RECENT ECONOMIC DEVELOPMENTS, 105*

October 2003–March 2004

Main developments

From October 2003 to March 2004 (the period reviewed) the rising trend of business-sector activity evident in the second half of 2003 became clearer and more pronounced. In addition, most of the economic indices relating to the period reviewed show that consumers' and manufacturers' expectations of continued and even stronger recovery have risen. Casting a shadow over these positive indications was the slack in the labor market that gave the clearest expression to the persistent low level of activity relative to the level and composition of potential growth.

The rise in the growth rate in 2003 started against the background of the accelerated pace of worldwide economic activity and trade and the relative calm in the security situation in Israel. Initially the growth was based on increased exports and private consumption, while during the period reviewed investments also showed signs of recovery. Growth was supported by the policy mix that combined fiscal restraint—which was essential, despite its contractionary effect, because of the level of the public-sector deficit, and which was required in order to boost the credibility of government policy—with a gradual reduction in the Bank of Israel interest rate.

The rise in exports was supported to a great extent by the recovery of international markets and trade in 2003 which started with growth in the US and spread to other countries. At the same time the domestic situation created conditions, mainly NIS depreciation and streamlining of companies, that improved the profitability of exports. Consumption rose, aided by the lowering of the interest rate and the increase in the real wage in the second half of 2003, and by the increased value of the public's asset portfolio during the year.

Several additional positive developments took place in the period reviewed. The construction industry, in a slump for the last three years, showed signs of gradual recovery: according to the National Accounts investment in residential building rose in 2003:IV by 1.2 percent, in annual terms. In the months November 2003 to January 2004 there was a rise in the number of apartments sold. Another indicator of positive change in construction is the expansion in 2003:IV in the industries that supply raw materials to the construction industry. Nevertheless, according to the Bank of Israel's Companies Survey the level of activity in 2004:I continued to shrink, albeit more slowly than in previous quarters. The number of building starts and completions continued to contract, as did the supply of apartments for sale, which shows that the supply continues to adjust itself to the low level of demand. The tourist industry also started recovering in the middle of 2003, and the number of foreign and Israeli tourists started rising substantially. The rise in private consumption and the economic recovery trend also affected the commerce and service industries, and their output increased too.

Two central indicators reflect manufacturers' expectations that the recovery will persist: the first is the slower fall in investments, the increase in investment in equipment and machinery in 2003:IV and the considerable rise in imports of capital goods at the beginning of 2004 following a lengthy recession; the second is the rise in the number of employees in 2003:IV, following an increase only in the number of hours worked, in 2003:III. Both of these indicators attest to manufacturers' caution, as they delayed increasing their physical investments or their staffing despite the initial signs of growth evident in 2003:III and waited for it to become firmly based. Nevertheless, according to the National Accounts data investments in the principal industries continued to contract in 2003:IV, apparently due to considerable surplus production capacity that slow down the rate of investment at times of growth. The decline in labor input persisted, and at the end of the period reviewed the rate of unemployment—11 percent[1] —was exceptionally high, another indication of untapped production potential in the economy.

At the end of 2003 the budget deficit, 5.6 percent of GDP, deviated widely from the target of 3 percent of GDP for the year. However, the sharp turnaround in government policy in the second half of 2003—expressed in a sharp reduction in government expenses—with a concurrent rise in tax receipts resulting from the recovery in activity improved the path of the deficit. Thus the development of the budget throughout the period reviewed was consistent with the achievement of the target deficit of 4 percent of GDP set for 2004. A further budget cut was carried out in February 2004 following approval of the budget for the year, and when it became

* *For diagrams (bilingual) please turn to the end.*

[1] In February; trend data.

clear that tax revenues exceeded the forecast, cuts in direct and indirect taxes were announced in February and April. At this stage it is premature to assess the effects of these steps on the tax revenues.

In the light of the high government debt, 105 percent of GDP, attention should be focused on cutting it, in order to reduce the rate of interest in the economy and to release financial sources in the government's budget by lowering interest payments of the debt. The tax burden in Israel is in line with the norm of about 39 percent in the OECD; consequently, and in view of the cumulative effect of the reforms of indirect taxes and income tax, further cuts in tax rates that might limit the government's ability to reduce the debt should be avoided.

The Consumer Price Index (CPI) went down by 0.4 percent in the period reviewed—less than the 1–3 percent target range set for 2003 and 2004. The reduction in prices reflected mainly the surplus production capacity that enabled the increase in demand to be satisfied in full without utilizing the economy's full growth potential. The decline of the CPI and the stabilization of inflation expectations within the target inflation range enabled the Bank of Israel to continue reducing the interest rate in the period reviewed, by a cumulative 2.2 percentage points, without adverse effect on the stability of the financial markets. The persistent cuts in the interest rate spurred the rise of the money supply, and this rose rapidly, by 10.7 percent. The General Share-Price Index also went up in the period reviewed by a marked 11.7 percent, mainly due to the recovery of domestic activity and the rise in companies' profitability, as well as the reduction in alternative yields. The rise in the share index continued into 2004:I despite the fall in share prices in the international markets in that period.

Despite the early signs of growth in the period reviewed, there are indicators that the process did not affect the various strata of society to the same extent, and the composition of growth may widen economic inequality, at least in the initial stages. Although data are not yet available to enable this effect to be quantified, the trends observed lead in the direction of wider gaps: the 'wealth effect'—i.e., the rise in the value of the public's financial assets, the main beneficiaries of which are the capital-owning upper deciles of the population—played an important role in spurring growth. Also, employment increased in the second half of 2003 mainly in the advanced, skilled-labor-intensive industries, and was accompanied by a rise in the wage in those industries. On the other hand, the high rate of unemployment, mainly among those with few years of education and the cuts in National Insurance allowances affected the lower deciles. Moreover, some of the lower deciles do not benefit from the lowering of the rates of income tax, because they do not reach the minimum tax threshold. Policymakers should take steps to allow also low-wage earners to benefit from growth, for instance increasing the return to labor (e.g., via negative income tax or the reimbursement of expenses).

The National Accounts and the principal industries

GDP rose by 2.5 percent in 2003:IV, in annual terms, and by 1.3 percent, annual average for the year[2] (Table 1). Business-sector product increased by 3.6 percent in the last quarter of 2003. National Accounts quarterly data indicate gradual acceleration of the rate of increase in business-sector product from 2002:IV to 2003:IV, indicating that the forces acting to end the recession that started in mid-2000 grew stronger.[3] The turnaround in economic activity and the acceleration of the growth rate are reflected in various indices, such as the composite State of the Economy Index, the Bank's Companies Survey, and other indicators of activity in the principal industries.

The background to the faster rate of growth in 2003 and during the whole of the period reviewed was the recovery in the global economy and the relative calm in Israel 's security situation. Growth was based on increased exports and private consumption, and from the last quarter of 2004 some recovery in investment is also evident. The policy mix, which included fiscal restraint—essential despite its contractionary effect, in the light of the level of the public-sector's growing deficit and the need to boost the credibility of government policy—and a gradual reduction in the Bank of Israel interest rate supported growth.

Export growth was helped by the recovery in activity world wide, which stemmed from the US but which had also spread to Europe and Asia, and by the marked real depreciation of the NIS against the currency basket during the period reviewed, by the reduction of the real wage, and from streamlining that contributed to increased productivity and improved the profitability of exports. Exports of goods and services were 5.4 percent higher

[2] Henceforth all rates of change in this review are in annual terms, unless stated otherwise.

[3] According to several indicators the current recession started in the second half of 2000 and continued until the second half of 2003 (see the 2003 Annual Report of the Bank of Israel Research Department, the section on Output and Principal Industries). The years 1996 to 1999 were also years of very low growth—an average of about 0.5 percent a year.

Table 1. National Accounts, 2003–2004
(seasonally adjusted data)

	2003	2003 I	2003 II	2003 III	2003 IV	2004 I	Oct. 2003–Mar. 2004*	**
Rates of change (annual averages, percent, constant prices), compared with preceding quarter								
GDP	1.3	3.3	–1.1	2.8	2.5		1.9	12
Business-sector product	1.8	4.9	–0.5	3.1	3.6		2.8	12
Business-sector product excl. start-ups	2.2	5.8	–0.1	2.4	3.3		2.8	12
Private consumption	1.7	–4.1	11.9	6.4	2.7		4.1	12
Gross domestic investment	–13.4	–30.9	–13.1	16.5	–4.5		–9.6	12
Fixed investment	–5.0	–3.8	–1.2	–12.2	–1.3		–4.7	12
Goods and services exports	6.1	9.1	1.2	21.2	–7.8		5.4	12
Goods and services exports excl. start-ups and diamonds	6.0	11.6	–7.9	30.9	–8.5		5.4	12
Goods and services imports	–2.3	–15.3	3.0	19.3	–6.0		–0.5	12
Goods and services imports excl. diamonds	–2.2	–7.5	9.8	11.4	–4.6		1.9	12
Public-sector consumption	–1.8	0.1	–10.3	–0.3	–8.7		–4.9	12
Public-sector consumption excl. defense imports	–0.6	1.7	–5.3	1.5	–7.2		–3.2	12

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

in 2003:IV than in 2002:IV (Table 1).[4] Goods exports rose in the last quarter of 2003 by 7.5 percent from the level in the third quarter, and by an additional 8.5 percent in 2004:I (based on Foreign Trade data, Table 5). All export industries contributed to the rise in exports, with high-tech industries featuring most prominently, with a quantitative diversion from the US to Europe as the euro gained strength and the dollar depreciated (see the section on the balance of payments below).

