

Recent Economic Developments 123

September - December 2008

**Bank of Israel
Research
Department**

Jerusalem, January 2009

©

Bank of Israel

Passages may be cited provided source is specified

Catalogue # 3077509123/1

<http://www.bankisrael.gov.il>

Printed in Israel by Ayalon Press, Jerusalem

Part 1: Review of Recent Economic Developments, September to December 2008¹

Main Developments

In the period reviewed, September to December 2008, the slowdown in economic activity became more severe, following several years of rapid growth that resulted in the closure of the output gap and a full-employment environment. The slowdown greatly weakened inflationary pressures.

The global financial crisis deepened, and with it the slowdown in real economic activity that spread from the US to the other advanced economies and to the rest of the world. These developments also affected Israel's economy, and were reflected by a fall in the value of the public's assets, a drop in world demand and increased economic uncertainty.

The contraction of the world trade reduced Israel's goods exports for the first time in a long period. The adverse effect on the public's wealth, the greater insecurity regarding employment and the erosion of the real wage dented consumers' confidence and slowed the rise in private consumption overall, and in particular considerably reduced purchases of durables. The moderation in economic activity with the rise in the cost of finance and difficulties in obtaining nonbank credit are likely to result in investment plans being deferred.

GDP rose at an annual rate of 1.9 percent in the third quarter of 2008, in line with the rate of population growth, compared with 4.9 percent in the first half of the year. The composite state-of-the-economy index fell by 2.7 percent in the four months reviewed, after a long period of constant rises (Figure 1.1). The sharp decline in economic activity was evident in most of the major industries: manufacturing production contracted, trade and services revenue fell, and the standstill in the construction industry persisted. This was reflected by a drop in the import of production inputs and consumer goods in the period reviewed. In contrast, activity in the tourist industry continued to be buoyant.

Signs of the slowdown were evident in the labor market too, as the expansion of employment in the business sector came to a halt: the number of terminations of employment rose and the number of vacant positions filled declined, so that the balance of employment became negative for the first time since the end of 2003. These developments led

to a marked increase in work seekers, particularly among graduates, and in the number of claims for unemployment benefits. Employers' expectations with regard to a rise in their economic activity and number of workers are negative.

The moderation of economic activity was also reflected by tax revenues: the shortfall of tax revenues compared with the forecast widened during the year, and in particular at the end of the year. Direct tax revenues settled at a sixth lower in the last four months of 2008 than in the equivalent period in 2007; indirect tax revenues declined moderately, mainly due to a drop in import taxes, particularly on vehicles, and in December they slumped. Projecting forward, a large increase in the deficit is expected in 2009.

Towards the end of the period reviewed Operation Cast Lead was launched in the Gaza Strip. The operation lasted three weeks, during which Israel's southern area was under constant missile attack. The effect on overall economic activity, however, seems to have been limited, as that area accounts for a small share of Israel's total economic activity, and the fact that the impact on its daily routine and production was moderate. The direct cost of the operation and the damage it caused in Israel has not yet been determined.

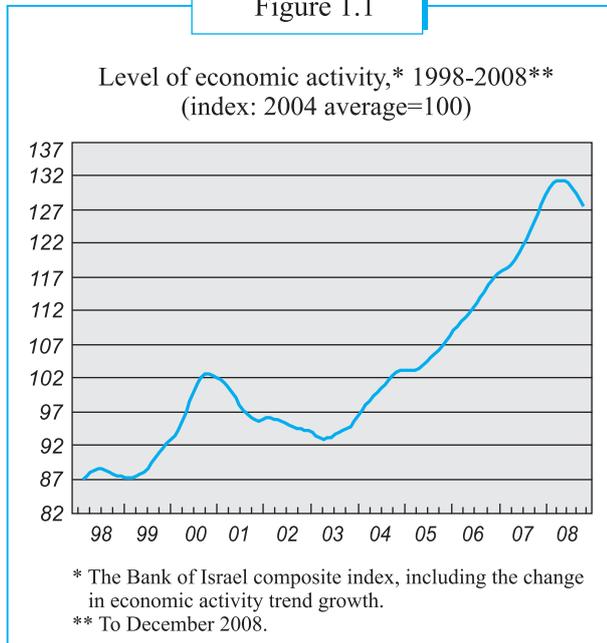
The major influence on the capital market in the period reviewed was the deterioration in the global financial crisis and its spread into Israel's economy. Its effect was evident in the drop in the value of financial assets, the increase in withdrawals from provident funds advanced study funds, a sharp decline in inflation and inflation expectations, and a reduction in the slope of the real yield curve. These developments led the Bank of Israel to reduce the interest rate from 4.25 percent in September to 2.5 percent in December, and to 1.75 percent and 1.0 percent in January and February, respectively (outside the period covered by this review).

In light of the deteriorating economic situation, the Knesset Finance Committee in mid-December approved a program to boost economic activity. It included multi-year infrastructure investment, increased professional retraining, and an increase in the budget of the Chief Scientist in the Ministry of Industry, Trade and Labor; reducing credit constraints by providing guarantees and loans to businesses and easing the schedule for payment of taxes and guarantees by suppliers to the government, and establishing investment funds to deal with nonbank credit. In addition, a safety net

¹ Since January 2008 Recent Economic Developments covers a four-month period. Until then it covered a quarterly period.

was spread for savers close to retirement age whose savings had been seriously affected by the steep drop in provident funds' yields.

Figure 1.1



Aggregate real activity

In the third quarter of 2008 the rate of economic growth slowed, as did domestic uses (Table 1.1). GDP rose at an annual rate of 1.9 percent (in line with the rate of population growth), and business-sector product rose at a rate of only 1.5 percent. Goods and services imports (excluding diamonds) rose moderately, resulting in a modest increase in the sources available to the economy.

Private consumption rose by only 1.8 percent in the third quarter. Current consumption increased at a rate of 3.9 percent, while consumption of durables fell. There are indications of a steep downward trend in consumer goods imports in the fourth quarter (in dollar terms). The slowdown in private consumption, particularly of durables, is consistent with the continued decline in the value of the public's asset portfolio and the impact on employment security resulting from concern over indications of rising unemployment, with the additional effect of the erosion of the real wage. Car purchases dropped heavily partially due to expectations that prices would fall at the beginning of 2009, with the continued implementation of the planned reduction in purchase tax on vehicles—expectations that were not realized, because of the depreciation of the shekel. Among other factors pointing to

the sluggishness of private consumption was the continued decline in the indices of consumer confidence (of Globes Research and Bank Hapoalim), the worsening assessment by participants in the surveys of the general economic situation and their personal situation six months ahead, and their reduced inclination to purchase durables in the near future.

Fixed investment dropped at a rate of 9.8 percent in the third quarter, after substantial increases in previous periods. Investment in the principal industries, and in particular in machinery and equipment, fell even more steeply, partly due to the increasing signs that the economic recession was becoming more severe—which is likely to result in investments being deferred—and the rise in financing costs and the shortage of credit. There was a standstill in vehicle imports, due in part to expectations of forthcoming price reductions, as mentioned above, and possibly due also to reduced payrolls in companies and reduced employment perks. Housing investment fell in the third quarter, both in residential construction, and even more so in nonresidential; this followed a similar trend in the previous quarter.

Public consumption rose at a rate of 3.7 percent in the third quarter. Civilian consumption went up by a modest 0.3 percent, whereas defense consumption, whose inter-quarter volatility is very high, surged.

Goods and services exports (excluding diamonds) grew at a rate of 13.2 percent in the third quarter. Foreign trade data, however, indicate a contraction later in the year, resulting from the global economic slowdown and the slowdown in world trade, the weakness of the shekel in the last quarter notwithstanding.

Manufacturing exports, in dollar terms, have been falling since the middle of 2008. This is very evident in medium-low-tech industries, in which there were sharp falls in world prices, and to a lesser extent in high-tech ones which was paralleled by slowdowns in high-tech industries in the US and Europe, Israel's main export customers. Activity in the diamond industry continued to decline in the third quarter of 2008, with a slump in the level of trade, but the overall effect on the economy is limited because of the low added value in the industry.

Services exports fell at a rate of 2.5 percent in the third quarter, the net result of conflicting trends: exports of tourist services continued to expand, while other exports, including business services, including start-ups, contracted.

Civilian goods and services imports (excluding ships, aircraft and diamonds) increased by 4.4 percent in the third quarter, its slowest rise for many years, despite reduced import prices relative to prices of domestic product. Goods

imports fell by 46 percent in the period reviewed (in dollar terms) compared with the previous period, in line with the weakening of the shekel, with a sharp drop in December—imports of current consumer goods rose moderately, imports of durables continued to decline, imports of investment goods did not change, and of production inputs (excluding diamonds and fuel) dropped steeply. These changes are consistent with a slowdown in economic activity, which impacts on consumption, investment, and production.

GDP prices rose by 3.2 percent (in quarterly terms) in the third quarter. The slowdown in economic activity was reflected in a moderate rise in prices of private consumption, in line with that of the CPI. The trend of real appreciation of the NIS, calculated by weighted purchasing power, halted mid-year, since when there has been real depreciation (Figure 1.16).

By-industry real activity

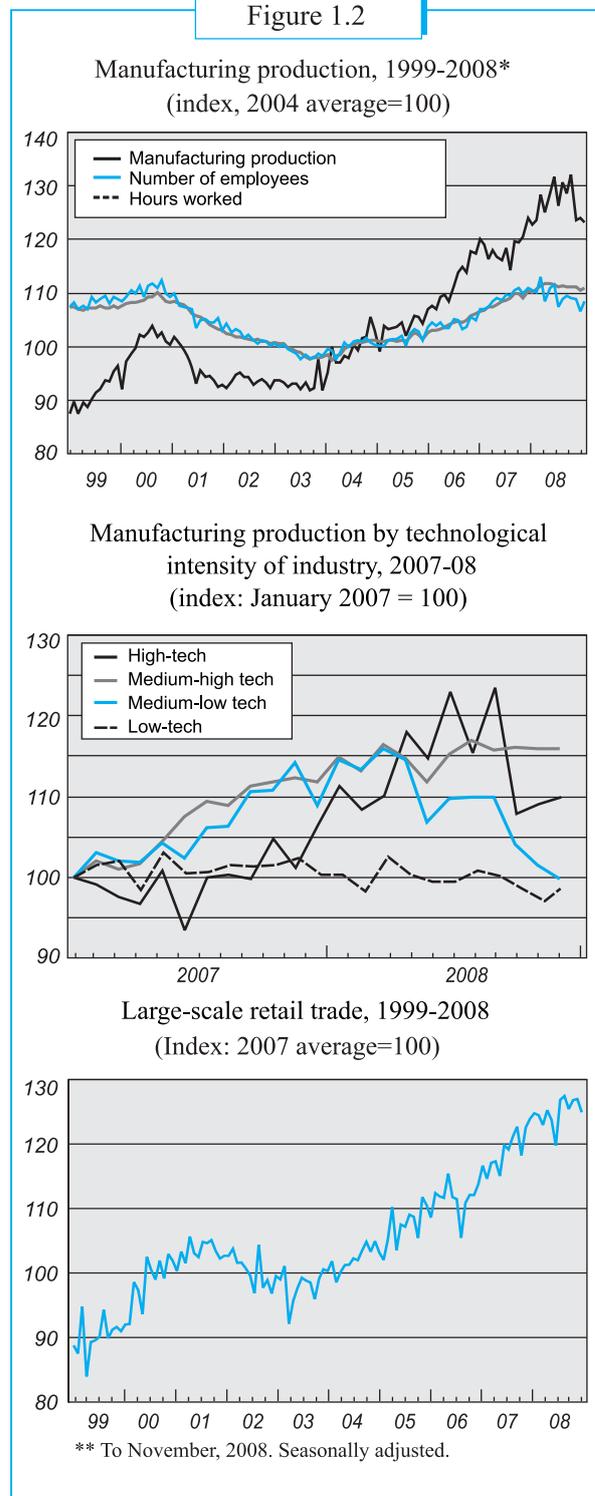
Manufacturing production dropped in the months September–November by 5.2 percent compared with the previous three months (seasonally adjusted), after a long upward trend (Figure 1.2). The number of employee posts and the number of hours worked remained unchanged, after rising in the previous period. The slowdown in manufacturing production was most noticeable in high-tech industries and medium-low-tech (mining and quarrying, rubber, plastic, etc.), which had been expanding rapidly.

