	1.3	-3.2	-5.2	-6.6		3.2	-3.5	12
Business-sector product	8.5	-1.9	0.4	-6.2	-6.6	-9.9		3.6	-5.7	12
Business-sector product excl. start-ups			1.5	-2.5	-4.4	-9.6		1.4	-3.8	12
Private consumption	6.6	3.3	5.4	2.2	4.5	-5.3		6.6	1.6	12
Gross domestic investment	-3.5	-3.9	-3.1	-28.3	-17.8	-56.5		1.7	-29.4	12
Gross domestic investment excl. start-ups	-7.4	-6.2	-5.0	-22.0	-21.9	-41.6		-7.9	-23.8	12
Goods and services exports	23.9	-11.0	-2.2	-20.7	-16.9	-1.6		10.9	-10.8	12
Goods and services exports excl. start-ups			7.4	-17.4	-15.0	-8.8		8.7	-8.9	12
Goods and services imports	12.2	-4.4	-12.0	-14.3	-14.8	-9.3		12.7	-12.6	12
Public-sector product	1.1	2.9	1.8	3.0	-2.2	12.1		1.1	3.5	12

* Last month for which data available.

^a Compared with same period in preceding year.

The principal industries

National Accounts data for 2001:IV indicate a further deterioration in GDP. The slowdown stems from the decline for the first time in the year in private consumption and the particularly sharp fall in investment, both of which were partly offset in this quarter by the moderation of the decline in exports (Table 2). The fall in private consumption can be attributed to the persistence and intensity of the recession and the decline in the real wage and income in the second half of 2001 (see section on the labor market below). The lagged effect of these factors could reinforce the adverse effect on domestic demand, strengthening the forces operating to continue the slump. The decline in investment was led by a fall in investment in fixed assets and in machinery and equipment, which was particularly steep in 2001:IV—6 percent and 6.3 percent respectively. This trend also impacts adversely on the future growth rate. Investment in transport vehicles also plummeted by 14.3 percent, as activity in the industry declined due to the security situation and the slump in tourism. There was some recovery in construction, however, and investment in it rose by 2.2 percent after declining continuously in the last two years (see below).

According to the various indicators for 2002:I, the trends of economic activity were mixed. With the moderation of the slump in exports, the decline in the index of manufacturing production moderated too. Indices of revenues in the commerce and services industry as well as in construction also rose, albeit due to temporary factors. The recession in tourism exacerbated as a result of the security situation, however. The composite (state-of-the-economy) index was 5.1 percent lower in this period than in 2001:I. Although in December–February, for the first time since November 2000, it rose by a cumulative one percent, it dipped again in March by 0.3 percent (Table 1, Figure 2). The rise in the composite index in 2002:I was led by an increase in both the index of revenues in commerce and the services and the index of imports, and was supported by the moderation of the decline in the index of manufacturing production.

The Bank of Israel's Companies Survey for 2002:IV reports a decline in activity in all the principal industries except transport and communications (Table 1). In manufacturing as well as in business services companies note that the fall in output stems primarily from the decline in orders from the domestic market, and to a lesser extent from the contraction of exports, whereas companies in the transport and communications industry

point to the drop in land transport activity vis-à-vis the rise in sea and air transport and in communications. Most of the companies surveyed reported that they expect a decline in orders in 2002:II, too.

The index of manufacturing production fell by 5 percent in 2001, after a 10 percent rise in 2000—developments that largely reflected the swings in world demand for electronic goods (Table 1, Figure 3). The decline in this index moderated in October–January, primarily due to the recovery of activity in the high-tech industry from November, alongside the expansion of its exports. The recovery of this industry is explained by the rally in the global market (see section on foreign trade below). The number of hours worked has also risen to some extent since October, mainly in the high-tech industry, but because of its low level it is difficult to draw conclusions from it about a trend change in production and manufacturers' expectations.

The construction industry was in deep recession in 2001 due to the drop in demand for housing as a result of the slump, excess supply in 2000, and the security situation, which made owning an apartment more risky and uncertain.² Notwithstanding, in the second half of 2001 this industry appeared to recover to some extent, mainly from the demand side. In October 2001–January 2002 the number of construction transactions was up by 8 percent over the equivalent period last year. Concurrently, the number of mortgages taken rose and the number of 'supply months' of apartments for sale fell, despite the increase in the number of building starts and completions, and the stock of completed unsold units contracted (Table 1, Figure 4).