Goods and services imports remained at the same level in 2003:IV as in 2002:IV. Goods imports jumped in the period reviewed, by 4.4 percent from 2003:III to 2003:IV and by a further 10.2 percent from 2003:IV to 2004:I (based on Foreign Trade data, Table 5). Imports of consumer goods and raw materials headed the list of increased goods imports, and were followed at the beginning of 2004 by imports of capital goods.

[4] According to National Accounts data, exports of goods and services declined during 2003:IV. However, this was due to the sharp fluctuations in imports and exports of services, which rose in 2003:III and fell in 2003:IV. This volatility stems from temporary factors, and hence is not given prominence in the analysis of the data.

Private consumption increased by 2.7 percent in 2003:IV, following increases of 11.9 percent and 6.4 percent in the second and third quarters of 2003 respectively (Table 1). The import of goods for current consumption, that serves as an indicator of private consumption, rose by 19.8 percent in the period reviewed from the level in the equivalent period a year earlier, with most of the increase in the first quarter of 2004 (Table 5), indicating the continued growth of private consumption at the beginning of 2004.

The increase in private consumption at the end of 2003 was affected by the upward trend in the real wage in the second half of 2003, by the cuts in the interest rate, and by the increase in the public's financial assets.[5] This trend was supported by the relative calm in the security situation and the fall in prices during the year that boosted purchasing power, and by the public's expectations that the fall would not continue for long. The rise in private consumption was also expressed in a decline in the private savings rate during 2003, continuing the downward trend evident since 1999.

[5] According to the survey of consumers' expectations, in the period reviewed there was optimism regarding continued recovery. Such expectations may have contributed to the public's feeling of wealth and to the rise in consumption.

Public consumption declined by 8.7 percent in 2003:IV and is expected to continue falling in 2004:I (Table 1). The reduction derives from the government's policy of cutting the deficit which although it had a direct effect of holding back the rate of growth still contributed to the recovery by improving the government 's fiscal credibility and by its affect on the boom in the financial markets (see the section below on the public sector).

Investment in capital assets dipped by a relatively modest 1.3 percent in the last quarter of 2003, after declining more rapidly since the beginning of 2002 (Table 1). In that quarter investment in residential construction rose by 4.8 percent, and investment in machinery and equipment by 2.9 percent. Total investment in the principal industries fell in 2003:IV by 2.3 percent because of the sharp decline, 13.2 percent, in nonresidential construction and in intangible assets. The increase in investment in machinery and equipment and in construction was partly due to the expected reduction in real interest in the period reviewed, particularly towards the end of the period, the recovery in economic activity, and manufacturers' expectations that the recovery would continue. The sharp rise in imports of capital goods in 2004:I of about 70 percent in annual terms shows that the upward trend persisted at the beginning of 2004.

The positive change in the trend in activity, particularly in the second half of 2003, was reflected by other indices too: the composite state-of-the-economy index rose by 4.2 percent in 2003:IV and by another 6.3 percent in 2004:I. The rise in the index and the acceleration in its rate started in July 2003 after its constant decline over the previous three years (Table 2 and Figure 1). The rise in the index resulted from a turnaround in most of its components from 2003:III, especially in the index of manufacturing production, which rose by 12.5 percent in 2003:IV, in the revenue index in the commerce and services industries, which rose by 11.9 percent in that quarter, and in the goods import and goods export indices, which went up by 14.7 percent and 10.8 percent respectively in the period reviewed. In contrast to these indices, no significant change was evident in the number of employee posts, which is also one of the components included in the composite index (Figure 2). (The changes in these indices are described in greater detail below.)

Table 2. Indicators of Business Activity, 2003–2004

(all data excluding construction are seasonally adjusted)

		2003				2004	Oct 2003–	
	2003	I	II	III	IV	I	Mar 2004	*
Rates of change (annual averages, percent), compared with preceding quarter								
State-of-the-economy index	–2.0	–2.7	–2.1	1.0	4.2	6.9	1.2	3
Large-scale retail trade	–2.5	–7.6	–1.1	4.3	11.1	–0.3	1.4	2
Manufacturing production (excl. diamonds)	–0.4	–3.4	–1.6	1.3	12.5	10.4	3.2	2
Business-sector consumption of electricity	4.2	–0.9	11.4	5.6	–5.3	12.6	4.0	2
Index of revenue in commerce	0.7	–4.3	8.2	3.1	10.3		4.2	12
Index of total revenue	–0.6	–11.1	6.8	8.4	11.9	3.8	5.1	2
Tourist arrivals	22.0	–21.7	36.5	20.7	7.4	–1.3	54.4	3
Construction (change from equivalent period in previous year)								
Residential starts	–8.5	–14.8	–13.9	–7.9	6.4		3.6	1
Of which: Government-initiated	–4.6	18.2	–23.8	4.7	–11.6		–25.5	1
Residential completions	–13.3	–12.0	–12.5	–23.3	–3.0		–8.1	1
Of which: Government-initiated	–17.6	–9.2	–10.9	–33.4	–10.3		–7.1	1
Survey of companies (net balance, percent)[c]								
Output of manufacturing firms	–3**	–16 **	–10**	3**	9**	29**		3
Sales by commercial firms	7	–28**	30**	12**	13**	60**		3

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

* *Last month for which data available.*

** *Not significant at 5% level.*

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

The Companies Survey carried out by the Bank of Israel Research Department lends support to the above findings. Following reports in the Survey of stable activity in most industries in the last quarter of 2003 and of expectations of recovery to come, the Survey does in fact show expanded activity in 2004:I (excluding the construction industry, which reported continued contraction in activity also in the first quarter of 2004, albeit slower than in the previous quarters), with a focus on manufacturing for exports. The Survey also shows that the expectations in all industries were that activity would continue to rise in the next quarter (2004:II), both in exports and on the domestic market.

Manufacturing production increased in 2003:IV by 12.5 percent, and by another 10.4 percent in January and February 2004 (Table 2 and Figure 2). At the same time manufacturing exports rose markedly, by about 10.6 percent in the period reviewed compared with the equivalent period a year earlier (Table 4). Production in the high-tech industries was 5 percent higher than in the equivalent period a year earlier (to February), with the rate of increase accelerating during the period. The revival in the advanced industries at the end of 2003 lagged behind the recovery around the world that had started towards the end of 2002, due to the deterioration in the security situation at the beginning of 2003, and in particular to the war in Iraq and the Intifada (Figure 8). The mixed-traditional industries also showed high growth rates, with a rise of 3.1 percent from the level one year earlier, due to the fact that this group includes two-digit industries that produce for the construction industry. The growth rates of the product of the mixed-advanced and the traditional industries were relatively low, 0.8 percent and 0.3 percent respectively.

As production and exports rose in 2003:IV, the number of hours worked declined, by 1.4 percent, and the number of employees also edged up, by 0.8 percent, compared to the levels in 2002:IV. The slow rate of increase of labor input relative to the rapid rise in manufacturing production indicates that the increase in output was achieved mainly by a rise in labor productivity deriving from companies implementing streamlining processes over the last few years.

In construction, after a long slump, several indicators suggest some improvement: (1) investment in residential construction went up by 4.8 percent in 2003:IV; (2) the number of building starts was 3.6 percent higher in the period reviewed than in the equivalent period in 2002–03 (Table 2); (3) the total number of Israelis employed in the construction industry in 2003:IV was 10 percent higher than in 2002:IV; (4) the number of new apartments sold in October 2003–January 2004 increased by 17 percent over the equivalent period in 2002–2003, slightly slower than the rise in 2003:III, but a fast increase nonetheless. The trend reversal indicated by these data is apparently aided by the signs of recovery in the economy and lower interest rates, especially mortgage interest, the lowering of which served to increase housing demand. The level of activity in the industry is still very low, however, following its three-year slump, and according to the Companies Survey the contraction in activity persisted in 2004:I (although for the first time expectations of recovery were reported). The continued reduction in the stock of apartments for sale to a low of 11,500 new apartments at the end of 2003 also indicates that the supply continues to adjust itself to the low level of demand.

The increase in tourism that started in 2002:II continued in the period reviewed, although at a more modest rate that its rapid recovery in the second and third quarters of 2003 (Table 2 and Figure 4). The number of tourists arriving by air was 54.4 percent greater than the number in the equivalent period a year earlier, and exceeded its level prior to the war in Iraq. The number of tourist bed nights in hotels grew at a similar rate. As foreign tourism increased, so did internal tourism, and the number of hotel bed nights of Israel was 10.5 percent higher than in the equivalent period a year earlier.

As a result of the increase in private consumption, the revenue of the commerce and services industries increased by 11.6 percent in 2003:IV (Table 2).[6] The rise in revenue of financial institutions (17.3 percent), against the background of the improvement in the capital markets and in the level of activity and the profitability of the banks and insurance companies, was particularly marked, as it was in hotels and catering due to the increase in foreign and domestic tourism. Revenue in commerce surged by 10 percent in 2003:IV; retail sales went up by 15.8 percent in the period reviewed, and in the multiple retail outlets by 10.8 percent.

The labor market

The rate of unemployment rose by 0.4 percentage points in the period reviewed, to reach 11 percent[7] (Table 3, Figure 5). Total labor input declined in 2003:IV in both the business sector and the public sector, by 0.6 percent and 1.4 percent respectively, while the number of employees rose by 1.3 percent, and the number of hours work went down by 0.5 percent. These changes indicate the low level of activity relative to the potential, on the

[6] The last quarter of 2003 was a period with many labor sanctions, so that great caution should be used regarding these data.