The slowdown in manufacturing activity was reflected in other indices too. Manufacturing exports fell by 10 percent compared with the previous period, with a steep decline in December. Exports of the medium-low-tech industries contracted,¹ and only the low-tech industries maintained a steady level. The mirror image of this development was the fall in raw material imports for those affected industries. The Bank of Israel Companies Survey shows that utilization of machinery and equipment declined in the last quarter of 2008 and financing difficulties increased.

Manufacturers' expectations derived from the Manufacturers' Association survey of expectations for the last quarter of 2008 and, and expectation of manufacturing companies for the first quarter of 2009 shown in the Companies Survey do not paint an optimistic picture: domestic and export orders are expected to fall, the rate of employee dismissals is expected to rise, as are financing costs. The cost of the military operation in Gaza (Operation Cast Lead) which

started towards the end of the period reviewed, apparently had little effect on manufacturing production, as the southern part of the country (excluding the Dead Sea area) accounts for less than one sixth of total manufacturing production, and day-to-day activity was affected only slightly.

Figure 1.2

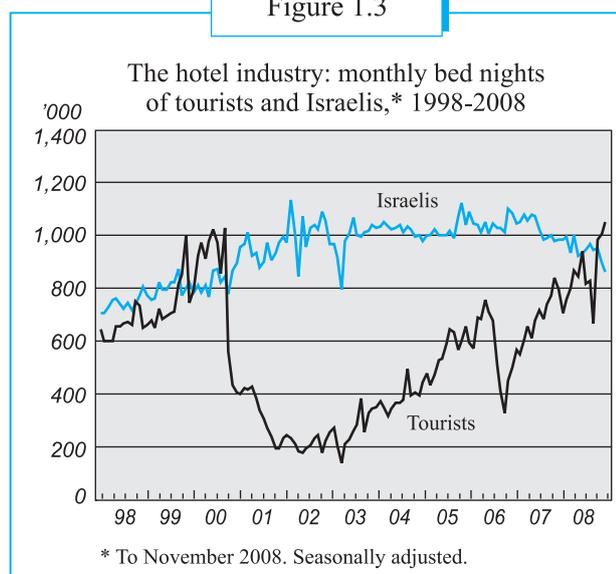


¹ The impact on the mining and quarrying industry was even more pronounced due to a significant decline in profitability due to a fall of about a third in export prices from the second quarter to the third.

The slowdown in **commerce** revenue became more severe in the last few months (Table 1.2 and Figure 1.2). This can be seen from the standstill in sales of chain stores in the months September–November and from the reduction in sales via credit cards. Employment in commerce declined by 1.4 percent in the third quarter of 2008 from its level in the second quarter. The Companies Survey shows that commerce companies expect sales and the number of permanent employees to fall in the first quarter of 2009, and financing difficulties to worsen.

Revenue of other service industries, for instance financial and business services, showed hardly any change, and revenue in computer services declined a little. The number of employee posts in those industries, however, continued to increase. Business service companies expect both activity and export orders to fall at the beginning of 2009. Operation Cast Lead had a very limited effect on trade and service revenue, as the southern part of the country (excluding Eilat) accounts for less than 5 percent of the total revenue.

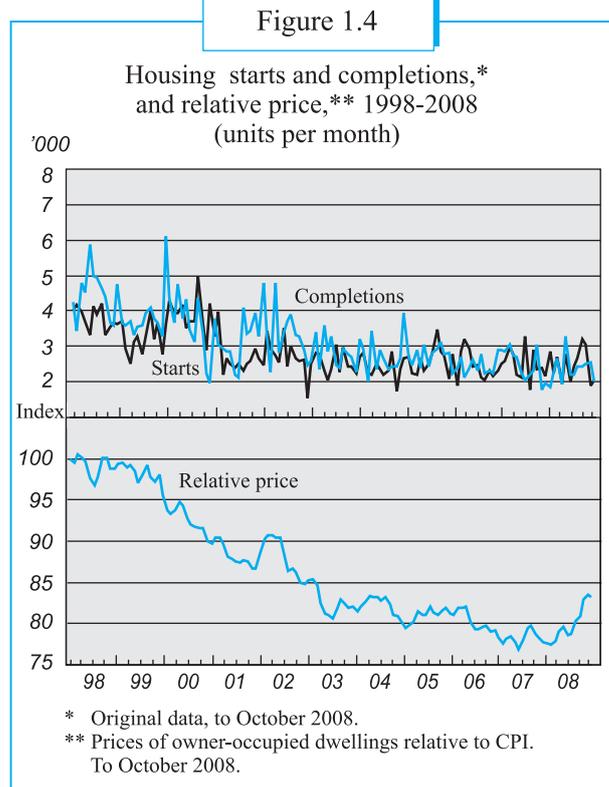
Figure 1.3



In the **tourist industry**, activity continued at a very buoyant level in the period reviewed, as reflected by the number of tourist arrivals and the number of bed nights in tourist hotels. Whereas bed nights of Israelis declined (as did their journeys abroad), reflecting the economic recession, tourist bed nights continued to rise (Figure 1.3). The outcome was that hotels' occupation rate rose and their revenue surged in the first three quarters of 2008, despite the appreciation of the shekel, and the number of employee posts increased, compared with the first three quarters of 2007. Hoteliers reports to the Companies Survey show a significant

reduction in the number of reservations for the first quarter of 2009, presumably reflecting the global slowdown. The military operation in Gaza is expected to have an adverse effect on activity in the industry in the short term, at least as far as foreign tourism is concerned. This effect is likely to be limited, however, as the conflict is confined to areas where there is little tourist activity in any case, and the military operation was a relatively short one.

Figure 1.4



The slump in the **construction** industry persists: in the third quarter of 2008 building starts and completions were low (Figure 1.4), and the number of new apartments under private construction continued to fall. (The stock of new apartments for sale also contracted.) The number of employee posts in construction dropped steadily from the beginning of the year. Nonetheless, prices of owner-occupied apartments (according to the Survey of Apartment Prices, which is not part of the CPI) rose in the course of 2008, and steadied towards the end of the year. A possible explanation for this development is the narrowing of the gap between the low supply of new apartments in an industry in recession and the demand deriving from natural population growth, and to some extent the rise in the number of apartments bought by nonresidents until recently.

The recession is likely to have an adverse effect on demand for housing, partly because of rising employment insecurity, the decrease in the public's wealth, the increase in the interest on mortgages in the period reviewed, and the decline in nonresidents' demand for apartments in Israel resulting from the global economic crisis. Acting in the opposite direction is the reduced attractiveness of investing in financial channels. Construction companies' responses to the Companies Survey indicate that on the supply side financing difficulties have increased, but on the other hand, prices of inputs have fallen, with the drop in world prices. The increased risk in the construction industry is evident from the significant widening of the yield gap between corporate bonds of construction companies and government bonds (Figure 1.14).

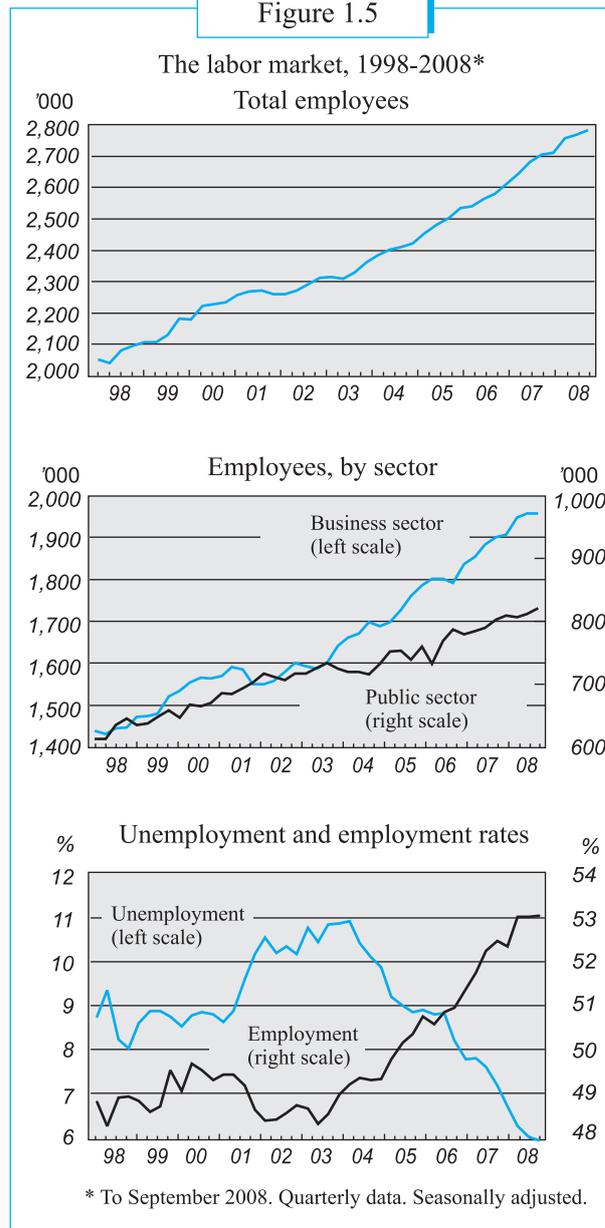
The labor market²

According to the CBS Labor Force Survey for 2008:Q3, the labor market was stable: the unemployment rate continued to decline moderately and reached 5.9 percent (seasonally adjusted), where it remained in October according to trend data—the lowest figure ever—and the participation rate remained unchanged at 56.4 percent (Table 1.3 and Figure 1.5). However, there are signs of a slowdown: business-sector employment stopped expanding and the number of hours worked per employee declined—a development which is characteristic of the start of an economic slowdown (as occurred, for example, after the eruption of the second Intifada), when employers reduce the number of hours worked and only at a later stage start to dismiss employees. Another indirect index of the weakness of the labor market may be found in the persistent fall in the number of employees temporarily absent from work.

The signs of a slowdown in the labor market are also evident in other indices relating to 2008:Q4: the number of employee posts in the business sector remained constant; the Ministry of Industry, Trade and Labor's employers' survey indicates that there was a significant fall in the number of vacant posts in the business sector, a rise in the number of employees laid off, and a decline in the number of posts filled, so that the employment balance was negative for the first time since 2003. These developments were evident in all the principal industries. According to the Manpower Israel employment agency, demand for employees plummeted, as reflected in want ads in the press. It is hardly surprising, therefore, that the number of work-seekers, especially among persons with academic qualifications, has risen steeply in recent months after declining continually previously. Applications

² An extensive review of labor market developments may be found in Part 2 of this survey.

Figure 1.5



for unemployment benefit have also risen. According to the survey of employers, their expectations regarding the labor force (and the expansion of their economic activity) were negative for the first time in four years.