The recovery of the construction industry in the second half of 2001 was due to several factors: the Ministry of Construction and Housing instituted a program, in effect till end-2001, to provide additional aid in the form of grants and mortgages in 20 specified localities, thereby leading to a significant increase in units purchased in these places. Another incentive for purchasing apartments was provided by the sharp reduction in mortgage interest. This appears to have had an effect in the form of the persistent rally of construction demand in 2002:I. In January and February 2002 the number of mortgages taken was up by 23 percent over the same period in 2001. Note that this figure does not accurately reflect

² The supply constraint deriving from the shortage of Palestinian workers was not particularly effective in 2001, due to the substitution of some of them by foreign workers and the slowing of demand.

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the number of house-buyers, as in some cases old mortgages were replaced by new ones in order to ensure that the interest rate remained at the previous, low rate.

The index of revenue in the commerce and services industry rose by 1.2 percent in annual terms in 2001:IV, and by 3.5 percent in annual terms in January and February 2002. This was led by an increase in the indices of welfare services (community services and health and welfare) and of business services. These trends reflect mainly the greater need for institutionalized aid due to the economic and security situation, and the increased resort to security guard services (which are part of business services). The rise in the index of revenues at the beginning of 2002 also appears to stem from temporary factors, including the fact that purchases were brought forward due to local-currency depreciation, and at present there is no evidence of a positive shift in the trend of activity in commerce and the services.

The slump in tourism is particularly grave. It began at the end of 2000, with the eruption of the *intifada*, and was exacerbated by the events of September 11 in the US.

Although in December–February there was a slight rise in tourist entries and Israelis' bed-nights in hotels, the level of activity remained particularly low. The number of tourist entries by air into Israel was down by 37 percent in the period reviewed from the equivalent period last year (Table 1, Figure 5), and is expected to continue declining because of the rise in the number of terrorist attacks and exacerbation of the security situation in March.

After a succession of terrorist attacks in March 2002 the IDF initiated Operation 'Defensive Shield,' for which purpose tens of thousands of reservists were called up. The deterioration of the security situation has negative repercussions, including an expected decline in revenues in commerce and the services due to the fall in demand in the domestic market, the deleterious effect on productive activity due to greater uncertainty and the call-up of the reserves, possible damage to exports (which could be aggravated by sanctions on Israeli exports by some European countries), and a further decline in exports of tourism services (additional effects are discussed below).

Table 3. Indicators of Labor Market Developments, 2000–2002
(seasonally adjusted)

	2000	2001	2001				2002	Oct–Mar ^a		*
			I	II	III	IV		2001	2002	
			('000s)							
Civilian labor force	2,437	2,503	2,478	2,493	2,515	2,526		3.2	2.7	12
Israelis employed	2,224	2,271	2,266	2,275	2,275	2,268		3.1	1.0	12
Business sector	1,559	1,578	1,569	1,590	1,586	1,567		3.1	-0.2	12
General government	662	692	692	691	689	695		1.2	4.0	12
Average hours worked per employee	38	37	37	37	37	37		-0.3	-3.2	12
Business sector	41	40	40	40	39	39		0.1	-3.1	12
General government	31	31	31	31	30	30		-5.2	-1.4	12
Labor input of Israelis employed	84,580	83,778	83,942	85,020	83,664	82,485		4.9	-4.5	12
Business sector	63,954	62,635	62,697	63,785	62,631	61,426		6.2	-6.3	12
General government	20,626	21,143	21,245	21,235	21,033	21,058		1.0	0.8	12
Claims for unemployment benefit	106	118	108	111	124	128	130	-1.8	20.5	3
Work seekers	165	186	169	182	194	199	201	3.7	18.8	3
Real wage per employee post (NIS) ^b	4,562	4,683	4,709	4,727	4,665	4,631	4,632	4.8	-0.9	1
of which: Business sector	4,690	4,809	4,853	4,830	4,788	4,767	4,696	6.3	-2.0	1
Unemployment rate (%)	8.7	9.3	8.6	8.8	9.6	10.2				12

* Last month for which data available.

^a Percent change compared with same period in preceding year.

^b At 1994 prices.

The Activity and Profitability of the Banks in 2001¹

The severe recession in Israel in 2001, the exacerbation of the security situation, and the crises affecting the capital markets in Israel and abroad had a deleterious effect on the performance of Israel's banking system. The net income of the five major banking groups contracted significantly, from NIS 3.8 billion in 2000 to NIS 1.9 billion in 2001. Concurrently, the return on capital fell from 11.8 percent to only 5.9 percent in 2001, well below its level at the end of the 1990s. Most of the decline in banks' income derived from the increase in loan-loss provision (86 percent), amounting to NIS 4.4 billion, *inter alia* because of the instruction issued by the Supervisor of Banks (in specific credit examination and in a general regulation) in view of the substantial rise in the risk inherent in banks' activities.