[7] In February; trend data.

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

(seasonally adjusted data)

	2003	2004	2003				2004	Oct 2003–	
	IV	I	I	II	III	IV	I	Mar 2004*	**
			('000s)						
1. Civilian labor force	2,646		1.0	–0.1	0.6	1.4		2.8	12
2. Total employees[a]	2,359		0.3	0.1	0.5	1.3		2.0	12
Of which: General government	718		–0.9	2.0	0.5	–1.5		–0.2	12
Business sector	1,646		0.1	–0.5	0.7	2.7		3.0	12
Of which: Israelis	1,646		–0.9	0.4	1.9	1.6		3.0	12
Non-Israelis[b]	229		–4.7	–2.0	–1.8	–2.9		–10.9	12
3. Average hours worked weekly per employee	37.0		0.0	–1.9	1.4	–0.5		–3.7	12
4. Labor input in business sector (incl. foreign workers)	75,449		–1.6	–5.3	4.4	–0.6		–3.3	12
Of which: Israelis	67,371		0.8	–1.7	0.5	2.4		–1.0	12
5. Labor input in general government (Israelis)	20,158		0.1	–0.9	2.5	–1.4		–3.9	12
6. Israeli employees (total)	2,363		–0.3	0.4	0.6	1.4		2.0	12
7. Unemployed	287		7.0	–1.8	1.9	2.7		9.4	12
8. Work seekers	235	232	7.3	1.4	11.6	6.5	–1.2	25.8	2
9. Claims for unemployment benefit	88	87	7.4	6.3	2.0	0.4	–0.9	–9.1	2
	Nominal NIS, (unadjusted)								
10. Wage per employee post[c]	6,838	7,471	–0.1	–2.6	2.7	–0.2	7.2	1.8	1
General government	6,437	7,952	–1.9	–6.4	5.7	2.2	15.1	3.5	1
Business sector	6,917	7,148	0.5	–0.5	1.1	–0.7	3.1	0.9	1
Percent									
11. Participation rate			54.5	54.2	54.3	54.8		1.3	12
12. Employment rate (=2÷1)			89.2	89.4	89.3	89.1		–32.1	12
13. Unemployment rate (=7÷1)			10.8	10.6	10.7	10.9		6.8	12
14. Depth of unemployment[d]			35.7	40.6	36.3	36.1		11.4	12

* Compared with October 2002–March 2003 (original data).
** Last month for which data available.
[a] Including Israelis and an estimate of foreign workers.
[b] Foreign workers and Palestinians.
[c] Excluding Palestinians.
[d] Percent of unemployed seeking work for more than six months.
SOURCE: Central Bureau of Statistics, Labor Force Survey, except for data on Israelis, non-Israelis, and labor input in the business sector, and total Israelis employed, which are the Central Bureau of Statistics' National Accounts estimates.

one hand, and signs of recovery and manufacturers' expectations that the recovery will intensify, on the other. It is natural that to expect a lag in the reaction of the labor market to the recovery of activity, and improvement may be expected as the pace of growth picks up.[8]

The unemployment rate reached 10.9 percent at the end of 2003, as stated, and according to trend data it rose to 11 percent in February 2004. The rise was mainly due to the 1.4 percent increase in the civilian labor force in 2003:IV, with new entrants joining the market, apparently because of the need for additional breadwinners. It is worth noting that more than half of the new participants in the labor market are women. The signs of economic recovery may have contributed to this rise, as they raised the chances of finding employment.

[8] The labor force increases with the recovery of activity as workers who had previously despaired of finding work return to the labor market. Thus in the first instance recovery may be expected to be accompanied by a rise in the unemployment rate.

The increase in the labor force would have raised the unemployment rate by 0.9 percentage points, but the expansion of production and the 1.3 percent rise in total employment offset the increase in the number of unemployed persons, and the unemployment rate went up by only 0.2 percentage points.

As the unemployment rate rose, the depth of unemployment remained at the high level it had reached at the beginning of the year. Those who had been looking for work for more than half a year made up 36.1 percent of all the unemployed in 2003:IV (Table 3). The share of those who had not worked at all in the previous year increased in that quarter (compared to the previous quarter and compared to the last quarter of 2002), but in the absence of additional information, it is not known whether these are new entrants into the labor force or unemployed who have been looking for work for a year or longer.

Total employment increased by 1.3 percent in the last quarter of 2003, and that of Israelis by 1.4 percent (Table 3). Employment in the public sector declined by 1.5 percent, the outcome of the economic recovery program which entailed dismissals and early retirement, and a 2.7 percent rise in business-sector employment, despite the 2.9 percent reduction in the number of foreign workers in the sector in 2003:IV.

The rise in employment in the last quarter of 2003 from the previous quarter (seasonally adjusted) was most notable in the advanced industries (6.6 percent in the electronic components industry, and 25.9 percent in control and medical equipment), in business services (26.7 percent), commerce (13.4 percent), construction (14.1 percent), and hotels and catering (14.8 percent). In contrast, employment fell in public administration (by 28 percent), health and welfare services (8.7 percent), agriculture (10 percent), and manufacturing overall (3.2 percent).

The rise in the number of employed persons in 2003:IV occurred together with a decline of 0.5 percent in the average number of hours worked per Israeli employee, following a rise of 1.4 percent in 2003:III (Table 3). The increase in the number of employees following the rise in the number of hours worked indicates employers' firmer expectations that activity is going to expand, expectations that are initially expressed by a rise in the number of hours worked, and then followed by an increase in the number of employees.

The wage per employee post went down in 2003 by 2.1 percent (a real fall of 3 percent), reflecting the effect of the economic program to reduce the budget deficit, and the high rate of unemployment (Table 3, Figure 6). The nominal wage declined by 0.2 percent in 2003:IV, with the public-sector wage rising by 2.2 percent and the business-sector wage going down by 0.7 percent (Table 3, Figure 6).[9] Changes in the wage in the last quarter of 2003 and January 2004 were partly due to certain non-regular single-time occurrences such as the adoption of the program to encourage growth, the postponement of the payment of the Jubilee grant and vacation supplement, and deductions due to strikes. Nevertheless, despite the volatility of the data, a positive change in the business-sector wage was evident in the second half of 2003 relative to the downward trend that had persisted since 2001.

Labor relations suffered unrest in 2003:IV, due to the dispute between the Ministry of Finance and the Histadrut (Labour Federation) relating to the economic recovery program, with work stoppages occurring from time to time in the public sector. An agreement was signed at the beginning of 2004, delaying to 2005 dismissals of public-sector employees (other than those regarding whom there was an agreement from May 2003), postponing the worsening of conditions of retirement, canceling or reducing some of the structural changes planned for several parts of the sector, and changing the fundamentals of the plan to rescue the established pension funds. This agreement, that among other things included raising the retirement age for women and men, brought about relative calm in labor relations in the first quarter of 2004. One of the knottiest problems as yet unresolved is the non-payment of wages by some municipalities for several months because of a deterioration in their financial situation resulting from a sudden sharp cut in government grants (for details see the section on the public sector below). Withholding wages is illegal, and is forbidden according to any criteria, and avoiding it is essential for stability and for preserving the credibility of the public sector.

Global developments

In April 2004 the IMF raised its forecast of global growth in 2004 to 4.6 percent due to the expandsion of global trade, optimism in the financial markets, and positive indicators of economic growth in the US. Concurrently, the World Trade Organization revised its growth forecast regarding international trade in goods to 7.5 percent (after this had expanded by 2.5 and 4.5 percent in 2002 and 2003 respectively). An examination of trends in various countries clearly shows that global economic growth and trade were led by the US and Asia, especially China. Thus, growth forecasts for the US were hiked to 4.6 percent, the highest rate since 1985, for Japan they were

[9] In January 2004 the wage rose steeply due to the deferral of some seasonal payments due in 2003 to that month (e.g. the Jubilee grant and the vacation supplement).

doubled to 3.4 percent, and for China they were raised to 8.5 percent. Growth forecasts for the EU were reduced to 1.7 percent, however.

The GDP of the US expanded by 2.9 percent in 2003. Estimates of growth for 2004:I are also relatively high—4 percent (annual rate). Another encouraging figure is the creation of 300,000 jobs there after a long slump in the labor market. The optimistic forecasts were undermined to a slight extent by low retail sales figures for February. In addition, the decline in the unemployment rate in recent months, from 6.3 percent in June 2003 to 5.6 percent in December, also mainly reflects the 'discouraged worker effect,' rather than the recovery of the US labor market. These trends are supplemented by a rise in security risks following the terrorist attack in Madrid and rising deficits: the US trade deficit was 4.5 percent of GDP at the end of 2003, and the budget deficit was 5 percent of GDP.

GDP rose by 0.4 percent in the EU in 2003—the lowest rate for ten year— most of it in the second half of the year. In 2003:IV (when the GDP growth rate was a relatively high 1.2 percent) the high rate of investment (4 percent) in the EU was notable, but most of it was in inventory, while private consumption hardly changed at all, imports expanded, and exports fell—in contrast with the trend of improvement in foreign trade that had characterized the preceding quarters. In the last two months of 2003 the unemployment rate dropped in the EU, too, returning to its level in 2002—8.8 percent—but most of the decline stemmed from the structural reforms in many countries (reduction of eligibility for unemployment benefit, etc.) rather than expressing a real change in the European labor market.