The weakening of economic activity is also expressed in wages. The average nominal wage per employee post in the business sector (seasonally adjusted) has hardly changed in the last few months, but the real wage has been eroded with the rise in the CPI, so that in November 2008 it was 1.4 percent lower in real terms than in November 2007 (Figure 1.6). Unit labor cost in the business sector remained unchanged in 2008:Q3; this was the result of a similar rate of

increase in labor productivity—deriving from the expansion of output and the reduction in hours worked—and in unit labor costs (Figure 1.7).

Figure 1.6

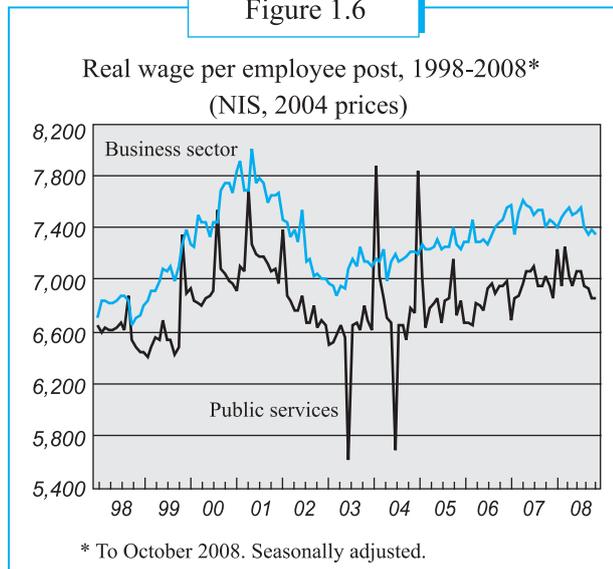
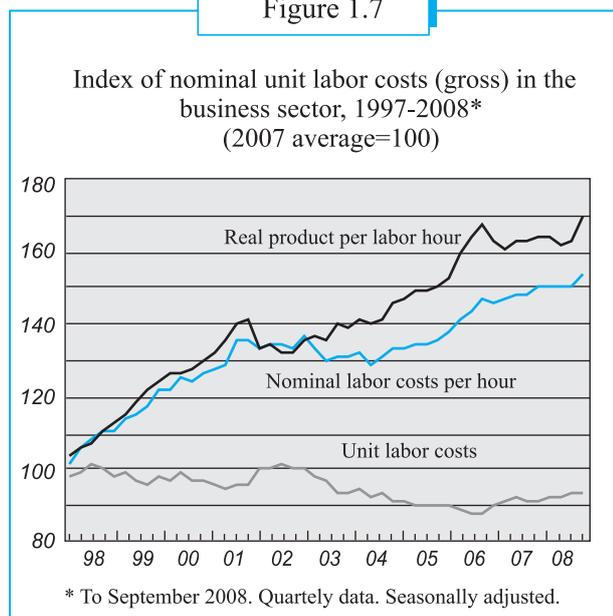


Figure 1.7

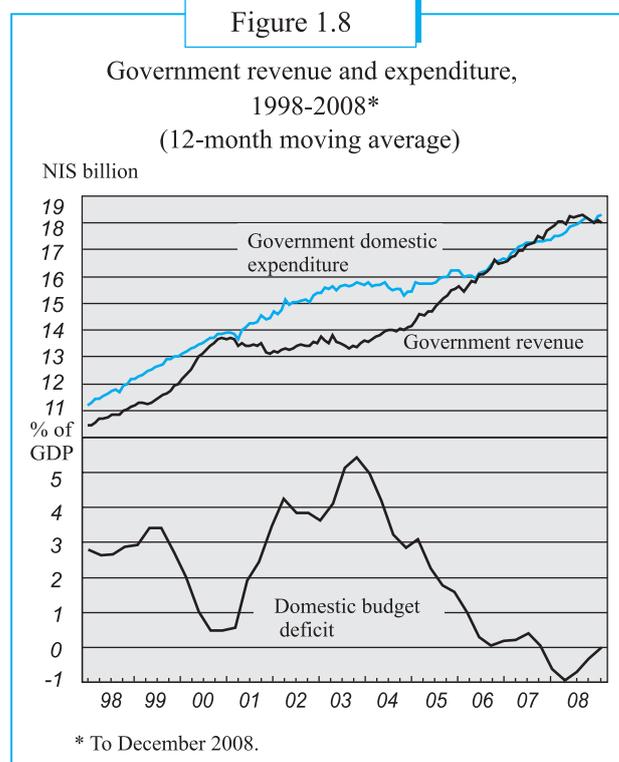


The government

The overall deficit excluding credit was NIS 15.2 billion in 2008, constituting 2.1 percent of GDP, NIS 3.8 billion above the limit set in the national budget. The deviation reflects revenues that were NIS 5 billion below the budget forecast,

and expenditure that was NIS 1.2 billion below the forecast. However, the deviation of the deficit from the forecasts stems primarily from the expenditure side: whereas in the period from July to November there was under-utilization of expenditure compared with the predicted seasonal path—just when the rise in domestic demand was moderating—at the end of December the government brought forward expenditure of NIS 4.4 billion from the 2009 budget, at the expense of the under-utilization of the 2008 budget, thereby creating an opening to continue activity in 2009 that had not yet been budgeted by the government (as the national budget had not yet been approved by the Knesset), without exceeding the limit on expenditure. The deficit also deviated from earlier estimates because of the exacerbation of the slowdown in tax receipts and recording adjustments (of interest income), which cut about NIS 1 billion from tax receipts. The foreign deficit in 2008 was in line with that set in the budget.

Figure 1.8



Tax revenues were NIS 6.5 billion below the budget forecast, and this gap grew during the year, particularly in December. Whereas at the beginning of the year tax revenues were consistent with the budget forecast, and even slightly above it, from the middle of the year there was a monthly shortfall of about NIS 1 billion, and in December this gap rose to NIS 2 billion. Direct tax receipts stabilized in the period reviewed at a level that was one-sixth down from the equivalent period

in 2007 (Table 1.4) as a result of the contraction of income from the capital market, the lower profitability of firms, the decline in the nominal wage, and the cessation of the expansion of employment, also expressed in the reduction of health tax receipts which are based on wage payments. Revenues from indirect taxes dipped slightly in the period reviewed—largely because of the decline in tax receipts from imports, especially from the reduction of imports of consumer durables and of automobiles in particular—and revenues plummeted in December. Receipts from land taxes also declined.

In response to the deteriorating economical situation, in December 2008 the Knesset Finance Committee approved an economic stimulus package. This included the following measures, inter alia, (the figures in parentheses denote the amounts allocated in billions of NIS): multi-year expansion of infrastructure investment (10), augmentation of vocational training (0.4), increase in the budget of the Government Scientist in the Ministry of Industry, Trade, and Labor (0.25); in addition, in order to ease the credit constraints of businesses, it was decided to make loans available to small and medium-sized firms, permit them to pay their taxes in installments, and relax the guarantees required from government suppliers (0.8), investment funds were established to deal with nonbanking credit (5), and state guarantees were made available to the banks for financing purposes (6); finally, tax concessions were extended to foreign investors.

In order to allay the impact of the sharp fall in the yields of provident funds on older savers who were nearing retirement age, it was decided to provide them with a 'safety net.' According to the terms of the plan, which was approved by the Knesset Finance Committee in January 2009, the real value of savings at the end of November 2008 was guaranteed for persons aged 57 or more, up to a limit of NIS 1.5 million of savings and subject to additional conditions.

The balance of payments

In 2008:Q3 there was a surplus of \$0.5 billion (seasonally adjusted) on the current account, similar to the surplus in 2008:Q2 but far below that in previous periods (Table 1.5). On the goods and services account the deficit was \$1 billion, similar to that in Q2, and the level of imports and exports remained unchanged. The slight increase in goods exports was offset by an equivalent rise in services imports.

The deficit on the goods account amounted to \$1.6 billion in Q3 (Figure 1.9), after a deficit of \$2.0 billion in Q2. The reduction was the result, inter alia, of the crisis in the diamond industry, which caused diamond imports to plummet and

Figure 1.9

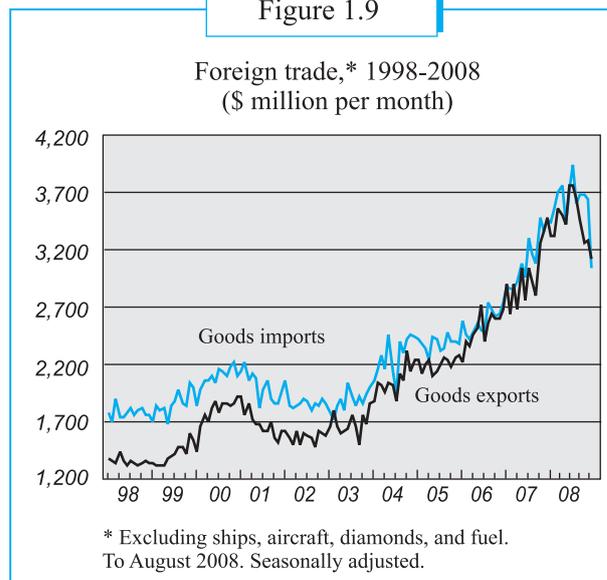
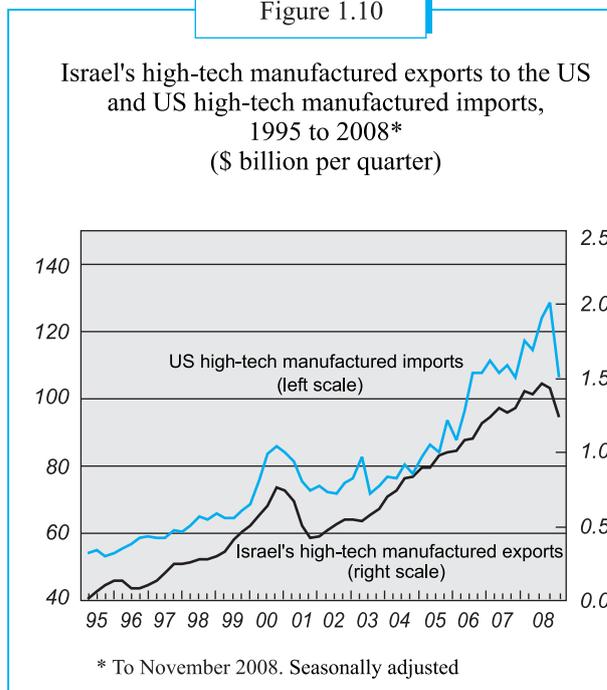


Figure 1.10



their export to decline. Foreign trade data for recent months indicate that goods exports, particularly those of the mixed-traditional and high-tech industries, have contracted along with the global economic slowdown, and also that goods imports have fallen, especially those of intermediates and consumer goods, and this trend was accentuated in December. The surplus on the services account fell to \$0.6 billion in 2008:Q3 from \$0.9 billion in 2008:Q2, mainly because of the rise in services imports. Data from the banking system

indicate that in October–November exports and imports of services (excluding tourism) contracted by 5 percent.

In view of the global financial crisis, the steep fall in foreign investment by residents is notable—especially that of the banking system, which drew down its deposits in banks abroad because of fears regarding their stability. At the same time, there were net sales of commercial paper in Israel by nonresidents. However, direct investment in Israel by nonresidents rose from \$2.5 billion to \$3.1 billion in 2008: Q3, alongside the expansion of direct investment abroad by residents.

In 2008:Q3 the terms of trade deteriorated by 3.2 percent, as export prices fell by 2.6 percent and import prices rose by 0.6 percent. During the course of the year import prices appear to have moderated considerably, concurrent with the sharp drop in global energy and food prices.