The increase in potential risk in 2001 was expressed in the banks' greater exposure to credit risk and the decline in the quality of their credit portfolio; this was expressed by several indicators, including the increased share of loan-loss provision in total credit (from 0.5 percent to 0.85 percent), and the greater share of credit under special supervision in total credit (from 3.4 percent to 5.4 percent). Nevertheless, the risk-based capital ratio (capital adequacy) was 9.4 percent, similar to its level in 2000 (slightly above the minimum capital ratio of 9 percent).

The total assets of the commercial banks rose by 8 percent in 2001 (compared with a 6 percent increase in 2000)—up by NIS 48 billion—and at the end of the year their balance stood at NIS 663 billion.² The increase in the banks' assets was led mainly by the accelerated expansion of bank credit to the public, which grew by 11 percent in 2001, similar to its rate in 2000. This is explained primarily by the process of return to reintermediation, with the contraction of credit alternatives from nonbank sources—issues of shares and bonds on the primary market, direct credit from abroad, and financing from venture capital funds. The crisis in the capital markets in Israel and abroad, together with the economic uncertainty stemming from both the economic slump and the exacerbation of the security situation, reduced firms' ability to raise capital from sources outside the banking system. This left the Israeli banks, which have an advantage in risk dispersal, as the main source of finance. Note that credit flows into Israel from all sources (domestic and foreign banks) were down by 26 percent from 2000, with a marked shift in their composition—away from domestic nonbank sources of finance to bank finance.

Another explanation for the increase in bank activity is to be found in the greater extent of foreign-currency credit (up by 18 percent) as the interest-rate differential between Israel and abroad widened, leading to increased demand for credit by nonresidents and Israeli firms which operate mainly abroad, and the local-currency depreciation. The expansion of credit activity alongside stability in the overall interest margin, led to a 5 percent increase in the banking groups' net interest income, which amounted to NIS 16.2 billion. Alongside the rise in net interest income, banks' non-interest income fell by a marked 16 percent due to the crisis in the domestic capital market and the decline in activity in it. In addition, there was a decline in income from payment services due to the economic slowdown, so that the banks' total non-interest income fell by 3.3 percent to stand at NIS 7.6 billion. The smaller contribution of the subsidiaries to the banks' income, due to the economic slump and crisis in the high-tech industry, was also notable in 2001.

¹ This section was written by the Research Section of the Banking Supervision Department.

² Unless stated otherwise, the reference here is to end-year figures.

The labor market

In 2000:IV the labor market was still in step with the business sector in reducing economic activity, maintaining a trend that had begun in 2000:III. The adjustment of the labor market was expressed in the reduction of the real wage, rise in unemployment, and decline in the average number of hours worked and of full-time positions (Table 3, Figures 6 and 7). In the public sector, by contrast, both the real wage and employment continued to rise (Table 3). The lag in the adjustment of the labor market to the level of activity is well-known, and is connected with market rigidities and uncertainty as to the duration and intensity of the slowdown. In addition, the expansion of public-sector employment and the drop in the number of Palestinian workers served to moderate the impact of the slump on the employment of Israelis in the first half of the year. The adjustment of the labor market at this time was evident in industries with a small proportion of Palestinian workers—apparently because

the ongoing slowdown in the industries employing many of them had previously led to a slump in activity.

The unemployment rate stood at 10.2 percent in 2001:IV, compared with 9.6 percent in 2001:III and an average of 8.8 percent in the first half of the year (Table 3, Figure 7). Trend data indicate that in October 2001 to February 2002 the unemployment rate rose from 9.9 percent to 10.3 percent. The rise in the unemployment rate in 2001:IV reflected the recession, which led to a 1.2 percent contraction in annual terms in the number of Israelis employed. The effect of the decline in the number of persons employed was offset to some extent by the slowing of the rise in the labor supply of Israelis to 1.8 percent in annual terms. The expansion of unemployment is concentrated primarily in transport, agriculture, manufacturing, and banking, insurance and financial services as activity contracted in these industries. The rise in employment in the public sector in 2001:IV moderated the rise in unemployment in that quarter to some extent.