In Japan the estimate of growth for 2003:IV was revised to 6.6 percent in annual terms because of the expansion of exports and domestic demand, and in particular the

Table 4. Indicators of Economic Development in Advanced and Developing Countries,[a] and Forecast for 2004[b]

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

[a] According to "World Economic Outlook," Israel is classified as an advanced country.
[b] Annual rate of change, percent, except for unemployment and interest rates.
[c] Average price per barrel in 2002 was $25.00; estimated price in 2003 is $31.00.
[d] Six-month Libor rate
SOURCE: "World Economic Outlook" (IMF), April 2003.

Table 5. Balance of Payments, Foreign Trade,[a] and the Reserves, 2003–2004
($ million, current prices)

	2003	2003 I	2003 II	2003 III	2003 IV	2004 I	Oct. 2003–Mar. 2004[b]	*
Percent change from previous period								
Goods imports	0.4	–3.2	6.0	0.2	4.4	10.2	14.7	3
Of which: Consumer goods	–1.7	–3.8	7.4	6.1	2.7	8.5	19.8	3
Capital goods	–4.0	–12.4	8.2	–6.7	0.5	14.1	1.5	3
Intermediates	3.0	1.3	4.6	1.3	6.6	9.3	19.0	3
Goods exports	7.1	6.8	–4.0	–0.1	7.2	8.4	10.8	3
Manufacturing	6.7	6.3	–3.8	–0.0	7.4	7.8	10.6	3
High-tech	3.3	8.8	–10.8	1.6	7.0	9.9	6.1	3
Quarterly averages, $ million								
Trade deficit	204	78	253	260	223	277	250	3
Current account, net	–43	397	–95	–840	364			12
Financial account (excl. foreign exchange reserves)	–31	–714	–229	1,002	–185			12
Nonresidents' direct investment	918	798	1,631	506	736			12
Nonresidents' portfolio investment	580	–216	–75	1,321	1,290			12
Residents' portfolio investment abroad	824	95	532	622	2,048			12
Net foreign debt (% of GDP)	–6.03	–3.80	–4.73	–4.83	–6.10			12
Bank of Israel reserves, end-period	25,788	23,486	24,089	24,767	25,788	26,161	26,161	3

** Last month for which data available.*
[a] $ million, current prices, seasonally adjusted. Foreign trade data do not include ships, aircraft, diamonds, or fuel.
[b] Compared with October 2002–March 2003.
SOURCE: Central Bureau of Statistics.

rise in private consumption and investment in export-biased industries. The unemployment rate declined, to stand at 4.9 percent in December. Notwithstanding, prices continue to decline in Japan, and severe structural problems hamper the banking system, continuing to impair business-sector profitability.

The expansion of economic activity in the US and the eurozone could push up their interest rates, which are currently very low (e.g., the interest on two-year T-bonds was 1.5 percent in the US at the end of March and 2 percent in the EU).[10] These forecasts could be harmed by the increasing security uncertainty of recent months because of fears of further attacks like that of March 2004 in Madrid, and the rise in oil prices in the second half of 2003 in the context of low levels of stocks.

[10] Interest has already begun to rise in the UK (by 0.25 percentage points in February) in the wake of the publication of growth rates there for 2003:IV and expectations of further growth in 2004.

The balance of payments

During the period reviewed Israel's goods imports rose from 4.4 percent in 2003:IV to 10.2 percent in 2004:I. Concurrently, goods exports expanded by a marked 8 percent (quarterly rate), and the trade deficit rose slightly in 2004:I, after remaining relatively stable in 2003:IV (Table 5. Figure 7; the data in this section are not in annual terms). At the end of 2003 the euro appreciated against the dollar, especially in 2003:IV, and this served to increase the nominal value (in dollar terms) of European imports and exports, as well as to divert exports to Europe at the expense of the US and Asia (see Bank of Israel, Foreign Exchange Activity Department, *Annual Report* 2003, chapter on the Balance of Payments).

Imports of consumer goods and factor inputs (excluding oil and diamonds) were up considerably—by 19 percent each—in the period reviewed over the equivalent period in 2003. The expansion of imports reflects Israel's economic recovery, led *inter alia* by the rise in private consumption. There was a turnaround during the period in imports of investment goods: after declining in the first three quarters of 2003 and remaining stable in 2003:IV—reflecting the unutilized inventory of investment goods and producers' uncertainty regarding the intensity and persistence of growth—imports of basic commodities rose by 14.2 percent in 2004. *Goods exports* were up by a quarterly rate of 8 percent in the period reviewed (Table 5). This growth rate of exports encompassed almost all manufacturing industries, whose downward trend or stability in 2003 became a protracted rise throughout the period reviewed.

In 2003:IV Israel's terms of trade deteriorated: import prices (excluding ships, aircraft, and diamonds) rose by 2.8 percent, while export prices went up by 1.2 percent. During the period reviewed energy prices increased by 10.2 percent (in annual terms), mainly in 2004:I. The depreciation of the dollar against the euro in 2003—and in 2003:IV in particular— and the rise in energy prices were among the causes of the deterioration in the terms of trade in this period. Note that the there was real local-currency depreciation in 2003:IV,[11] and the NIS reverted to its relatively high rate at the beginning of 2003, supporting the expansion of exports at the end of 2003 and the beginning of 2004.

The services account was in surplus in 2003:IV, reflecting an 11 percent rise in exports of tourism services (continuing their upward trend in 2003:II), as well as an improvement in the balance of transport and insurance services, on the one hand, and decline in exports of the other services and expenditure by foreign workers, on the other. At the same time, current transfers to Israel—mainly to the general government—soared. The surplus on the services account and in current transfers offset the deficit in the trade account and the rise in payments for factor inputs abroad (due to the increase in nonresidents' income from their investments in Israel and decline in interest income from abroad, alongside the reduction of global interest rates), so that there was a $ 364 million surplus on the current account in 2003:IV, compared with a $ 232 million deficit in 2003:IV (Table 5).

The global developments that had dictated nonresidents' investment policy in 2003 persisted in 2003:IV. The most prominent of these included the recovery of global demand, alongside slack yields in developed country markets and lower overall risk in emerging markets—which caused investment in the latter to expand in 2003. In Israel this trend reached its apex in 2003:III and 2003:IV, finding expression in a rise in both direct and portfolio investment (Table 5). Note, however, that the extent of investment in Israel is still lower than in the emerging markets because of its security risks. In the first two months of 2004 these investments even dipped somewhat (according to figures from the Bank of Israel's Foreign Exchange Activity Department).

Investment abroad by residents was led by domestic developments in 2003. especially the redemption of foreign-currency credit and its replacement by foreign Treasury bonds, as well as the investment policy of institutional investors abroad as part of the long-term policy of risk diversification.[12] Thus, investment abroad by residents was particularly high in 2003:IV—$ 2 billion. The increase in investment by nonresidents throughout the period reviewed was offset by the rise in investment abroad by residents, so that in the course of the period a deficit was created in the net financial account.

The general government

2003 ended with a marked deviation of the deficit—5.6 percent of GDP—from the target of 3 percent of GDP. There was, however, a sharp turnaround in government policy, beginning in the second half of 2003, expressed in spending cuts. The rise in tax receipts during the period reviewed, due to the recovery of economic activity, improved the deficit path. Thus, the development of the budget during the period reviewed was in line with the deficit target of 4 percent of GDP set for 2004 (Table 6, Figure 9).

From mid-2003, in the framework of the economic recovery package, *government spending* was slashed, as expressed in its decline as a share of GDP—from 38.5 to 35.8 percent. The cuts focused on reducing general government wage and current transfer payments. The decline in public expenditure in 2003 encompassed all the components of the budget, except for investment in the transport infrastructure. Despite their immediate effect of restricting growth, these cuts were necessary in view of the growing deficit, and served to restore confidence in fiscal policy as well as to contribute indirectly to the resurgence of the financial markets in 2003. It seems, therefore, that the positive effects of the government's policy on growth in 2003 outweighed its contractionary influence.[13] At the end of January the 2004 budget, with across-the-board cuts of NIS 6 billion, was approved, The belated approval of the budget and additional across-

[11] Calculated as the nominal exchange rate *multiplied by* the level of prices in Israel's trading partners, and *divided by* the domestic price level.

[12] Part of the policy derives from the replacement of expired domestic Treasury bonds (*Gilboa*) by foreign Treasury bonds.

[13] This subject is discussed more fuly in Box 3.2 of Bank of Israel, *Annual Report* 2003.