Global developments

The economies of the developed countries appear to be rapidly entering a deep recession and are currently experiencing the gravest financial crisis since the 1930s. The financial crisis, which erupted in the US with the collapse of the sub-prime mortgage market in 2007, worsened in September 2008, with the marked deterioration of the stability of the banking system and the investment houses. This was expressed in liquidity difficulties, repayment capacity problems, fears of a run on the banks and, of course, plummeting prices of financial assets, which also affected pension funds. All these developments obliged the US government and its central bank, as well as the central banks and governments of other countries, to introduce emergency measures. These included, inter alia, aid for financial institutions in order to alleviate the credit crunch and increase liquidity—providing loans on easy terms and guarantees for their commitments, and even injecting capital and/or buying up parts of these institutions (e.g., ‘bad’ mortgage-backed assets) or in some cases nationalizing them. The central banks of developed countries slashed their interest rates. Recently, developed countries have also introduced counter-cyclical government programs (primarily the reduction of taxes and expansion of investment) and extended direct aid to sectors which have suffered most as a result of the crisis.³

The global crisis in the financial markets—which has been accompanied by a steep drop in securities prices, severe financing difficulties, and wider interest-rate

differentials—soon spread to real economic activity. In the second half of 2008 global economic growth slowed markedly: the GDP of the OECD countries was down by 0.14 percent in Q3 from Q2 (by 0.12 percent in the US and by 0.20 percent in the Eurozone). The slowdown was all-encompassing: manufacturing output, including that of the high-tech industries, fell; private consumption, particularly of consumer durables, contracted; investment declined, the crisis in the housing market worsened, and unemployment rates soared. GDP growth forecasts for 2009 have been revised downwards once again, and now stand at –0.3 percent in the developed countries (Table 1.6). Emergence from the recession will be gradual, and will not begin before late 2009.

The growth rate of world trade slowed markedly, and this trend is expected to persist in 2009, too, so that global demand for Israel’s products will apparently continue to contract.⁴ Imports by the US and the Eurozone, especially of manufacturing imports and capital goods, have fallen, and this mix impacts to an even greater extent on Israel’s exports.

Finally, the grave slowdown in economic activity—which has recently been accompanied by the moderation of prices of energy and primary goods—has led to a steep drop in the rate of increase of consumer price indices in western countries.

Prices, monetary policy, and the money and capital markets

From September to December 2008 the *CPI* fell by 0.6 percent, and during 2008 as a whole it rose by 3.8 percent—exceeding the upper limit of the inflation target. The development of the *CPI* in the period reviewed expresses the sharp moderation of the inflation rate, over and above seasonal factors. Seasonally adjusted, as measured by the Research Division, the *CPI* rose by only 0.25 percent in the period reviewed.

The development of the *CPI* was affected primarily by the decline in global energy prices, though this was partly offset by the rise in housing prices. Excluding energy prices, the *CPI* rose by 0.8 percent during the period reviewed, while excluding housing prices it fell by 2.4 percent. After a significant and protracted increase in global energy prices, the trend reversed, and as of July they began to plunge; thus, for example, the price of Brent oil fell from a peak of almost \$150 a barrel in July 2008 to about \$40 in December—the

³ Some of the developments mentioned in this section appear in the Inflation Report for 2008:IV, as well as in the Diary of Events at the end of this survey.

⁴ The elasticity of Israel’s exports vis-à-vis world trade is 1.4 (see Box 7.1 in the Bank of Israel’s Annual Report for 2007).

same level as in December 2004. Against the backdrop of these developments, the items of the CPI which are affected directly by energy prices fell by 15.4 percent in the period reviewed.^{5,6} Note that while the sharp drop in world food prices has not yet been translated into a significant decline in domestic food prices, their rate of increase moderated significantly in the period reviewed, and was even negative in the second half. In contrast, the housing item rose by 7 percent, and because of its considerable weight in the CPI its contribution to inflation amounted to 1.8 percent in the period reviewed.

Inflation expectations for the 12 months ahead fell to a negative level during the period reviewed: in September they stood at 2.1 percent, at the mid-point of the inflation target, but with the exacerbation of the global economic crisis and its effect on domestic financial markets expectations fell to -0.7 percent in December. At the same time, domestic forecasters' assessments of expected inflation also declined. In September the average of the forecasts for the next 12 months was 2.7 percent, while in December it was only 0.4 percent, significantly below the lower limit of the inflation target.

In view of the aggravation of the crisis in the financial markets and the decline in inflation expectations, the entire real yield curve shifted upwards and its slope moderated. This development reflects a rise in the market's assessments of risk in general, and short-term risk in particular. Throughout the period reviewed the nominal yield curve for the short term declined in accordance with the downward path of the Bank of Israel's key interest rate. The moderate slope of the curve for December for terms of between two and twelve months embodies expectations that the interest rate will remain stable in the next few months.

The value of *the public's asset portfolio*⁷ fell by 10 percent in the period reviewed, and by 11.8 percent in 2008 as a whole.⁸ Most of the decline occurred in September and October, upon the announcement of the bankruptcy of the Lehman Brothers investment bank on September 15 and the consequent worsening of the global financial crisis. In

⁵ Electricity for private consumption, gas, oil for household use, diesel and heating oil, and fuel for automobiles (gasoline and diesel).

⁶ Domestic energy prices responded only partially to global prices for several reasons, including: the local-currency depreciation vis-à-vis the dollar, which moderated the decline in local-currency prices vis-à-vis global prices; government control of some energy prices, as well as the fixed excise tax on gasoline (NIS 2.4 per liter) and diesel (NIS 2.1 per liter), as a result of which the rate of change of their domestic price was lower than that of the global price.

⁷ The data in this section relate to the period up to November.

⁸ Excluding government aid to the established pension funds.

Figure 1.11

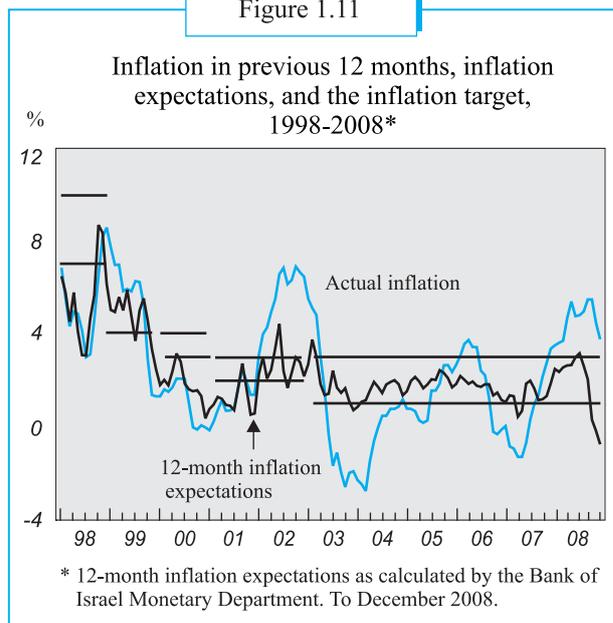
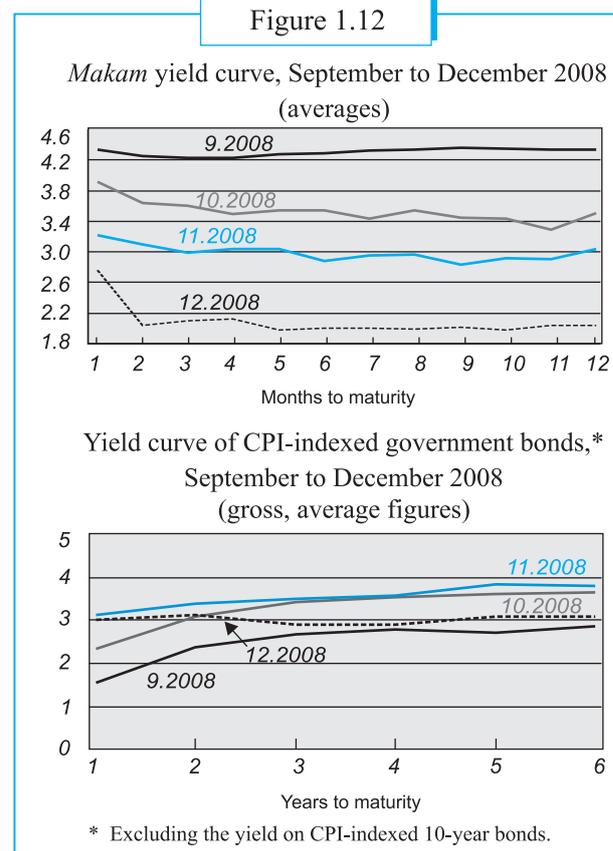


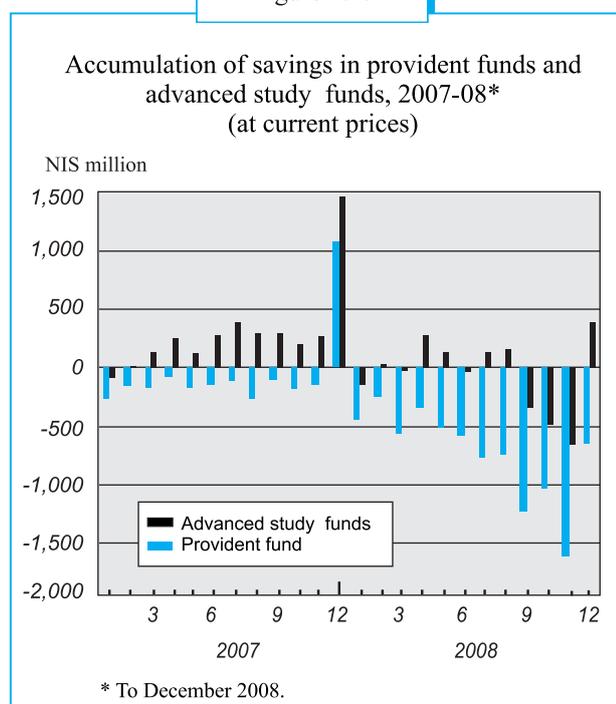
Figure 1.12



September the value of the asset portfolio dipped by 5.1 percent, and in October by another 4.5 percent. As a result of the growing crisis the proportion of shares in the portfolio

contracted from 23.3 percent in August to 16.3 percent in November; concurrently, the share of cash and deposits rose in these months from 31 percent to 35.4 percent, and that of government bonds rose from 17.9 to 20.3 percent. These changes resulted from the decline in the value of shares in the stock market as well as from the switch to safer assets. The change in the composition of the asset portfolio was reflected, inter alia, in the surge of redemptions in provident and advanced study funds (Figure 1.13). From September to November the rate of negative accrual in the provident funds accelerated: this was 150 percent higher in these months than in the period from January to August.⁹ The advanced study funds shifted from positive accrual until August to negative accrual amounting to 1.7 percent of their value in the period from September to November.