Table 4. Balance of Payments, Foreign Trade, and the Reserves, 2000–2002
(\$ million, current prices)

	2000	2001	2001				2002	Oct–Mar ^a		*
			I	II	III	IV		2001	2002	
Monthly averages										
Trade deficit	309	307	286	279	320	344	386	303	365	3
Goods imports	2,093	1,984	2,122	1,996	1,939	1,878	1,903	2,154	1,891	3
Consumer goods	376	388	416	365	386	384	399	406	392	3
Capital goods	493	499	521	515	498	460	439	519	450	3
Intermediates	1,221	1,096	1,183	1,115	1,052	1,032	1,062	1,227	1,047	3
Goods exports	1,784	1,676	1,836	1,718	1,618	1,534	1,517	1,850	1,525	3
Manufacturing	1,722	1,620	1,780	1,652	1,563	1,484	1,473	1,794	1,478	3
High tech	918	833	983	820	813	717	763	1,000	740	3
Quarterly averages										
Net current account	-354	-432	-328	-896	-1,343	836		-243		12
Financial account (excl. foreign-currency balances)	767	-333	-510	-121	467	-1,167		46		12
Nonresidents' direct and portfolio investment	1,098	761	1,062	834	632	516		654		12
Nonresidents' portfolio investment	1,253	27	555	545	-377	-615		624		12
Residents' direct and portfolio investment	1,178	511	149	739	556	600		547		12
Net foreign debt (% of GNP)	6.48	4.06	3.95	4.07	3.95	4.14		5.15		12
End-period Bank of Israel reserves	23,164	23,181	23,840	23,074	24,478	23,181	23,945	23,840	23,945	3

* Last month for which data available.

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

^b Compared with same period in preceding year.

The labor input of Israelis was down by 4.5 percent in 2001:IV from 2000:IV, and this was concentrated entirely in the business sector. The labor input of Palestinian workers plummeted by 91 percent in that quarter over 2000:IV, and was partly offset by the 12.2 percent rise in that of foreign workers. Because of the negative effects of the employment of foreign workers on the employment of Israelis, the government reduced the number of permits for foreign workers from about 100,000 at the end of 2001 to 70,000 in 2002:I.

The number of work-seekers was up by 18.8 percent in the period reviewed over the equivalent period last year (Employment Service data, seasonally adjusted). When Operation 'Defensive Shield' began, at the end of March, some 30,000 reservists were called up. This, together with the increased need for security guards, because of the deterioration in the security situation, could serve to reduce unemployment from April, but these developments represent damage to the economy on both the supply and the demand sides, and hence in effect continue to have an adverse effect on employment.

The real average wage per employee post in the business sector was down by 2 percent in October to January from the equivalent period last year, mainly because of wage cuts in construction, retail trade, banking, and business services (Table 3, Figure 7). In agriculture and hotels, by contrast, wages rose in 2001:IV due to the dismissal of low-paid workers and the lack of Palestinians, whose wage is relatively low.

The real wage in the public sector rose during the period reviewed (until January) by 2.1 percent, largely due to the implementation of the collective wage agreements for 1999–2001, especially in 2001:IV. Because of the large share of wage payments in the budget, an attempt was made during the period to reduce the wage drift of public services employees by slowing their promotion by means of grades and job redefinition. This met with opposition from the workers and the Histadrut (General Federation of Labor) and was stopped. The attempt to freeze the wage of senior officials was only partly successful, due to the lack of cooperation on their part. In February, however, the section of the Budget Arrangements Law pertaining to pensions was amended, so that as of April new recruits to the civil service will belong to a funded pension scheme rather than an unfunded one. The implementation of this step was also deferred to May.

In July 2001 the amendment to the law regulating employment via subcontractors went into effect. This aims at reducing long-term employment via subcontractors, thereby preventing discrimination against these workers vis-à-vis those employed directly by the employer.³ The amendment set a limit of nine months, after which the worker has to become part of the employer's staff, and also brought the terms of employment of persons employed via a subcontractor into line with

³ This subject is dealt with in greater detail in Chapter 2, Box 2.2 in Bank of Israel, *Annual Report 2001*.

Table 5. The Budget and its Financing, 2000–2002

(cash flows, as percent of GDP)

	2000	2001	2001				2002	Oct–Mar		*
			I	II	III	IV		2001	2002	
1. Government domestic expenditure	36.3	37.8	33.3	39.9	37.9	40.2	37.5	35.9	38.8	3
2. Government receipts	35.8	34.1	34.5	34.6	35.9	31.1	35.6	34.2	33.3	3
3. Domestic budget deficit (1)–(2)	0.5	3.8	-1.2	5.3	2.0	9.1	2.0	1.7	5.5	3
4. Government and Jewish Agency domestic deficit ^b (5)+(6)	-0.4	3.1	-2.4	3.9	2.0	9.1	0.4	1.1	4.7	3
5. Government net borrowing from the public	0.2	3.7	1.1	4.9	1.4	7.5	8.5	0.3	8.0	3
6. Public-sector injection (9)–(8)–(7)	-0.6	-0.6	-3.5	-1.0	0.6	1.6	-8.0	0.8	-3.2	3
7. Bank of Israel injection	0.6	1.6	5.4	2.0	-2.1	1.4	9.7	0.0	5.6	3
8. Private-sector foreign-currency conversions	-0.1	-0.4	-0.5	-0.2	-0.2	-0.7	-0.4	-0.3	-0.6	3
9. Change in monetary base	0.1	0.9	2.0	1.1	-1.6	2.4	1.2	0.8	1.8	3

* Last month for which data available.