Table 6 Government Budget Performance vis-à-vis Deficit Target, 2003–2004

		2003				2004	Oct 2003–	
	2003	I	II	III	IV	I	Mar. 2004[a]	*
Domestic deficit as percent of GDP	0.5	1.5	2.9	1.1	2.1		3.5	3
Deviation from path[b] (NIS billion)								
Government revenue	–3.9	–5.0	–7.5	–5.0	–2.7	0.5	7.9	3
Government expenditure	–5.1	0.6	–0.3	–2.5	–2.9	–0.1	–2.5	3
Domestic deficit	1.3	–5.5	–7.2	–2.5	0.2	0.6	–82.1	3
Total government deficit (excl. credit extended)	–18.7	–4.4	–9.9	–5.4	–8.0	–0.6	–86.6	3
Percent change from previous period								
Government tax revenue	–1.9	–1.3	–4.9	–2.3	1.1	7.0	4.7	2
Of which: Income tax, gross	–8.2	–12.4	–12.6	–4.4	–2.3	9.3	3.2	2
V.A.T., gross	1.9	7.9	–0.5	–1.9	2.3	3.4	2.9	3
Government expenditure	2.6	7.8	1.3	2.4	–0.6	–2.1	–1.3	3
National Insurance allowances	–5.1	–2.3	–3.3	–3.7	–11.2	–6.2	–9.7	1
Of which: Unemployment benefit	–31.3	–36.1	–35.5	–24.8	–25.9	4.6	–19.6	1
Income support	–18.9	–0.2	–27.1	–20.2	–25.8	–19.5	–24.1	1
National Insurance contributions received from public	3.4	10.2	9.8	–0.4	–4.4	1.6	–2.1	2

* Last month for which data available.
[a] Compared with October 2002–March 2003.
[b] The path was determined on the basis of a deficit of 3 percent of GDP in 2003, and 4 percent of GDP in 2004.
SOURCE: Ministry of Finance.

the-board cuts in the supplementary budget approved in February,[14] were expressed in an expenditure path that was consistent with the deficit path at the beginning of 2004, too (Table 6).

Tax receipts were up in 2003:IV, for the first time that year, by 1.1 percent from 2003:III (Table 6). In the first two months of 2004, as economic activity picked up, real-estate transactions increased, and imports expanded (primarily of heavily-taxed consumer goods), tax receipts also accelerated—by a massive 7 percent. Note that part of this acceleration at the beginning of 2004 was due to the postponement of wage payments to January 2004 (the vacation supplement and Jubilee grant), but most of it reflected the recovery of economic activity. The expansion of tax receipts encompassed all their sources: direct taxes were up by 1.2 percent over the equivalent period last year, indirect taxes rose by 7.4 percent, and import tariffs increased by 14.2 percent.

Due to the accelerated expansion of tax receipts in 2004, in February this income was up by NIS 1 billion over the seasonal path that is in line with the deficit path, and there are expectations that this trend will persist for the rest of the year. This led the government to reduce V.A.T. and purchase taxes that month (thereby lowering expected tax receipts by over NIS 2.5 billion). Concurrent with the tax reductions, across-the-board cuts were made to the base of the 2004 budget, and the inflation reserve was utilized to the full. At the beginning of April, in view of encouraging forecasts of a NIS 6 billion tax surplus from the Ministry of Finance, a further reduction of the income tax on low and medium wages was announced, alongside an increase in the marginal tax on wages between NIS 7,500 and NIS 11,040. Corporate taxes, as well as purchase taxes on basic commodities and construction inputs were reduced, so that expected tax receipts went down by another NIS 2 billion. It is still too early to assess the effect of these measures on tax receipts.[15]

[14] The expenditure under-performance relative to the deficit target path stemmed *inter alia* from the delay in approving the budget and the subsequent lag in allocating some of the funds.

[15] Various empiricial examinations have shown that a reduction in tax rates generally leads to a decline in receipts, except at the highest tax brackets (highest decile), see, e.g., E. Szez (2003), "Reported Incomes and Marginal Tax Rates, 1960–2000; Evidence and Policy Implications," NBER Working Paper 10273.

In view of the size of the government *debt*—105 percent of GDP—particular attention should be paid to its development, in order to reduce domestic interest rates and free sources in the government budget as debt-servicing costs decline. Note that the tax burden in Israel does not deviate from the OECD norm—about 39 percent of GDP. Consequently, and because of the cumulative impact of the reforms implemented on the extent of indirect and income tax, further tax reductions, which could hamper reduction of the deby, should be avoided.

Total national insurance *allowances* were down by 9.7 percent during the period reviewed (until January) over the equivalent period last year (Table 6). Unemployment benefit payments fell by 19.6 percent and child allowances by 16.2 percent. The contraction in national insurance allowances despite the high unemployment rate and low level of economic activity, derived from the government's policy of reducing allowances and making eligibility criteria more stringent.

During the period reviewed the deterioration in the financial situation of some of the *local authorities* assumed prominence.[16] The deterioration, after a long period in which the local authorities' financial situation had improved, derived mainly from the steep and sudden cut in the government's participation in their budgets (by a cumulative NIS 2 billion in 2002–2004, constituting 40 percent of their budget) as well as from the reduction in education and welfare grants. The latter impacted largely on local authorities where a large section of the population belongs to lower socio-economic groups. As a result, the government's decision of January 2004, to add NIS 550 million to the local authorities' budget and

[16] For a review of these developments, see A. Brender (2003), "The Effect of Budget Performance on the Results of Elections for Local Authorities, 1989–1997," in Bank of Israel, Economic Review 75 (Hebrew), and Bank of Israel, *Annual Report* 2003, Chapter 3.

BOX
Major Infrastructure Projects and their Financing[1]

The 2004 government budget asserts that it is incumbent upon the government "to expand investment in the infrastructure in order to enable Israel's growth potential to be fulfilled… while increasing infrastructure investment from extra-budgetary sources." The budget also states that "All over the world vital functions that were formerly financed from the national budget are being increasingly transferred to the private sector, and in the coming years this will also be the case in Israel…, enabling sources of finance to be added and efficiency increased." These objectives should be examined as regards both their essence and practical implementation.

Government investment has risen by 2.5 percent since 2000, and within that investment in the infrastructure has grown by 40 percent. Similarly, in the last few years there has been a significant turnaround in the approach to major infrastructure projects. Until 2000 most projects were implemented by government entities and fully financed by the government. Recently, however, a growing number of projects have been implemented jointly with the private sector. This approach, known as P.P.P. (Public-Private Partnership) involves signing long-term cooperation agreements between the public and the private sectors.[2] Some of the agreements are according to the P.F.I. (Private Finance Initiative) system, in which the public sector makes the private sector responsible for supplying a public good (including the construction, purchase, maintenance, repair, and finance of the project). Within the framework of the P.F.I. agreements are projects using the B.O.T. (Build, Operate, Transfer) system, in which, after a pre-set period (generally 20–35 years), in which the private company builds and operates the project, the asset is transferred to the public sector. In addition, some projects are implemented under the B.O.O. (Build, Own, Operate) system, in which the asset remains in the hands of the private company.

[1] This review is based in part on the study undertaken by the government company, Inbal.

[2] The only project using the P.P.P. system and which is not in the sphere of the infrastructure is the construction of a private prison south of Beer-Sheba.

In Israel the main project built and completed under the B.O.T. system is the main section of the Cross Israel Highway, which was opened to the public in February 2004 (about six months before the estimated date). This project embodies the main advantages of the system: (i) its construction was financed from a non-government budget (although it is not certain at present whether the government will have to provide a 'safety net' for the minimum number of journeys to which it is committed); (ii) the project was completed in time, in contrast with most of the road-building projects undertaken in Israel in the last few decades.

Some 16 infrastructure projects are currently in various stages of construction using the P.P.P. system. Most of the projects were begun in 2000, and their financing in conjunction with the private sector amounted to $ 6.5 billion by the end of 2003, 75 percent of it in transport, 12 percent in desalination, 6 percent in construction, and 4 percent in energy (these are reported in greater detail in Bank of Israel, *Annual Report* 2003, chapter on the principal industries). Note that during the construction process the government learned many lessons, and has improved the planning and tendering processes involved.

Involving the private sector in these projects makes it possible to utilize the comparative advantage of each sector and distribute risks between them. It is also very important to increase competition within the economy while reducing government involvement and utilizing non-deficit sources. However, under the current arrangement by which projects are managed in Israel many of these advantages are eroded.

Financing the construction of projects is one of the major problems which need to be addressed. Non-government financing of major projects requires long-term nonbank domestic credit. Israel's situation in this respect is in contrast with that in advanced economies, where institutional elements are a growing source of credit for such projects. Thus, for example, in England 40 such projects were financed by institutional elements in 2003, whereas in Israel by 2004 Bank Hapoalim and Bank Leumi are expected to finance 80 percent of all the projects built using the B.O.T. system.[3] The relatively small extent of Israel's banking system and its credit limitations in the last few years also hamper credit extended to projects of this kind at the level required. Moreover, because of the high regional security risk it is difficult to borrow money abroad. These difficulties impair the progress of projects and increase their cost, which in the final event is borne mainly by the government. Thus, the Jerusalem light railway and the sea-water desalination installations at Palmachim, the Haifa Bay area, and Kibbutz Shomrat are in difficulties because of financing problems.

It is necessary to maintain international standards in managing these projects, as well as to establish professional centers for administrative and consultancy purposes,[4] while utilizing the experience aquired in the course of the various projects in order to ease the processes. Long-term sources of finance must be freed for these projects, subject to the reduction of the government deficit, thereby easing government demand for sources of finance and diverting them to the private sector. It is possible to help finance these projects by designating future US guarantees for financing infrastructure projects via the private sector, as well as by opening long-term investment in the infrastructure to institutional investors—pension and provident funds and insurance companies—by reducing the extent of borrowing to finance the government deficit. The government should also provide grants for setting up some of the projects, thereby reducing their financing costs.

[3] This forecast has been provided by T.A.S.K.

[4] An example of this is the Project Division of the Inbal government company, which was set up in 2001 to provide organizational and consultancy services.

allocate a significant amount (NIS 500 million) to recovery programs in some of them was unavoidable. Note that until this writing (end-April 2004) and because of the long-term disbursement arrangements for these payments, most of the money has not yet been transferred to the local authorities, and their financial situation, as well as that of their employees who have not been paid, is deteriorating.