Figure 1.13

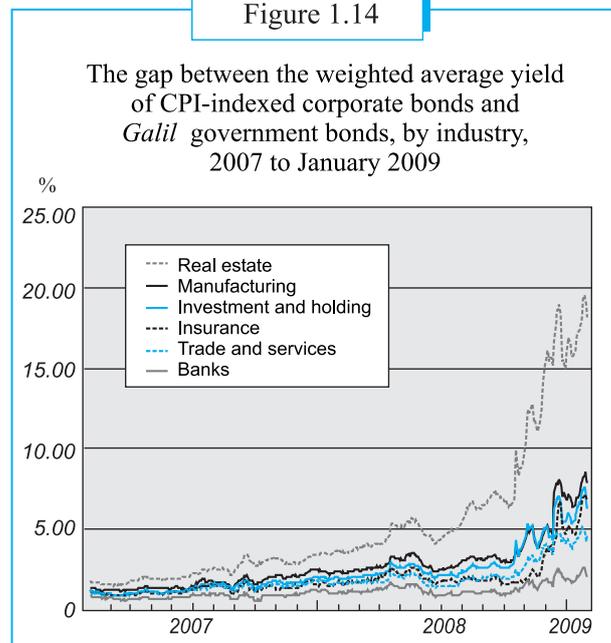


The general share-price index on the Tel Aviv Stock Exchange (TASE) fell consistently in the period reviewed. On average it was 27.1 percent lower than in the preceding quarter, declining by 45 percent from the beginning of the year. In October alone the general share-price index was down on average by 17.5 percent from September because

⁹ The data do not include December because the accrual in that month is affected by tax considerations. In December there was a net decrease of NIS 657 million in deposits in the provident funds, compared with a net increase of NIS 1.1 billion in December 2007; although there was a net increase in advanced study funds, this was 73 percent lower than the increase in December 2007.

of the exacerbation of the global financial crisis and the resulting surge of redemptions. The steep fall in share prices encompassed all the principal industries, real-estate firms and bank shares being most prominent among them as these industries are more exposed than others to the credit crisis—real estate on the demand side and banks on the supply side.

Figure 1.14

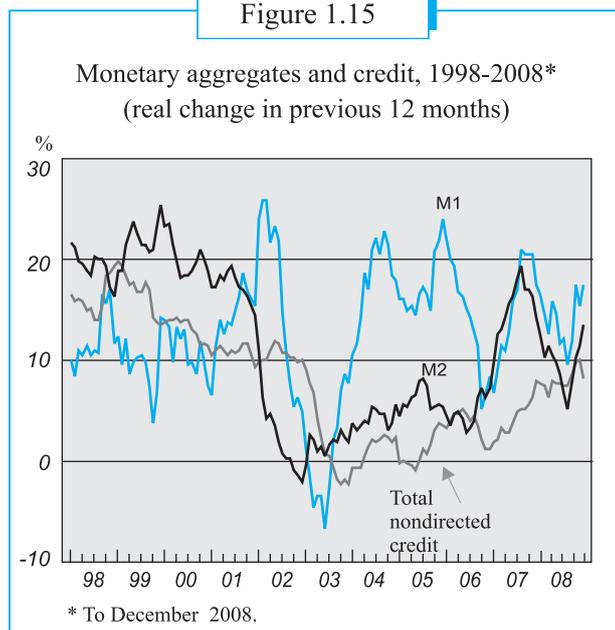


The repercussions of the crisis are clearly evident in nonbank financing. Because of the increase in risk, corporate bond issues ceased almost completely, after having constituted the principal source of credit in 2006 and 2007. The increase in risk was also reflected in the marked rise in the yield spread between corporate and government bonds, especially in real-estate and manufacturing (Figure 1.14). *Nondirected bank credit*, on the other hand, continued to expand, and constituted an alternative source of finance to bonds. Alongside the rise in bank credit its cost increased: real interest on new CPI-indexed credit grew from 3.5 percent in August to 4.7 percent in December—expressing both the increase in risk and the banks' monopoly power.

The *monetary aggregates* continued to rise at a relatively rapid rate. Both the monetary base and the narrow money supply were up by 7.5 percent on average over the preceding period, and by 15 percent over the equivalent period in 2007, while M2 grew by 5.6 and 10.8 percent respectively in these periods. It is difficult to discern indications of the crisis in these aggregates, at least to date.

The NIS depreciated against the dollar by 8.7 percent during the period reviewed, from an average of NIS 3.56 to the dollar in August to NIS 3.87 in December. The NIS appreciated against the euro by 2.3 percent in this period, and the NIS remained stable against the trade-weighted currency basket. The depreciation of the NIS against the dollar was bolstered by the Bank of Israel's foreign-currency purchases as well as by the strengthening of the dollar world wide against most of the principal currencies in the period reviewed. During this period the Bank of Israel bought \$6.85 billion, so that at the end of it the foreign-currency reserves stood at \$42.3 billion.

Figure 1.15



During the period reviewed the Bank of Israel reduced the *interest rate* steeply and frequently, in line with the policy adopted by other central banks. At the beginning of the period the key interest rate stood at 4.25 percent, but as a result of the deterioration in the global financial situation, apprehensions of its rapid spread to real economic activity, and the sharp drop in the inflation environment, the Bank of Israel reduced the interest rate to 2.5 percent for December. These reductions were implemented in five stages, two of which were not made on the usual interest-rate decision dates. The rate for January, which is after the period reviewed, was reduced to 1.75 percent, followed by a further cut, to 1 percent, for February. The frequent and steep interest-rate cuts were intended to ease the credit crunch by reducing the cost of credit, thereby boosting real economic activity and inflation. Note that to date the cuts in the Bank of Israel's key interest rate have not been translated into the reduction of the expected real interest rate because of the sharp fall

in inflation expectations, although in December there were initial indications that this was beginning to occur.

Figure 1.16

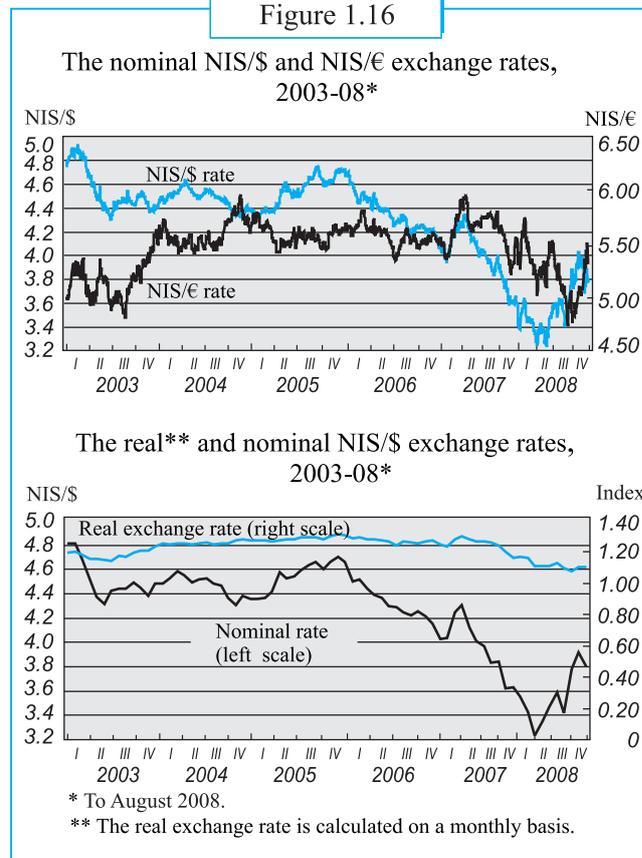
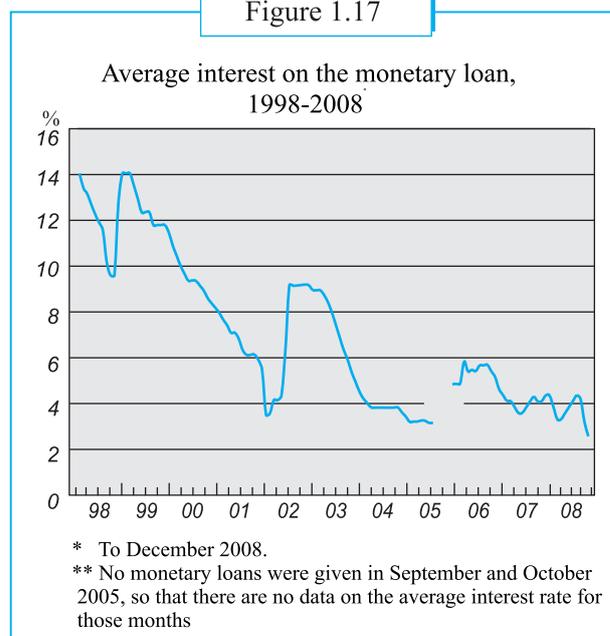


Figure 1.17



BANK OF ISRAEL RESEARCH DEPARTMENT

In addition to its active interest-rate policy, at the end of December the Bank of Israel issued a program intended to increase liquidity in the economy. Within this framework it sought to reduce the absorption of excess liquidity by means of *makam* (short-term Bank of Israel bills), issuing

additional discount-window loans, and publishing repo tenders for terms of more than a day or a week, as has been the case till now, as well as by reducing the 'corridor' around its key interest rate.

Table 1.1 National Accounts,^a 2007-08

	Change from previous quarter						
	2007		2008			2008/III	
	2007 ^b	III	IV	I	II	Change from previous quarter	Year on year change ^b
GDP	5.4	6.2	5.7	5.1	3.6	1.9	4.1
Business-sector product	6.2	7.6	6.9	5.8	4.2	1.5	4.6
Private consumption	6.7	8.7	3.0	10.1	-2.6	1.8	3.0
Gross domestic investment	12.0	4.3	11.7	-23.1	27.3	-8.2	0.1
Fixed investment	15.5	50.7	-11.8	8.8	1.6	-9.8	-3.2
Goods and services exports ^c	9.0	10.8	21.9	-0.2	-0.3	13.9	8.4
Goods exports	7.5	8.3	-3.0	61.3	-18.8	-2.5	5.5
Services exports	9.5	11.5	13.7	26.8	-3.3	13.2	12.1
Goods and services imports ^c	11.1	27.6	-2.8	3.3	-3.8	5.0	0.4
Goods imports	16.4	-5.5	14.8	15.0	-4.6	7.5	7.9
Services imports	13.5	10.7	16.3	10.4	-7.7	4.4	5.5
Public sector consumption	2.9	-0.6	-2.9	9.0	-4.7	3.7	1.1
Public sector consumption ^d	3.5	0.8	3.3	1.9	-1.5	7.9	2.9
Domestic use of resources	6.5	4.1	7.6	0.2	3.5	1.2	3.1

^a Percentage change in annual terms, at constant prices, seasonally adjusted.

^b Unadjusted data.

^c Excl. diamonds.

^d Excl. defense imports.

SOURCE: Central Bureau of Statistics.

Table 1.2. Indicators of Business Activity,^a 2007-08

	Change from previous quarter					September - December 08			
	2007 ^b	2007		2008			Change from previous period	Year on year change ^b	Last month for which data available ^c
		IV	I	II	III				
Composite state-of-the-economy index	0.0	12.4	13.3	7.0	-1.4	-5.2	3.6	Nov	
Manufacturing production ^d	4.9	12.3	13.3	6.9	-4.3	-19.2	1.0	Oct	
Index of trade and services revenue	9.0	5.2	0.7	-4.7	-3.4	-10.4	-3.2	Oct	
Index of trade revenue	7.6	3.9	4.6	-3.8	-6.0	-12.7	-3.2	Oct	
Large-scale retail trade	6.7	10.6	1.5	-2.5	10.5	-1.1	3.8	Nov	
Index of export - services	10.1	56.5	73.7	-44.3	16.4	11.5	5.4	Nov	
Tourist arrivals	24.3	69.9	30.3	25.5	2.5	24.3	22.1	Nov	
Residential construction ^b									
Starts	0.2	-2.1	-6.2	-1.7	5.6		-13.9	Oct	
Completions	-7.0	-29.4	-6.7	5.1	4.9		21.6	Oct	
Nonresidential construction ^b									
Area of starts		0.0	17.6	33.2	12.6			Sep	
Survey of companies (net balance, percent) ^e									
Weighted balance of the business sector	33	37	17	13 ^f	3 ^f	-32		Dec	
Output of manufacturing firms	27	24	10	4 ^f	4 ^f	-34		Dec	
Sales by trading firms	37	38	31	-5 ^f	-5 ^f	-59		Dec	

^a Percentage change in annual reports, at constant prices, seasonally adjusted.