^a Compared with same period in preceding year.

^b Including non-budgetary injection.

those of workers on the employer's staff. In December a collective agreement was signed regulating the details of the law, but in the wake of these steps, which entail a rise in employers' wage costs, many public-sector employers began to lay off workers employed via subcontractors. Because of this effect of the amendment on employment and unemployment, and in view of the recession, the Knesset decided in the middle of March to freeze its implementation.

The balance of payments

The trends in the current account evident earlier in 2001 continued in the last quarter of the year, led by the deterioration in Israel's foreign trade, the increase in the deficit on the services account due to the drop in income from tourism—which fell further following the terrorist attacks in the US on September 11—and the reduction in the deficit in the factor input category due to sharp contraction in the number of Palestinian workers. Nonetheless, as a result of the steep decline in the number of Israelis traveling abroad and the receipt in December of part of the economic aid from the US, the current account showed a surplus for that quarter (Table 4 and Figure 8).

The rate of decline in goods imports and exports in 2001 was greater than that in Israel's main trading partners, and offset their sharp rise in 2000. Despite the expansion of world trade since the end of 2001, which caused an increase in goods exports from November to January, mainly in the advanced industries (seasonally adjusted data), Israel's exports continued falling in February and March, albeit more slowly than in the second half of 2001 (Table 4 and Figure 8). The persistent decline in Israel's exports may be the result of the major role played by traditional industries in the recovery of world trade, whereas Israel's main export markets are in the high-tech fields.

The low level of goods imports in the period reviewed reflects the recession in Israel's economy, which started in September 2000 (Table 4). During 2002:I Israel's goods imports were exceptionally volatile, due to the effect of the depreciation of the NIS in bringing forward purchases, although the trend data indicate that imports were steady from December to March. Following the rise in consumer goods imports in 2001, together with an increase in private consumption and a decrease in imports of capital goods and raw materials, the composition of imports changed in the first quarter of 2002: imports of consumer goods fell as private consumption

declined, raw material imports rose, and the decline in imports of capital goods moderated.

In 2001:IV, following the terrorist attacks in the US which led to increased economic and security-related uncertainty world wide and in Israel, nonresidents' direct investment in Israel mainly in high-tech industries declined even more steeply, and financial investments (also mainly in high-tech industries)⁴ almost stopped completely⁵ (Table 4). In the first few months of 2002 nonresident investors returned relatively slowly to the Tel Aviv Stock Exchange (according to data from the Foreign Exchange Control Department), and in particular their direct investments were somewhat below the level a year earlier. On the other hand, investment abroad by Israelis grew in 2002:I, mainly in foreign securities, probably due to pessimism regarding investing in Israel and the worldwide economic recovery.

The general government sector

In 2001:IV the trends which caused the deviation from the budget in 2001 intensified. The real fall in direct tax revenues—income tax and corporation tax—which started in October and which was due to the decline in economic activity and in the real wage, became more pronounced in November and December. The drop in import taxes and the rise in transfer payments also continued, but were partly offset by an increase in indirect tax revenues, so that total tax revenues went down by 5 percent in 2001:IV. The deferment of part of the US economic aid from December 2001 to February 2002 also served to increase the deficit in 2001, which rose from an (expected) rate of less than 3 percent of GDP at the end of 2001:III to an actual 4.6 percent of GDP at the end of the year (Table 5 and Figure 9).

In the light of the deepening recession and its implications, and to boost public confidence in the budget framework, at the end of December the government decided to revise the growth forecast underlying the budget from 4 percent to 2 percent and to make significant cuts in the budget, at the same time setting a deficit target of 3 percent for 2002 and a return to the downward deficit path, to reach 1 percent of GDP in 2005.

⁴ In contrast, direct investments in the public sector and in the traditional industries rose in 2001.

⁵ The share of foreign investment in the Tel Aviv stock Exchange went down to an all-time low of 8.7 percent at the end of 2001 (compared to its peak of 13 percent in 1998).