Prices, monetary policy, and the money and capital markets

The CPI dipped by 0.4 percent in the period reviewed, and the CPI adjusted for housing, seasonal items, and controlled goods—providing an indication of the inflation environment—also went down by a similar rate (Table 7,

Table 7. Selected Price Indices,[a] 2003–2004
(cash flows as percent of GDP)

		2003				2004	Oct. 2003–	
	2003	I	II	III	IV	I	Mar. 2004[b]	*
CPI	–1.9	3.2	–5.0	–3.9	–1.6	–0.4	–1.0	3
CPI excl. housing, fruit and vegetables	–0.6	2.7	0.8	–5.0	–0.8	0.0	–0.4	3
CPI excl. housing, fruit and vegetables, controlled goods, clothing and footwear	–0.4	4.2	–0.2	–1.0	–4.2	2.6	–0.9	3
Index of housing prices	–6.7	3.8	–26.2	5.3	–5.8	0.0	–3.0	3
Wholesale price index	3.3	15.4	–7.9	2.3	4.9	9.2	7.0	3
NIS/$ exchange rate	–6.4	7.6	–29.7	8.2	–6.3	10.4	1.7	3
NIS/currency-basket rate	–0.5	15.0	–23.2	3.6	7.3	11.5	9.4	3

* Last month for which data available.
[a] Annual rates of change during period, percent.
[b] Compared with October 2002–March 2003.
SOURCE: Central Bureau of Statistics.

Figure 10; rates of change in this section are not in annual terms). The decline in prices reflected mainly the economy's excess capacity—which made it possible to meet the rise in demand in full—the high unemployment rate, and firms' downsizing measures, expressed in the rise in productivity and decline in costs per hour worked. Note that the decline in prices in the period reviewed was more moderate than in the previous six months, when prices fell by 2.2 percent; this was a result of local-currency depreciation (by 0.8 percent against the dollar and 4.6 percent against the currency basket), compared with the appreciation of the previous six months, and the relatively steep rise in import and export prices throughout the period (by 2.8 and 1.2 percent respectively).

The lack of homogeneity in the development of the CPI and its various sub-sets also reflects a turnaround in its development relative to the preceding six months, when prices of almost all its components declined. During the period reviewed transport and communications prices fell (by 0.6 percent), as did prices of furniture and household equipment (by 2.4 percent), clothing and footwear (by 3.3 percent), and education, culture, and entertainment (by 2 percent). The reduction of prices of these items as well as of housing (by 2.4 percent) offset the increase in prices of other items during the period, especially of household maintenance (2 percent), health (1.9 percent), and food (0.7 percent).

Inflation expectations derived from the capital market (gross) stabilized in the middle of the inflation target in 2003:IV, averaging about 2.1 percent, and remained there in 2004:I. The stabilization of expectations within the inflation target range, despite the decline in actual prices in the period reviewed, derives from the public's expectations of an economic recovery, as well as from confidence that policymakers will adhere to their commitment to the stability of prices.

Against the backdrop of the decline in prices and stability of inflation expectations within the target range, the Bank of Israel continued to reduce its *key interest rate* in the period reviewed by a cumulative 2.2 percentage points (by about 0.4 percentage points a month, Table 9, Figure 11). As a result, expected real interest was 2.3 percent at the end of the period reviewed, and the interest-rate differential between Israel and abroad narrowed.

Concurrent with the reduction of interest by the Bank of Israel and the decline in the risk premium in Israel and elsewhere, the downward trend of *yields* on short-term Treasury bills persisted in the period reviewed. However, yields on long-term Treasury bills (above six months) rose towards the end of the period (in February and March),

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

	2003	2003 I	2003 II	2003 III	2003 IV	2004 I	Cumulative change over previous 12 months	Oct. 2003–Mar. 2004[a]	*
Rates of change	*Average*	*Compared with preceding quarter*						*During period*	
M1[a]	0.5	13.2	–1.6	9.7	10.5	32.4	14.3	22.5	3
M2[b]	1.7	–0.1	–4.0	6.0	8.4	3.6	3.5	2.1	3
M3[c]	2.2	6.3	–5.2	3.2	5.0	7.0	2.7	3.7	3
Nondirected bank credit	1.7	1.0	–5.9	–3.7	0.1	6.8	–1.0	2.9	3
Unindexed local-currency credit	7.1	–1.3	10.0	3.0	–1.6	7.3	4.6	4.5	3
CPI-indexed credit	–1.1	–3.8	–2.9	–7.8	–5.1	16.0	–1.3	4.3	3
Foreign-currency-indexed and denominated credit	–0.9	11.0	–26.1	–6.4	10.5	–5.5	–7.2	–1.1	3

* 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.
SOURCE: Bank of Israel.

attesting to the public's expectations that the Bank of Israel would resume raising the interest rate later in the year in order to attain the inflation target (Figure 13). The real long-term yield curve (between 5 and 9 years) dipped in 2003:IV to the average level that had characterized it in 2002, apparently because of the public's expectations of significant budget cuts in 2004, but in 2004:I the yield began to rise again, and the slope of the curve became steeper.

During the period reviewed the share of *liquid assets*—M1 and SRO deposits—rose notably, by 10.7 and 22.5 percent respectively (Table 8). The process of liquidating the financial assets portfolio has been continuing since the beginning of 2003, and reflects the effect of the reduction of interest on the composition of the portfolio. The share of the liquid assets (M1 and SRO deposits) in total assets (vis-à-vis M2 and M3) is similar to that evident at the beginning of 2002, when the interest rate was slightly lower than at the end of the period reviewed. M3 rose by 3.7 percent in the period reviewed—slightly above the rate that is consistent with the rate of expansion of real economic activity and expected inflation.

Total nondirected *credit* expanded by 1.4 percent during the period reviewed, most of it in January 2004, after contracting continuously since 2000 (Table 8, Figure 12). The increase in credit occurred against the backdrop of the reduction of interest and assessments that growth would accelerate, reducing borrowers' risk premium. During 2004:I local-currency credit—both indexed and unindexed—expanded, while foreign-currency-indexed credit decreased, in contrast with the trend in 2003:IV (Table 8).

The General Share-Price Index rose by 11.7 percent in 2004:I, continuing its 20.7 percent increase in 2003:IV. This rise expresses the public's confidence in economic policy, the decline in alternative yields, and the recovery of economic activity. It also reflects the rise in firms' profitability, continuing the trend evident during the year. In 2003:IV share prices rose, alongside the upsurge in global stock markets, while in 2004:I their upward trend was in contrast with that evident elsewhere. Prominent among the rise in share prices and profitability in 2003:IV were firms in the electronics, insurance and banking industries, whereas in 2004:I the real-estate and electronics industries were notable, followed by manufacturing. The steep increase in share prices in 2003 was also expressed in the public's higher level of involvement in stock-market activity, stimulating a significant rise in corporate bond issues in the second half of the year.

Table 9. Interest Rates, Yields, and the Share-Price Index, 2003–2004

			2003[a]				2004	Oct. 2003–	
	2003	2004	I	II	III	IV	I	Mar. 2004[b]	*
Nominal interest									
Marginal interest on monetary loan	7.8	4.5	9.4	8.7	7.3	5.8	4.6	5.2	3
SRO deposits	6.2		7.7	7.1	5.7	4.4		4.4	12
Nondirected local-currency credit	10.6		12.0	11.4	10.2	9.0		9.0	12
3-month Eurodollar	1.1	1.0	1.2	1.1	1.0	1.0	1.0	1.0	3
Yield to maturity on: Treasury bills	7.0	4.7	8.5	7.6	6.5	5.4	4.8	5.1	3
10-year bonds	4.8	4.2	5.8	4.8	4.6	4.2	4.1	4.2	3
5-year bonds	4.9	3.8	5.6	5.2	4.5	4.2	3.8	4.0	3
Expected inflation (gross)	2.7	1.8	3.8	1.9	2.7	2.2	1.8	2.0	3
Interest derived from expected inflation (gross)	4.1	2.5	4.5	5.2	3.7	3.0	2.5	2.8	3
General Share-Price Index (change)	55.7	63.3	–2.3	38.8	2.5	20.7	11.7	29.1	3

* Last month for which data available.

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

[b] Compared with October 2002–March 2003.

SOURCE: Bank of Israel.