^b Unadjusted data.

^c When the last month is December, the comparisons are September-December versus May-August ; when the last month is November, the comparisons are September-November versus June-August; when the last month is October the comparisons are September-October versus July-August; and when the last month is September, the comparisons are July-September versus April-June;

^d Excl. diamonds.

^e 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.

^f Not significant at 5% level.

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

Table 1.3. Indicators of Labor Market Developments, ^a 2007-08

	2008	2007	2008			September - December 08			
	III	IV	I	II	III	Change from previous period	Year on year change ^b	Last month for which data available ^c	
	('000s)	percent change from previous quarter							
Civilian labor force	2,957.9	-0.3	1.2	0.2	0.4	0.4	1.5	Sep	
Israeli employees	2,782.5	0.2	1.7	0.4	0.5	0.5	2.8	Sep	
<i>of which:</i> in general government	820.6	0.8	-0.3	0.7	1.1	1.1	2.5	Sep	
in business sector	1,957.2	0.3	2.2	0.4	0.0	0.0	2.9	Sep	
Foreign workers and Palestinians ^b	392.5	4.4	2.5	-2.2	1.1	1.1	5.8	Sep	
Average hours worked weekly per employee	36.9	0.0	0.0	1.4	-0.8	-0.8	3.7	Sep	
Labor input in business sector ^d	96,460	1.1	2.2	1.0	-0.3	-0.3	6.0	Sep	
<i>of which:</i> Israelis	84,486	0.8	1.9	1.3	-0.6	-0.6	5.7	Sep	
Labor input in general government (Israelis)	18,095	-0.2	2.8	1.4	2.0	2.0	10.6	Sep	
Unemployed	175.4	-6.9	-5.6	-4.0	-0.6	-0.6	-13.8	Sep	
Work seekers	192.4	-3.4	-2.1	-2.1	5.6	5.4	0.9	Nov	
Claims for unemployment benefit	60.6	-8.7	-3.4	3.8	4.8	19.8	8.3	Nov	
	(NIS, unadjusted)								
Real wage per employee post ^d	7,219	0.5	1.3	-1.0	-1.5	-0.9	-1.1	Oct	
In general government	7,085	0.6	0.8	-0.7	-1.6	-7.0	-1.8	Oct	
In business sector	7,278	-0.7	1.1	0.1	-2.0	-0.3	-0.8	Oct	
Nominal wage per employee post ^d	7,971	1.7	2.5	0.4	-0.3	3.6	4.3	Oct	
In general government	7,823	1.7	2.1	0.7	-0.4	-2.1	3.6	Oct	
In business sector	8,036	0.5	2.3	1.4	-0.7	5.1	4.6	Oct	
	percent, seasonally adjusted								
Participation rate	56.4	56.5	56.6	56.4	56.4			Sep	
Employment rate	53.1	52.5	53.0	53.0	53.1			Sep	
Unemployment rate	5.9	7.2	6.2	6.0	5.9			Sep	
Depth of unemployment ^e	32.1	30.4	34.0	36.2	32.1			Sep	

^a Percentage change, seasonally adjusted.

^b Unadjusted data.

^c When the last month is December, the comparisons are September-December versus May-August ; when the last month is November, the comparisons are September-November versus June-August; when the last month is October the comparisons are September-October versus July-August; and when the last month is September, the comparisons are July-September versus April-June;

^d Including foreign workers and Palestinians.

^e Percent of unemployed seeking work for more than six months (unadjusted).

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.

Table 1.4. Government Budget Performance, 2007-08

	2007	2008			September - December 08			
		IV	I	II	III	Change from previous period	Year on year change	Last month for which data available ^a
Domestic deficit as percent of GDP	1.4	-2.6	4.6	0.1	0.7	0.7 ^b	2.1 ^c	Sep
Deviation from domestic budget path, excl. credit extended ^d	NIS billion, ^e nominal prices							
Revenue	15.0	3.2	2.1	0.2	-3.4	-3.0	-9.2	Dec
Expenditure	-5.6	-0.6	-0.4	-0.8	-3.4	3.7	4.9	Dec
Deficit	20.6	-3.8	2.5	1.0	0.0	-6.7	-12.3	Dec
Total deficit (excluding credit)	-0.1	-7.9	5.2	-3.1	-0.9	-12.9	-9.0	Dec
	Real percentage change, year on year							
Government tax revenue	6.2	3.6	-1.9	-2.8	-9.2	-6.8	-9.3	Nov
<i>of which:</i> income tax, net	3.4	-0.5	-11.6	-7.5	-15.7	-4.7	-15.2	Nov
VAT, gross	6.2	10.5	9.5	3.4	-1.3	-7.8	-5.5	Dec
Government expenditure	3.4	1.0	4.1	1.2	-7.6	12.1	1.4	Dec
National insurance allowances	2.8	0.4	2.9	1.7	0.9	-2.6	-0.7	Nov
<i>of which:</i> Unemployment benefit	-10.6	-18.9	-12.1	-3.0	0.7	3.0	9.1	Nov
Income support ^f	-8.0	-10.6	-6.5	-6.6	-4.7	-3.6	-4.4	Nov
National insurance contributions received from the public	4.7	2.1	5.9	3.2	-1.5	-6.0	-0.3	Nov

^a When the last month is December, the comparisons are September-December versus May-August ; when the last month is November, the comparisons are September-November versus June-August; when the last month is October the comparisons are September-October versus July-August; and when the last month is September, the comparisons are July-September versus April-June;

^b The deficit in 2008:III compared with that in 2008:II.

^c 2008:III compared with that in 2007:III.

^d The path was determined on the basis of a deficit of 3.0 percent of GDP.

^e Year on year change. Does not refer to the seasonal path.

^f Income support is not included in old-age and survivors' pension

SOURCE: Based on Ministry of Finance and National Insurance Institute data.

Table 1.5. Foreign Trade, Balance of Payments, and the Reserves, ^a 2007-08

	2007		2008			September - December 08		
	2007 ^b	IV	I	II	III	Change from previous period	Year on year change ^b	Last month for which data available ^d
	percent change from previous period ^c							
Trade in goods^e								
Goods imports	21.0	7.9	3.7	2.2	2.8	-4.6	4.9	Nov
<i>of which:</i> Consumer goods	29.2	7.9	-5.5	-5.5	3.6	-2.1	7.4	Nov
Capital goods	24.2	7.5	1.2	1.2	-1.4	0.2	7.5	Nov
Intermediates	17.3	8.1	5.6	5.6	4.3	-7.3	2.9	Nov
Goods exports	18.6	15.4	4.8	4.8	1.9	-10.0	1.8	Nov
<i>of which:</i> Manufacturing	18.3	15.3	5.4	5.4	1.8	-10.3	2.3	Nov
<i>of which:</i> High-tech	13.0	12.2	7.9	7.9	-1.6	-8.8	0.2	Nov
Balance of payments								
	\$ million							
Goods and services exports	70,904	19,209	20,870	20,784	20,949			Sep
Goods and services imports	73,634	20,182	21,527	21,860	21,941			Sep
Balance of trade in goods and services	-2,730	-973	-657	-1,076	-993			Sep
Current account surplus	4,524	809	845	327	469			Sep
Financial account ^{b,f}	-1,013	-3,479	1,018	-432	4,710		-3,479	Sep
<i>of which:</i> Nonresidents' direct investment ^b	2,416	1,733	2,758	2,485	3,059		1,733	Sep
Nonresidents' portfolio investment ^b	540	-553	421	608	-1,150		-553	Sep
Residents' direct and portfolio investment abroad ^b	2,475	1,207	1,124	2,386	1,607		1,588	Sep
Net foreign debt (percent of GDP) ^b	-25.6	-25.4	-23.9	-23.2	-21.9		1,207	Sep
Bank of Israel reserves, end-period ^b	28,460	28,460	29,486	31,265	36,152		-25.4	Dec

^a Seasonally adjusted.

^b Unadjusted data.

^c The change relates to the dollar values of imports and exports.

^d When the last month is December, the comparisons are September-December versus May-August; when the last month is September, the comparisons are quarterly; when the last month is October the comparisons are September-October versus July-August; and when the last month is November, the comparisons are September-November versus June-August.

^e Not including ships, aircraft, diamonds, and fuel.

^f Excl. foreign exchange reserves.

SOURCE: Central Bureau of Statistics.

Table 1.6. Indicators of Economic Development in Advanced and Developing Countries^a
(annual rate of change, percent)^b

	2005	2006	2007	Estimate 2008	Forecast 2009
World GDP	4.4	5.1	5.0	3.7	2.2
Advanced countries	2.5	3.0	2.6	1.4	-0.3
Developing countries	7.0	7.9	8.0	6.6	5.1
World trade	7.5	9.4	7.2	4.6	2.1
Advanced countries					
Imports	6.1	7.5	4.5	1.8	-0.1
Exports	5.8	8.4	5.9	4.1	1.2
Developing countries					
Imports	12.1	14.9	14.4	10.9	5.2
Exports	11.1	11.2	9.6	5.6	5.3
Commodity prices (US\$)					
Oil ^c	41.3	20.5	10.7	40.2	-31.8
Nonfuel	10.3	23.2	14.1	9.4	-18.7
Inflation (CPI) in advanced countries	2.3	2.4	2.2	3.6	1.4
Short-term interest ^c (%)					
Dollar deposits	3.8	5.3	5.3	3.0	2.0
Euro deposits	2.2	3.1	4.3	4.5	3.0
Unemployment rate in advanced countries	6.0	5.7	5.4	5.7	6.5

^a According to World Economic Outlook, Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

^b Except for unemployment and interest rates, which are actual rates.

^c Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), November 2008.

Table 1.7. Selected Price Indices,^a 2007-08
(percent change)

September - December 08

	2007	2007		2008			Change from previous period ^a	Year on year change
		IV	I	II	III	IV		
Change during the quarter ^a								
CPI	3.4	1.1	0.1	2.2	2.0	-0.6	-0.6	3.8
CPI excl. housing, fruit and vegetables	3.7	2.0	0.4	3.0	0.1	-1.4	-1.9	2.0
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	3.8	1.3	1.2	2.3	0.7	-2.9	-3.3	1.3
CPI excl. Energy		0.4	0.1	2.0	2.0	0.8	0.8	5.0
Index of housing prices	1.9	-2.3	-2.3	1.0	8.2	4.9	7.0	12.1
Wholesale price index	11.4	5.0	1.0	6.2	-0.1	-10.9	-12.0	-4.4
NIS/\$ exchange rate	-7.1	-4.5	-10.1	-4.2	5.5	9.1	8.7	-0.9
NIS/ €exchange rate	2.4	0.3	-4.1	-4.1	-2.4	2.2	-2.3	-8.4
Year on year change ^d								
CPI	0.5	2.8	3.6	5.0	5.1	4.6	1.0	4.8
CPI excluding housing, fruit and vegetables, price controlled goods, clothing and footwear	1.1	3.1	4.2	5.3	5.6	2.9	-1.1	3.6

^a Last month of each quarter compared with last month of previous quarter.^b December 2008 compared with August 2008.^c December 2008 compared with December 2007.^d Year on year change, in average of period.

SOURCE: Central Bureau of Statistics.