Despite these decisions, and after a failed attempt to cancel private legislation entailing heavy budgetary expenditure (including the 'Negev Law' and the 'Large Families Law'), the budget for 2002 was eventually passed at the beginning of February; its underlying assumptions, particularly that of a real rise of 5 percent in revenues, strengthened the suspicion that in 2002 the budget deficit would again deviate significantly from the target. The government's pronouncements notwithstanding, the expected increase in expenses in 2002 provides no evidence of priorities which would encourage a return to a path of economic growth. Indeed, in 2002:1 fiscal developments have already deviated from the defined path, mainly in lower than expected tax revenues, particularly from income tax and land tax. Although the level of expenses was also lower than expected, partly because the budget was not passed until February, expenses in February and March have already deviated from the seasonal path. The receipt of NIS 2.6 billion of US economic aid in February, and receipts from the Ports Authority and the mobile phone companies totaling NIS 900 million reduced the level of the deficit in 2002:1.

The 'Defensive Shield' operation which started towards the end of March and the persistent recession in economic activity greatly aggravate concern that the budget forecast of a real increase in revenues in 2002 will not be realized, and that expenses will rise rapidly. The tax benefits in the Negev Law, the recommendations of the Rabinowitz Committee on Tax Reform, the increase in child allowances deriving from the Large Families Law, and the cost associated with the agreement signed with the disabled (detailed below) all contribute to the rise in such misgivings. All the above, combined with continued large-scale borrowing by the government in 2002:1

which prolongs the upward trend in the public debt, led the S&P rating company to lower Israel rating outlook from 'stable' to 'negative.'

The above points all indicate that the deficit in 2002 is expected to exceed the target of 3 percent of GDP quite considerably. The government therefore agreed, at the end of April, on a number of steps to reduce the deviation from the deficit target; these included cutting the budgets of government ministries by 4 percent, reducing child allowances by NIS 1 billion, raising VAT by 1 percentage point, increasing the tax on diesel oil and cigarettes, and increasing labor taxes—making National Insurance and Health Tax payable on the total wage by abolishing the ceiling, and reducing employers' compensation. The government also tightened the criteria for receiving unemployment benefit, and increased the deficit target for 2002 to 3.9 percent of GDP, and for 2003 to 3.5 percent. These measures still lack the element of a large cut in expenses, and are likely to obstruct the return to sustainable growth as they increase both the tax burden and the public debt.

From the end of December 2001 to the end of February 2002 the disabled were engaged in a public protest intended to improve their allowances. The demonstration ended with the signing of an agreement by the Ministry of Finance and the representatives of the protesters which granted 100,000 disabled persons increments of NIS 300 per month; those of retirement age would continue receiving their disability allowance, and an independent committee would be set up†to examine the other needs of the disabled. The cost of the agreement, about NIS 400 million, was not taken into account in the assumptions of the 2002 budget.

Table 6. Selected Price Indices, 2000–2002
(annual rates of change during period, percent)

	2000	2001	2001				2002	Oct–Mar		*
			I	II	III	IV		2001	2002	
CPI	0.0	1.4	-1.9	6.6	3.6	-2.3	9.8	0.0	3.6	3
CPI excl. housing, fruit and vegetables	0.9	0.2	-3.5	6.6	0.4	-2.4	3.2	-1.0	0.4	3
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	0.6	0.2	-1.6	5.9	1.1	-4.4	6.3	-1.9	0.8	3
Index of housing prices	-2.4	5.2	7.4	1.6	12.6	-0.4	36.7	5.3	16.7	3
Wholesale price index	2.0	-1.9	-4.2	5.0	-5.5	-2.7	7.6	-1.5	2.3	3
NIS/\$ exchange rate	-2.7	4.8	8.4	-0.2	16.3	-4.3	41.6	6.3	16.4	3
NIS/currency-basket rate	-6.3	3.7	7.2	-6.3	24.6	-7.4	38.2	6.7	13.1	3

* Last month for which data available.

Prices, and the money and capital markets

In the period reviewed the Consumer Price Index (CPI) rose by 3.6 percent, annual rate, having remained stable in the equivalent period a year earlier (Table 6). Prices did not rise uniformly during the period: in 2001:IV prices fell by 0.6 percent (2.3 percent annual rate) due to the recession, while in 2002:I, as the depreciation of the NIS accelerated, the rate of price increases rose to 2.4 percent (9.8 percent annual rate), far above the 2002 target inflation rate of 2–3 percent (Table 6 and Figure 10).