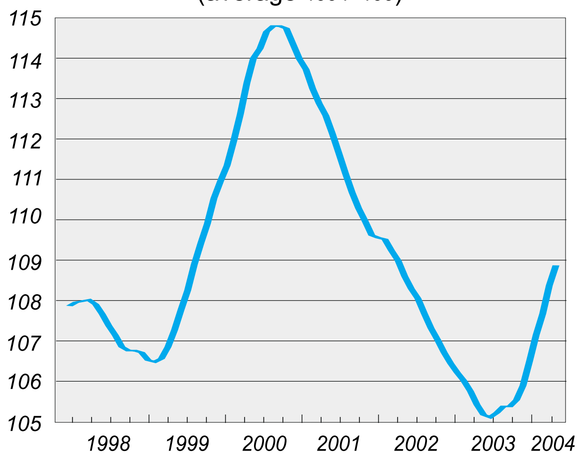
Timetable of Events: January–April 2004

Month	Day	Event	Explanation
January	1	Income-tax brackets and credits revised downwards.	By 1.95 percent, as part of automatic annual revision.
January	5	Agreement signed by Ministry of Finance and Federation of Labor ending 100 days of disruption of public services.	As part of agreement, the following was decided: a. No public-sector dismissals in 2004. b. Some structural changes in public administration proposed by Ministry of Finance to be postponed or cancelled. c. Some principles of program to save established pension funds to be changed.
January	7	National budget approved: NIS 255 billion.	
January	8	Pension Age Law approved by Knesset.	Pension age to be gradually raised by 4 months a year to 64 for women and 67 for men.
January	25	State's share of Zim Shipping Company sold.	For NIS 125 million.
February	1	Changes in child allowances introduced, as	a. Child allowances cut by NIS 24 per child. decided in 2003 fiscal package. b. Mechanism introduced for reducing allowances for children born before 1.6.2003, by 2006. c. Allowance for each child born after 1.6.2003 set at uniform amount, NIS 144.
February	1–18	Local authorities on strike due to non-payment of wages (15 major local authorities did not strike).	According to the agreement signed on 18.2.2004, the adverse effect on the local authorities was moderated, and some grants were reinstated.
February	25	Agreement signed to alter structure of Mekorot Water Company.	Monopolistic supply of water to be separated from other, competitive, segments.
March	1	Tax reductions announced in February went into effect.	a. V.A.T. lowered from 18 to 17 percent. b. Prices (controlled) of eggs and milk reduced by 1 percent. c. Import tariff on basic foods annulled.
April	4	Ministry of Finance announces several tax changes.	a. Corporate tax gradually lowered from 36 to 30 percent over next 5 years. b. Tax concessions on low and medium wages announced, and tax bracket for wages between NIS 7,500 and NIS 11,040 raised. c. Purchase tax on building materials cancelled.
April	4	Socio-economic cabinet committee approves amendment of Capital Investments Encouragement Law.	a. Tax benefit arrangements to be dealt with by Income Tax Department. b. Two new tax benefit arrangements introduced for large investments in national priority areas. c. A new criterion for tax benefit eligibility introduced, according grants only to firms whose exports are at least 25 percent of their sales.
April	15	Ministerial legislative committee approves proposed amendment to Labor Disputes Settlement Law limiting right to strike.	

Figure 1 דיאגרמה

המדד המשולב למצב המשק, 1998 עד 2004*
(100 = 1994)

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



* Until March. * עד מארס.

Figure 2 דיאגרמה

הייצור התעשייתי* (מדד, ממוצע 1994=100) והמסחר הקמעוני המאורגן (מדד, ממוצע 2002=100), 1998 עד 2004

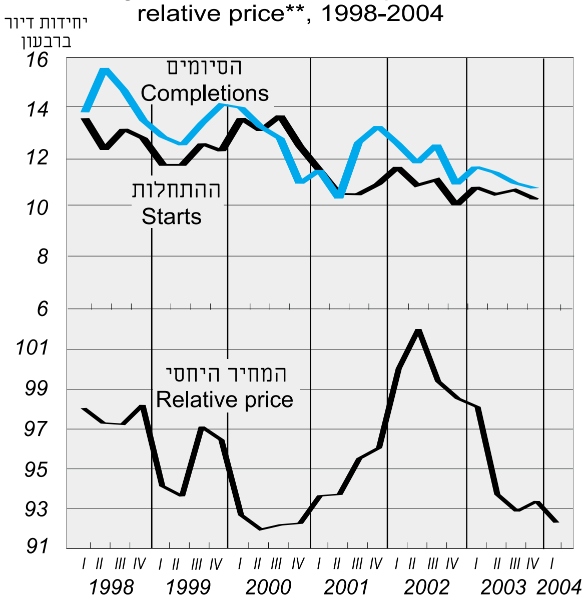
Manufacturing production* (index, average 1994=100) and large-scale retail trade (index, average 2002=100), 1998-2004

* Manufacturing production data Updated to March 2004. * הייצור התעשייתי מעודכן למארס 2004.

Figure 3 דיאגרמה

מספר התחלות והסיומים* של יחידות דיור והמחיר היחסי של הדיור**, 1998 עד 2004

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



* Original data, Updated to December. * הנתונים מקוריים, מעודכן עד דצמבר.

** Relative to CPI, Updated to March. ** במונחי מדד המחירים לצרכן, מעודכן עד מארס.

Figure 4 דיאגרמה

ענף המלונאות - לינות תיירים וישראלים[1], 1998 עד 2004*

The hotel industry: bed-nights of tourists and Israelis[1], 1998-2004*

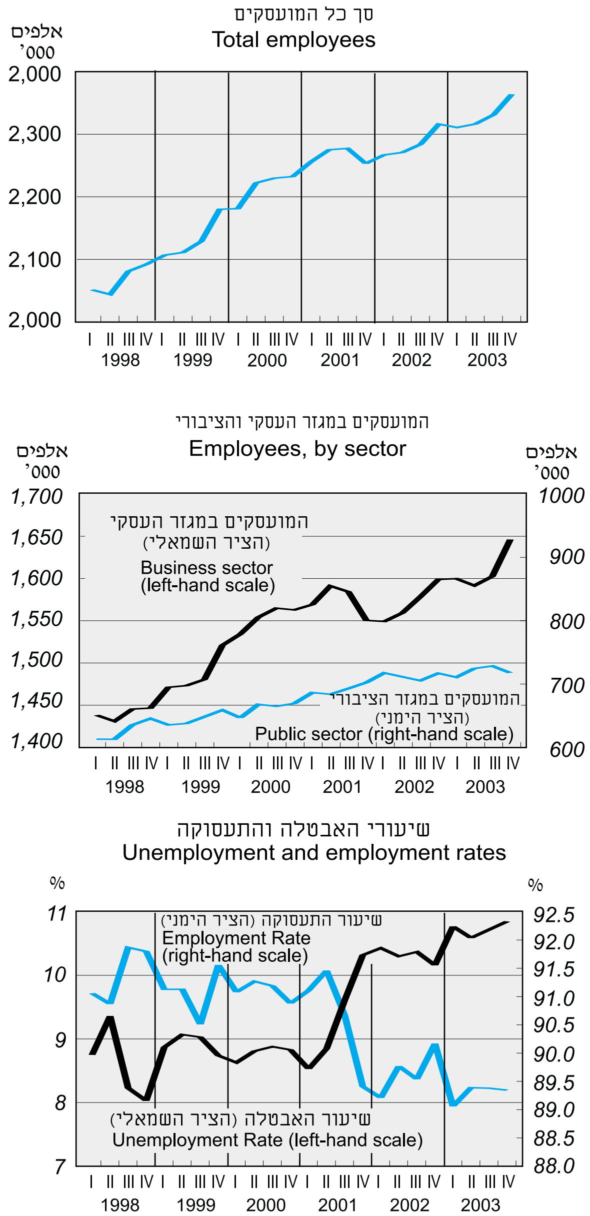
1) Seasonally adjusted. 1) בניכוי עונתיות.

* Updated to February. * מעודכן עד פברואר.

Figure 5 דיאגרמה

שוק העבודה[1], 1998 עד 2003*

The Labor Market[1], 1998-2003*



1) Seasonally adjusted. 1) בניכוי עונתיות.

* Until December. * עד דצמבר.

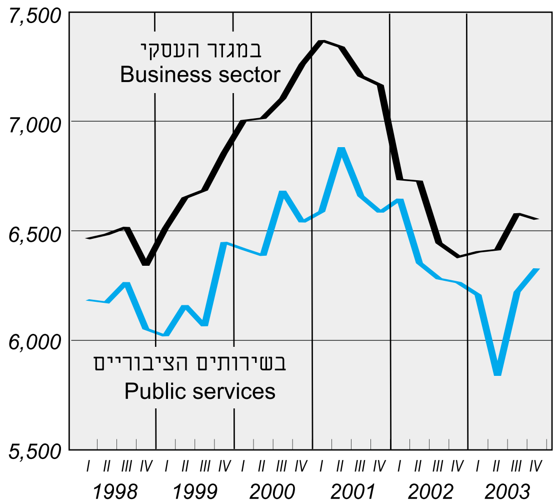
Figure 6 דיאגרמה

השכר הריאלי למשרת שכיר*, 1998 עד 2003

(ש"ח, במחירי 2001)

Real wage per employee post*, 1998-2003

(NIS, 2001 prices)



* Updated to December 2003. * מעודכן לדצמבר 2003.

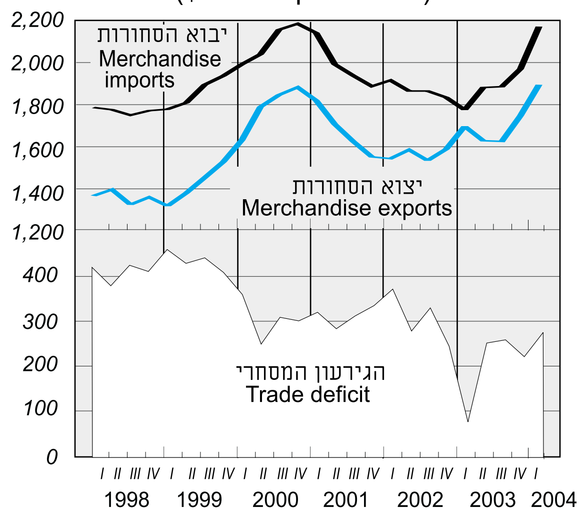
Figure 7 דיאגרמה

סחר החוץ[1], 1998 עד 2004*

(מיליוני דולרים לחודש)

Foreign trade[1], 1998-2004*

($ million per month)



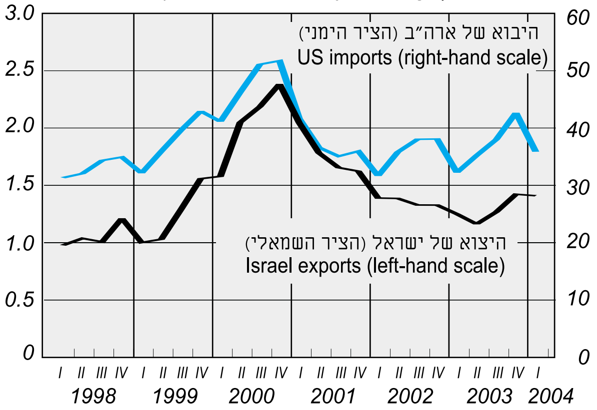
* Until March. * עד מארס.