Table 1.8. Monetary Aggregates and Nondirected Bank Credit, 2007-08
(annual rate of change, percent)

	2007						September - December 08	
	2007	IV	I	II	III	IV	Compared with previous period ^a	Year on year change
Rates of change	Change from previous quarter							
M0 ^b	9.8	7.1	0.0	18.4	17.8	27.0	25.4	14.7
M1 ^c	15.3	-1.5	2.3	21.5	24.6	19.9	23.0	15.5
M2 ^d	15.3	1.6	4.9	12.2	8.0	22.5	17.6	10.8
M3 ^e	12.9	4.0	3.1	6.7	4.7	20.1	15.1	7.7
Nondirected bank credit	4.3	5.8	5.9	9.4	10.3	11.9	11.0	9.0
Unindexed local-currency credit	15.7	16.9	24.0	23.9	15.8	14.9	14.3	19.6
CPI-indexed credit	-0.9	5.1	2.4	3.3	6.9	2.1	4.0	3.6
Credit in and indexed to foreign currency	-10.9	-18.6	-30.2	-19.7	-1.0	24.4	15.0	-10.7

^a May to August 2008.

^b The monetary base

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

^d M1 plus short-term local-currency unindexed deposits.

^e M2 plus short-term CPI-indexed demand deposits.

SOURCE: Bank of Israel.

Table 1.9. Interest Rates, Yields, and the Share-Price Index, 2007-08
(quarterly average, percent)

	2007						September - December 08	
	2007	IV	I	II	III	IV	Change from previous period ^a	Year on year change
Nominal interest								
SRO deposits	3.0	3.0	3.0	2.4	3.1	2.7	2.9 ^b	3.0
Nondirected local-currency credit	7.5	7.4	8.1	7.4	8.0	7.9	7.8	7.6
Effective interest on daily deposit auctions	3.9	4.1	4.1	3.3	3.8	3.3	3.3	4.1
LIBID 3-month dollar interest	5.2	4.9	3.1	2.6	2.8	2.6	2.7	5.0
Yield to maturity on:								
12-month <i>makam</i> (short-term Bank of Israel bills)	4.3	4.5	4.3	4.1	4.4	2.9	3.2	4.5
Yield on 5-year bonds	3.2	3.3	2.7	2.6	2.7	3.6	3.4	3.4
Risk premium ^c		0.3	0.3	0.7	0.9	1.7	1.1	5.5
Expected inflation, twelve months forward	1.4	1.5	2.5	2.8	2.6	-0.2	0.4	1.4
General Share-Price Index (change from previous period)	23.3	1.7	-16.8	5.5	-17.9	-25.8	-34.5	7.2

^a April to August 2008.

^b September-October compared with July-August.

^c As measured by the 5-year credit-default-swap (CDS) market.

^d Derived from the yield gap between indexed and unindexed bonds held by tax exempt institutional investors, minus the x-day effect on the price of the bond.

SOURCE: Bank of Israel.

Part 2: Broader Review of Selected Issues

The Israeli labor market—updated picture

- A downturn trend in demand for labor, which was evident in the first half of 2008, strengthened during the second half of the year and especially in the last quarter.
- This downturn encompassed all the principal industries.
- Retrenchments began at companies that were directly hit by the crisis: export companies, mostly those in the high-tech industries, foreign companies and multinationals, and companies in the finance sector.
- The increase in the number of university graduates dismissed was far higher than that of non-graduates.

The analysis of labor market developments is based mainly on employment and unemployment data that are derived from the Central Bureau of Statistics' quarterly Manpower Surveys. Since these data are published with a two-month lag, those for the fourth quarter of 2008 will only be available at the end of February 2009. During a period of stability in the business cycle, this lag can be reconciled. But when a turnaround in the cycle occurs, an updated picture needs to be obtained before the official statistical data are published. This article attempts to analyze the most recent developments in the Israeli labor market by means of indices from various sources which precede the CBS data.

The pace of employee retrenchments in the economy began to increase after the Succoth holiday. The first companies that decided to cut back their manpower were those in the high-tech industries, which have since dismissed about 2,000 employees. The special nature of employment in those industries (personal contracts and limited duration of employment according to the project requirements) permit a relatively high degree of flexibility in personnel management, and the decrease now apparent in the wages of high-tech employees can serve as an incentive for replacing veteran employees with new ones as a means of reducing costs. Even so, the retrenchment of high-tech employees is costly for the company due to the high salaries paid in the industry.

For the time being, and despite the retrenchments, most of the companies in these industries are maintaining their business activity and are continuing to raise capital, and only a few, relatively small companies that encountered financing

difficulties have closed or are in the process of stay of proceedings and receivership.¹

The retrenchments were not limited to the high-tech industries, and spread to industrial companies in various industries, to the finance sector and to other areas. According to data issued by the Association of Building Materials and Consumer Goods Industries, since September 1,500 employees have been dismissed from its member industries.² In the plastics industry, producing mostly for exports, 400 employees have been dismissed since the beginning of 2008. Data issued by the Metal, Electrical and Infrastructure Industries Association show that since September, workers have been dismissed at 28 percent of the enterprises in its member industries, and that the number of dismissals amounts to 1,000. In the diamond industry, most of the companies cut back the number of their employees by 25 percent in the last quarter of 2008, and laid off hundreds of polishing workers and office staff. In the finance sector, 130 employees have been dismissed from a number of investment houses to date. Three car leasing and rental companies dismissed together 110 employees.

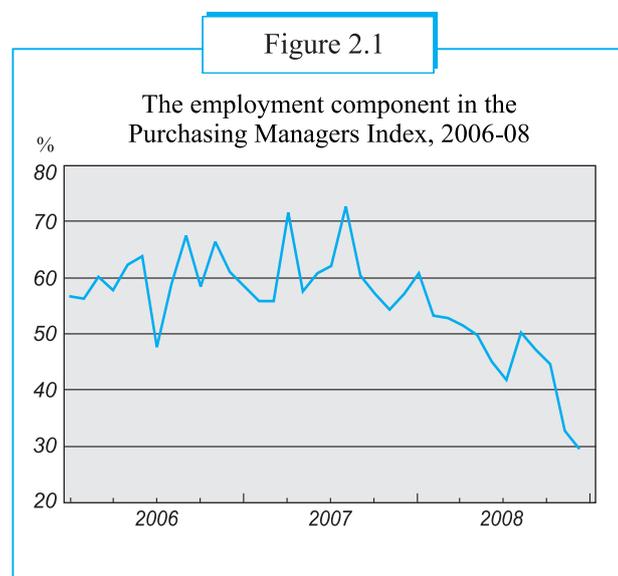
The slowdown in economic activity will become even more serious as a result of the decline in domestic consumption, which will hit the commerce and services industries. The survey of the Federation of Israeli Chambers of Commerce shows that 29 percent of commerce and services companies reduced their employment levels in 2008 compared with 2007. For 2009, 55 percent of the companies expect a decrease in the number of their employees, and only 7 percent of them expect an increase. In the near future, the large transportation companies in the economy are planning to dismiss over 1,000 employees, accounting for 10-15 percent of those employed in the transportation industry. A study by *Calcalist* revealed that the growth in employment at the large law offices has ceased, that part of them have begun to cut back on employment, and that more extensive dismissals are expected at the beginning of 2009.

The wave of dismissals in the economy was expected in view of the continuing global crisis, which began as a

¹ These include the Proxy software house, which had 40 employees, Negevtech, with 147 employees, the Mercado Software company, with 48 employees, and the Sky MobileMedia company, which had 15 employees.

² Including plastic and rubber, paper and paper products, publishing and printing, furniture, building materials and quarrying, cosmetics and shoe manufacturing.

financial crisis but spread into real activity. Indications of this development are apparent from data on the demand for workers. After 21 consecutive months of expansion, a contraction in the employment component of the Purchasing Managers Index has been recorded since May.³ The change in trend and slowdown in employment are attributed to a drop in demand for output.



Data from the Employers Survey issued by the Ministry of Industry, Trade and Labor show that demand for workers in the business sector excluding construction and agriculture, which is measured in terms of vacant posts, dipped by 60 percent in the fourth quarter of 2008 compared with the fourth quarter of 2007. This follows a 29 percent year-on-year decrease in the third quarter of 2008. The number of vacant posts already began to fall in the first and second quarters of 2008, albeit at the moderate rate of 4 percent compared with the previous quarter. The decrease in the number of posts that were filled and the increase in the number of job separations led to a negative employment balance (recruitments minus separations) in the fourth quarter for the first time since the end of 2003. A check on the effects of the size of the business on demand for workers conducted by the Ministry of Industry, Trade and Labor shows that initially, demand fell at small and medium-sized businesses (SMEs) while from the third quarter of 2008, a decrease was recorded at large companies as well.

Another index of the extent of demand for workers in the economy is the MIT (Manpower Information Technology)

³ The index is constructed in a manner whereby a decrease below the level of 50 percent implies a slowdown.

job placement agency index of demand for workers, which is based on “wanted” advertisements in the newspapers. According to this index, demand for workers fell in 2008 compared with the previous year, and the downturn in demand accelerated notably during the last two months of the year. This decline encompassed all industries, without exception, and consequently annual demand in 2008 was the lowest since 2004. The index of demand for high-tech employees fell by 6.8 percent in 2008 as a whole, and reached its lowest level since mid-2004. The fall in demand for these workers began as far back as the beginning of the year, but was not uniform in the course of the year, and accelerated in the last months of 2008. Year-on-year, demand fell by 2.5 percent in the first quarter and by 6.3 percent in the second quarter. In the fourth quarter, a large decrease of 14.1 percent was recorded compared with 2007:Q4.⁴

Table 2.1
MIT index of demand for workers, each period year-on-year change, 2007 to 2008

	January- October	January- November	January- December
The entire economy	-4.4	-5.1	-6.2
Manufacturing	-5.7	-6.7	-8.0
Construction	-14.1	-14.9	-15.9
Commerce	-3.6	-3.8	-5.0
Accommodation & food services	-1.8	-2.4	-3.8
Transportation, storage & communications	-2.0	-1.6	-2.5
Banking, finance & insurance	-2.9	-6.2	-9.6
Business services	-4.1	-5.0	-6.1
Education	-9.3	-11.5	-13.6
Health & nursing	-3.9	-3.5	-3.5
Community services	-8.2	-8.2	-9.4

The number of job offers at government Employment Service offices also fell in the last months of 2008. Following average monthly increases of 10.6 percent in the first quarter

⁴ Demand fell more rapidly towards the end of 2008: In November and December the demand for high-tech employees was 16.2 percent and 25.2 percent lower respectively than in the same months of 2007.

Table 2.2
Selected data from the Manufacturers Association Survey

	2007:Q3	2007:Q4	2008:Q1	2008:Q2	2008:Q3	2008:Q4 Forecast
Weighted net balance – Output	16	14	-6	-4.5	-8.5	-12
Net balance – Employment	10.5	7.5	0	0	-3	-9
Percentage of companies having difficulty in recruiting skilled workers	77	83	73	75	73	
Percentage of companies not seeking skilled workers	15	10	19	17	18	
Percentage of companies having difficulty in recruiting unskilled workers	47	56	49	53	51	
Percentage of companies not seeking unskilled workers	17	12	22	18	20	

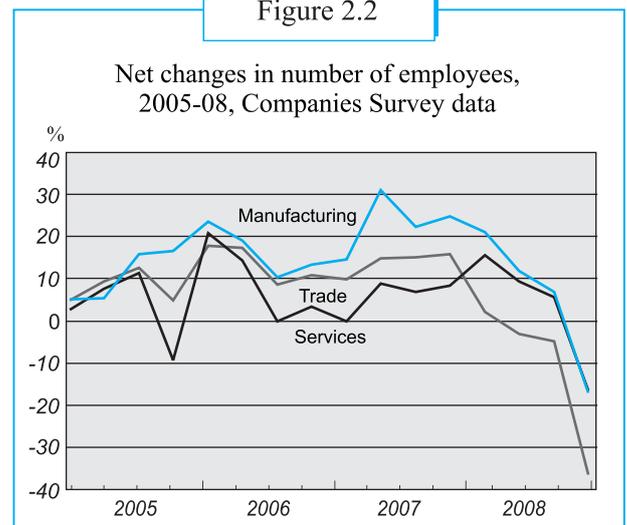
and 6.3 percent in the third quarter year-on-year,⁵ the number of job offers fell sharply, by 35 percent in October⁶ and by 5.9 percent in November year-on-year, mainly as a result of the drop in demand for skilled workers in manufacturing, construction and agriculture, and for unskilled workers as well.