At the end of 2001 many forces acted to slow down the rate of inflation: (1) the slowdown in domestic demand and economic activity intensified in 2001:IV, and the rate of unemployment reached 10.2 percent; (2) the real wage, after rising in the first three quarters of 2001, went down in the fourth quarter; (3) in that quarter the terms of trade fell—dollar prices of imports declined by 1 percent, export prices (excluding diamonds, ships, and aircraft) fell by 1.2 percent, and fuel prices by 17.1 percent; (4) the NIS appreciated by 1.1 percent against the dollar in 2001:IV and by 1.9 percent against the currency basket. Thus, despite seasonal price increases in 2001:IV, and after a surge in prices in 2001:II and 2001:III, the rise for the year as a whole was 1.4 percent, below the lower limit of the target range for the year (2.5 percent) but within the long-term target range of 1–3 percent.

In September and October the Bank of Israel kept the interest rate unchanged, halting the process of regular cuts, due to the increase in inflation expectations to above the upper limit of the inflation target. From November, as the depth of the recession became clear and inflation expectations fell, the Bank resumed the cuts in the interest rate, and the short-term rate⁶ in the middle of December reached 4 percent. Despite the reduction in the interest rate in 2001, the differentials between rates in Israel and the US widened, particularly after the terrorist attacks in the US in September, as a result of the steep cut in interest rates by the US Federal Reserve Board, so that in 2001:IV the NIS appreciated by 4.3 percent, annual rate, against the dollar (Table 6 and Figure 13).

Against the background of the recession in economic activity and the easing of inflation expectations, in mid-December a package of measures was agreed upon, the main ones being the government decision to revise the budget by introducing cuts as part of its commitment to a downward sloping deficit path, and an exceptional cut of 2 percentage points in the Bank of Israel's interest rate. The agreement also included a number of structural changes and the removal of several restrictions in the money and capital markets.⁷ The timing and the extent of the reduction in the interest rate were due among

⁶ The short-term real rate of interest is estimated as the difference between the Bank of Israel's headline interest rate and inflation expectations.

⁷ For more detail see the July to December 2001 issue of this publication, or the Bank of Israel, *Annual Report 2001*.

Table 7. Monetary Indicators and Nondirected Bank Credit, 2000–2002
(annual terms, percent)

	2000	2001	2001				2002	Oct–Mar		*
			I	II	III	IV		2001	2002	
Rates of change	Average		Compared with preceding quarter					During period		
M1 ^b	11.0	14.2	11.2	21.7	28.3	4.6	51.8	13.7	29.3	3
M2 ^c	20.0	17.2	19.7	12.8	14.9	14.2	-11.1	20.7	-4.4	3
M3 ^d	16.9	15.5	21.6	11.3	13.3	13.1	-0.6	20.3	1.6	3
Nondirected bank credit	13.1	10.8	11.5	9.5	12.7	8.1	9.1	10.9	7.2	3
Unindexed local-currency	25.2	15.0	22.0	10.5	7.8	6.3	1.8	15.5	4.3	3
CPI-indexed	6.9	4.7	0.3	6.2	13.8	9.6	-1.2	-1.4	2.3	3
Foreign-currency-indexed and denominated	9.5	15.7	17.1	13.3	17.9	8.2	38.3	27.6	19.1	3

* Last month for which data available.

^a Compared with same period in preceding year.

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

^c M1 plus short-term local-currency deposits.

^d M2 plus foreign-currency-indexed and denominated.

Table 8. Interest Rates, Yields, and the Share-Price Index, 2000–2002

	2000	2001	2001				2002	Oct–Mar		*
			I	II	III	IV	I	2001	2002	
Nominal interest										
Nondirected										
local-currency credit	8.4	11.6	7.2	9.2	9.6	10.3	11.1	10.0	12.9	2
Average monetary loan	4.8	8.0	3.7	5.8	6.2	7.0	7.7	6.7	9.3	3
SRO deposits	4.0	6.9	2.9	4.7	5.2	5.9	6.5	5.6	8.0	2
3-month Eurodollar	1.9	5.9	1.8	2.0	3.3	4.1	5.2	3.7	6.4	3
Yield to maturity on										
Treasury bills	5.2	7.8	4.8	5.7	6.4	6.6	7.3	6.5	8.8	3
10-year bonds	4.4	5.6	4.1	4.6	4.6	4.9	5.4	4.9	5.5	3
5-year bonds	3.9	6.0	3.2	4.5	4.3	5.0	5.7	4.9	6.0	3
General Share-Price										
Index (points)	197.8	214.5	199.6	196.1	194.7	196.5	202.5	197.5	248.6	3
Expected inflation (gross)	2.3	1.7	2.8	1.7	2.8	1.4	1.8	1.9	2.5	3
Interest derived from										
expected inflation (gross)	2.9	5.9	2.2	3.6	3.6	4.9	5.3	4.3	6.0	3

* Last month for which data available.