1) Excluding ships, aircraft, diamonds, and fuel. Seasonally adjusted. 1) ללא אניות ומטוסים, יהלומים ודלק. נתונים מנוכי עונתיות.

Figure 8 דיאגרמה

היצוא של ישראל[1] והיבוא של ארה"ב[2] - רכיבים אלקטרוניים, ציוד תקשורת אלקטרוני, ציוד לבקרה ולפיקוח וציוד מדעי, 1998 עד 2004
(מיליארדי דולרים, ממוצע חודשי)

Israel's exports[1] and US imports[2]: electronic components, electronic communications equipment, and scientific and monitoring equipment, 1998-2004
($ billion, monthly average)



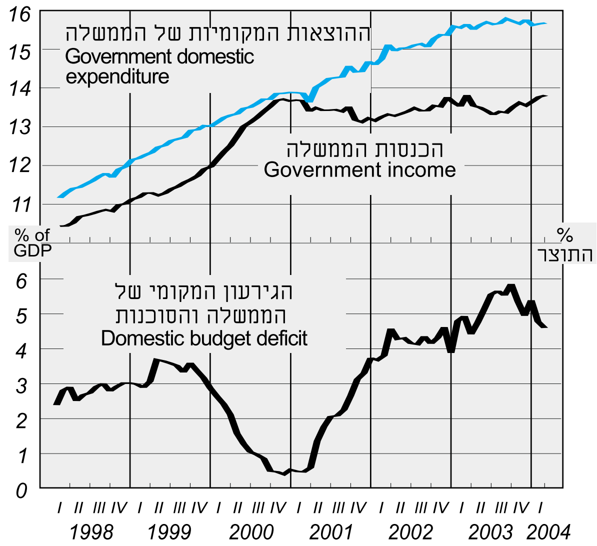
1) Until March.
2) Until February extrapolated until March.

1) עד מארס.
2) עד פברואר, מנופח עד מארס.

Figure 9 דיאגרמה

ההכנסות וההוצאות השוטפות של הממשלה, 1998 עד 2004*
(מיליוני ש"ח, ממוצע נע של 12 חודשים)

Government cash flows, 1998-2004*
(NIS million, 12-month moving average)



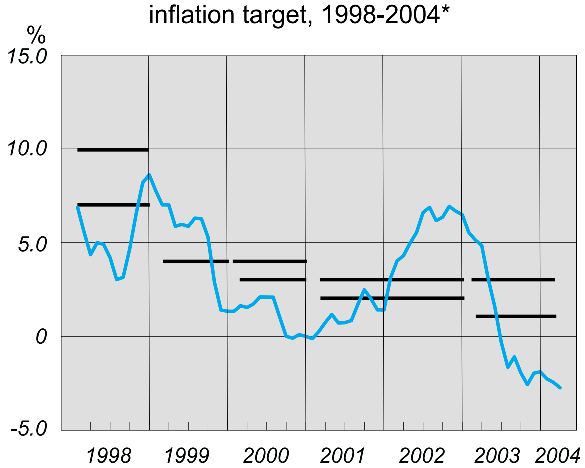
* Until March.

* עד מארס.

Figure 10 דיאגרמה

האינפלציה ב-12 החודשים האחרונים ויעד האינפלציה, 1998 עד 2004*

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



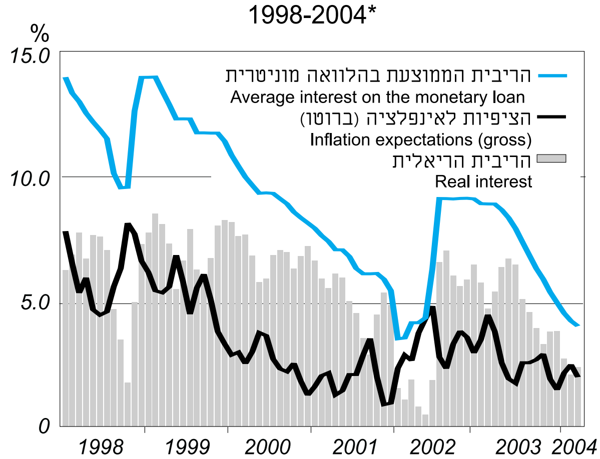
* Updated to March.

* מעודכן למארס.

Figure 11 דיאגרמה

הריבית והציפיות לאינפלציה, 1998 עד 2004*

Interest and inflation expectations, 1998-2004*



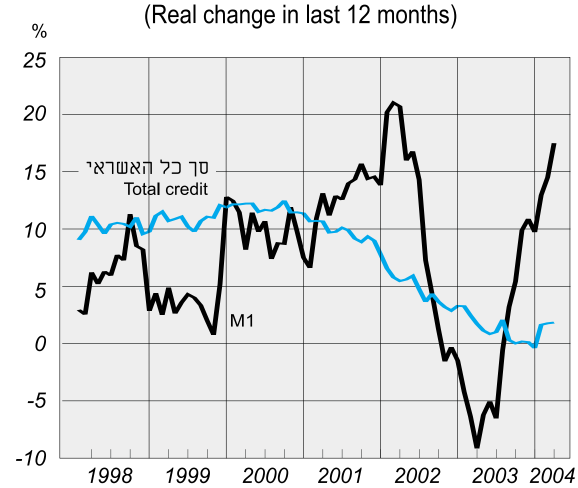
* Updated to March.

* מעודכן למארס.

Figure 12 דיאגרמה

המצרפים הכספיים והאשראי, 1998 עד 2004*
(השינוי הריאלי ב-12 החודשים האחרונים)

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



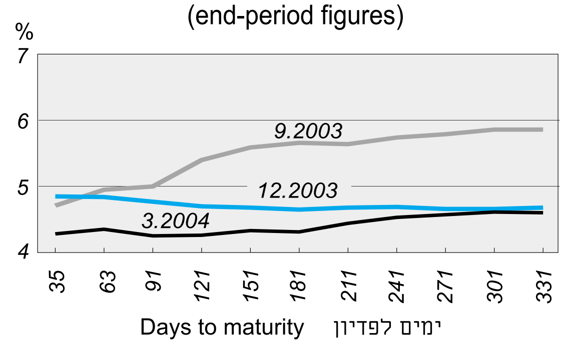
* Updated to March.

* מעודכן למארס.

Figure 13 דיאגרמה

עקום תשואות המק״מ, ספטמבר 2003 עד מארס 2004
(נתונים לסוף תקופה)

Yield on treasury bills,September 2003-March2004
(end-period figures)



עקום התשואות של איגרות החוב הצמודות למדד,
ספטמבר 2003 עד מארס 2004
(ברוטו, נתונים ממוצעים)

Yield on CPI-indexed treasury bonds,
September 2003-March 2004
(gross, average figures)

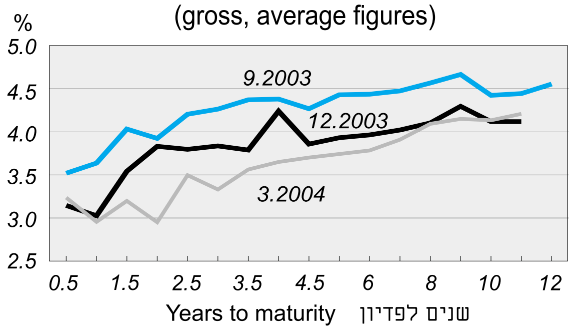
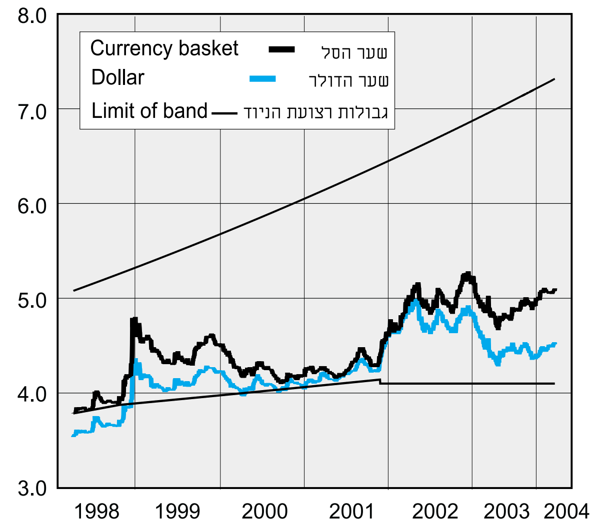


Figure 14 דיאגרמה

שער החליפין של השקל לעומת סל המטבעות והדולר (ש״ח),
1998 עד 2004*

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



* Updated to March.

* מעודכן למארס.