^a Compared with same period in preceding year.

other things to the assumption that the budget cuts and the lowering of the inflation environment would enable price stability to be maintained at a lower interest rate than previously. However, the reduction in the interest rate, the deterioration of the security situation, and the passing of the budget (in February) with a major deviation from the deficit target for 2002 resulted in a sharp 9.1 percent depreciation of the NIS against the dollar in 2002:I. In the wake of this depreciation, and despite the effect of the recession and seasonal price reductions, the rate of price increases accelerated in 2002:I, especially the index of housing prices, to 2.4 percent and 8.1 percent respectively. The adjusted CPI⁸ also accelerated, rising by 1.6 percent (6.3 percent in annual terms), and the index of wholesale prices rose by 1.8 percent (7.6 percent annual rate), mainly in industries reliant on imports, giving rise to concern that there may be further price increases in the pipeline (Table 6).

During the period reviewed, as the interest rate came down and in particular following the 2 percentage point cut in December there was a move into short-term deposits; the M1 money supply grew by 29.4 percent. The rise in M1 on the one hand, with high borrowing by the government on the other, led to a 4.4 percent reduction in M2 in the period reviewed compared to the level in the equivalent period a year earlier (Table 7 and

⁸ The CPI excluding housing, fruit and vegetables, clothing and footwear, and goods under government price control.

Figure 11). The rise in the money supply has not caused a rise in prices to date, due to the moderating effect of the recession. The rise in demand for liquidity is apparently the result of the reduction in the nominal and real interest rates, but it may also reflect a risk premium related to the deterioration in the security situation. At the beginning of 2002 the rate of expansion of the foreign-currency-indexed aggregates and of credit in or indexed to foreign currency also accelerated because of the wider interest differential between Israel and abroad at the end of 2001 and the sharp depreciation at the beginning of 2002. The rapid depreciation together with the acceleration in the rise in the money supply obliged the Bank of Israel to take steps to calm the financial markets, and it therefore raised the interest rate in March by 0.6 percentage points.⁹

Yields on medium- and long-term bonds were relatively stable in the second half of 2001, after declining in the first half year in line with the reductions in the short-term interest rate (Table 8 and Figure 14). Following the reduction of 2 percentage points in the interest rate by the Bank of Israel in December, real yields on bonds, especially short-term, fell too. The passing of the budget in February, however, gave rise to concern that fiscal discipline was seriously impaired, and that this would

⁹ In mid-February the Bank of Israel also made an exceptional announcement warning against the danger of investing in foreign currency.

increase the borrow requirement in the future, and lead to a rise in the short-term and particularly in long-term yields to a level higher than that prevailing prior to the December reduction of the interest rate. The fact that inflation expectations remained within the target range during this period suggests that the rise in yields reflects a rise in the risk premium, rather than a rise in expectations and this is also expressed in a rise in demand for liquidity. The rise in the Bank of Israel interest rate in February caused a temporary decline in yields on bonds. Towards the end of the period, however, as the security situation deteriorated further, yields rose again, even faster, and this time their rise reflected also a rise in inflation expectations, both short-term (against the background of the depreciation of the NIS) and long-term (against the background of the expected deviation from the deficit target) to levels exceeding the upper limit of the inflation target range. These trends, together with persistent depreciation of the NIS by 4.6 percent in April, led the Bank to raise the interest rate for May by 0.2 percentage points.

Following a 20 percent rise in share prices in 2001:IV, and a 9.3 percent rise for the whole of 2001, the share

price index fell by 13 percent in 2002:I (Table 8). The fall in the share price index in Israel while those in stock markets abroad were recovering is a reflection of the low level of profitability of Israeli companies,¹⁰ and the very serious effect of the security situation on the economy and on expectations for a recovery.

The government recently made a decision to change the Bank of Israel Law, and the process of legislation is expected to start soon. It is of great importance that any changes should reflect the principles accepted by most of the advanced countries and adopted by the Levin Committee: the maintenance of price stability as the prime objective of the Bank; complete independence for the Bank in the choice and operation of monetary instruments; interest-rate decisions to be taken by a Monetary Committee headed by the Governor, whose members are experts untainted by conflict of interest; and transparency of the Bank's policy.

¹⁰ The 25 largest quoted companies on the Tel Aviv Stock Exchange (the Tel Aviv 25 Index) made a cumulative loss of NIS 2 billion in 2001, compared to a profit of NIS 4.4 billion in 2000.