It is generally believed that during periods of turnaround in the business cycles, the labor market's response lags behind changes in real activity. This is mainly due to the costs involved in the dismissal process, and to investments that were made in the past in recruiting and training workers. Data from the Manufacturers Association Survey show that the downturn in business activity immediately halted the expansion in employment in manufacturing in the first half of 2008, and factories began to dismiss workers in the second half of the year. This is on the basis of net output and employment balances (the rate of companies reporting an increase minus the rate of companies reporting a decrease) as shown in Table 2.2. The table also shows an increase in the percentage of companies that were not seeking workers, and a decrease in the percentage of companies that had difficulty in recruiting workers in 2008.

According to the Bank of Israel's Companies Survey, the number of companies dismissing employees compared with the number of companies recruiting employees increased in all industries. Figure 2 shows that from the first quarter of

2008, the percentage of manufacturing companies recruiting workers fell heavily compared with the percentage of those taking on employees, and that from the second quarter the number of companies dismissing employees exceeded the number of those recruiting, resulting in a negative net balance. In the commerce and services industries as well, the percentage of companies recruiting employees compared with the percentage dismissing them also increased, and in the fourth quarter of 2008 the net balances in these industries were also negative. It should be remembered that the net balances in the Companies Survey refer to the number of companies and not their size. It is therefore not possible to know from them what would have been the employment balance, as reflected by the number of employees.

Figure 2.2



⁵ Due to sanctions, no Employment Service data are available for April and May 2008.

⁶ The demand for workers in October was particularly low because of the Jewish holidays that occurred during the month: Employment Service offices were open for only 12 days in October 2008, compared with 19 working days in October 2007.

Figure 2.3

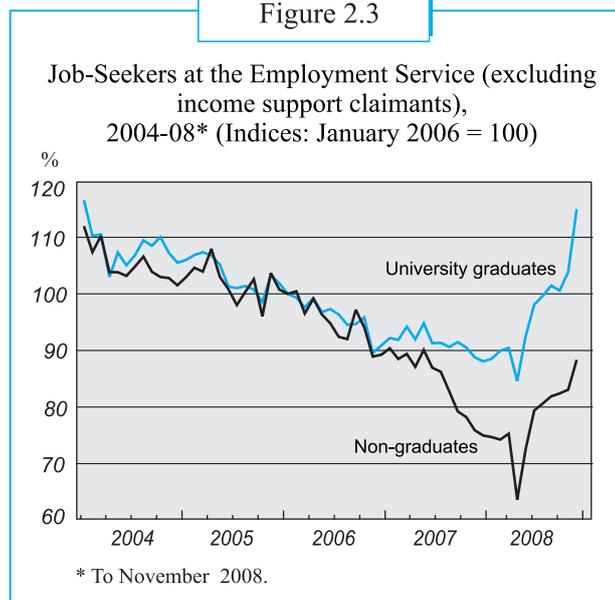
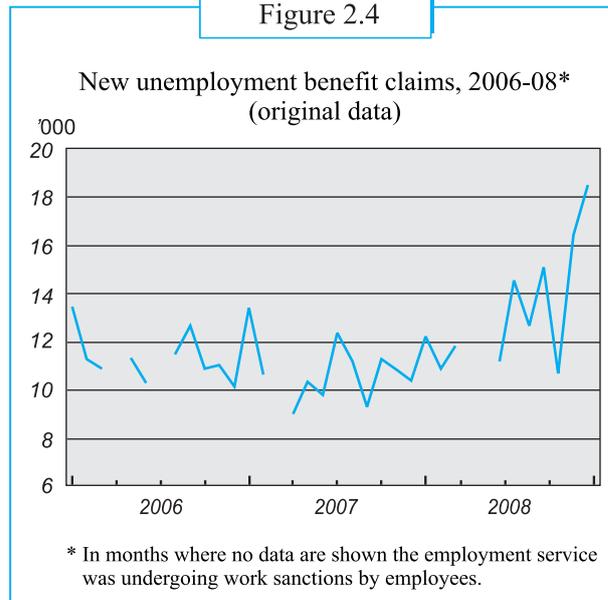


Figure 2.4



The net balances in the manufacturing and services sub-industries were negative at all technology levels in the fourth quarter of 2008. The Companies Survey also revealed that the severity of the labor shortage constraint weakened in all industries, and in all of them except for the construction industry, this constraint ceased to be an effective limitation on the supply side.

According to Employment Service data, the large-scale dismissals in recent months led to a sharp rise in the number of job-seekers. Figure 3 shows that the rise in the number of university graduates seeking work was much larger than the increase in the number of non-graduate job-seekers, a finding that matches developments in the labor market during recent months.

Employment Service data also show that the number of newly dismissed employees who were recorded as job-seekers (excluding income support claimants) increased considerably during recent months (Figure 4).

The data reviewed show that while some downturn in demand for workers and the pace of employee recruitment was already apparent at the beginning of 2008, this trend intensified during the second half of the year and especially in the fourth quarter. The drop in demand for workers and the wave of dismissals during recent months will be reflected by a rise in the unemployment rate in the fourth quarter of 2008 and in 2009. The fall in world demand as a whole and for Israeli products in particular, together with the decrease in domestic private consumption resulting from the reduction in the public's wealth and the sense of uncertainty as expressed by the decline in the Consumer Confidence Index, could lead to the dismissal of additional

workers from the manufacturing, commerce and services industries, to an extent that is difficult to assess at present. Based on the aggregate data in the Ministry of Industry, Trade and Labor Employers Survey regarding the pace of manning of employee posts and employers' expectations of changes in payroll levels, a decrease of 0.1-0.7 percent in the number of employee posts in the business sector (excluding the construction and agricultural industries) is forecast for the fourth quarter of 2008, and a further decrease of 0.2-0.8 percent can be expected in the first quarter of 2009. These numbers are translated into a decline of about 18,000 in the number of employees in these two quarters. (For an explanation of the forecast construction method, see T. Suchoy and N. Presman [2009], *Predictive Content of Employers' Expectations*, Discussion Paper Series, Bank of Israel Research Division.)

Arbitration ruling on physicians' wages and public expenditure

- When the arbitration ruling is fully implemented, public expenditure will increase by a billion shekels (NIS) compared with the 2008 budget (about a third of budgetary expenditure excluding credit)—about NIS 800 million as a direct result of the increase in physician's wages and NIS 200 million resulting from expenses unrelated to the agreement that are linked to the average wage in the economy.
- Higher wages for sick-fund physicians will be financed by increasing the budget for the health services basket, and the higher wages for physicians in state hospitals will be financed by increasing the price of a hospitalization day.

• Estimates of the cost of the arbitration ruling that were published when the ruling was presented, were substantially higher than the said estimate, principally due to the fact that some costs were duplicated and the view that the arbitration ruling would lead to a substantial wage hike throughout the public sector.

The arbitration ruling on physicians' wages states that physicians' wages should rise by 23.5 percent, and that physicians' wages in certain critical, specialist areas (anesthesia, intensive care, and neonatology) should rise by a further 8.5 percent, resulting in an average increase in physicians' wages of 24.2 percent. The arbitrators' decision applies to some 11,000 physicians in the public sector, 3,600 of whom are employed by the Ministry of Health and at state hospitals, and 7,000 by the Clalit and Leumit sick funds.⁷ The wage increase is retroactive from January 2008, and the physicians will receive it in five installments, the last in January 2011 (see Table 1).

Table 2.3
Wage supplement by date of payment

Payment date	Wage supplement (percent)	Cumulative increase in public expenditure (NIS millions)
1.1.08	6	260
1.4.09	4.375	450
1.1.10	4.375	650
1.6.10	4.375	840
1.1.11	4.375	1,030
Total	23.5	1,030

One of the arguments raised during the arbitration addresses the assertion that physicians' wages had been eroded compared with similar professions in the public sector. In 2002-2007 – during which period the physicians had no wage agreement – the wage for state-employed physicians (gross salary, excluding reimbursements and non-recurring payments) rose by 4.1 percent. During the same period, the Consumer Price Index (CPI) rose by 4.2 percent. Wages for university employees, including administrative staff, rose by 1.3 percent during the same period.

⁷ The agreement also applies to 800 doctors who belong to the Hadassah Organization and to doctors employed by public corporations whose cost of employment does not come from the state budget. The Maccabi, and Meuhedet sick funds employ 2,900 doctors who are not party to the arbitration agreement.

Total expenditure on the wages of physicians included in the arbitration and who are employed in the public sector is estimated at NIS 2.9 billion. If we add the physicians employed by the sick funds who are not included in the arbitration ruling, expenditure on wages rises to NIS 3.7 billion. The part of the wage that is linked to the combined wage (including overtime, shifts and provision for pension) is 91 percent of the cost of the physicians' wages (that is, NIS 3.35 billion). Thus, when fully implemented,⁸ the arbitration ruling will increase wage costs in the public sector by NIS 800 million relative to the original budget for 2008.

If the physicians who are not included in the agreement are not awarded a parallel wage increase, the cost will be reduced to NIS 650 million. In that case, the financing of the increase in the wages of physicians covered by the arbitration ruling by increasing the health basket budget will adversely affect competition between the sick funds and the financial robustness of those funds covered by the ruling (Clalit and Leumit): Increasing the health basket budget will only cover 40 percent of the increase in the physicians' wages.

An increase in physicians' wages will push up the average wage, and this in turn will further increase public expenditure. The statement of opinion that the government submitted to the arbitrators asserted that an increase in the physicians' wages will increase the expenses that are linked to the average wage and minimum wage (calculated as a percentage of the average wage) by more than NIS 200 million.⁹ This is based on the fact that a one-percent wage rise in the public sector will increase the average wage in the economy by one-third of a percent. The increase in physicians' wages will also increase expenditure by state hospitals, by the Ministry of Health and by the sick funds acquiring the services of physicians who are not salaried employees, if prices in this area are affected. We have no data at hand to help us quantify this expense, but in our opinion it is small.

Previous estimates of the cost of implementing the arbitration ruling that were published when the ruling was presented were substantially higher than the estimate presented here. Some of the estimates addressed the possibility that the arbitration ruling would generate a significant wage increase

⁸ Assuming that all the doctors, including doctors of the sick funds that are not party to the arbitration, the increase in the combined wage will be 24.2 percent, a calculation that takes into account the indemnity for doctors in the critical, specialist areas.

⁹ The opinion submitted to the arbitrators by the Israel Medical Association claimed that the pass-through effect between wages in the health sector and wages in entire public sector ranges from 14 to 38 percent. However, based on the wage agreement in the public sector, we assumed that there is no pass-through effect between doctors' wages and wages in the public sector.

Table 2.4
Annual rate of change of selected indices, 2002-07 (percent)

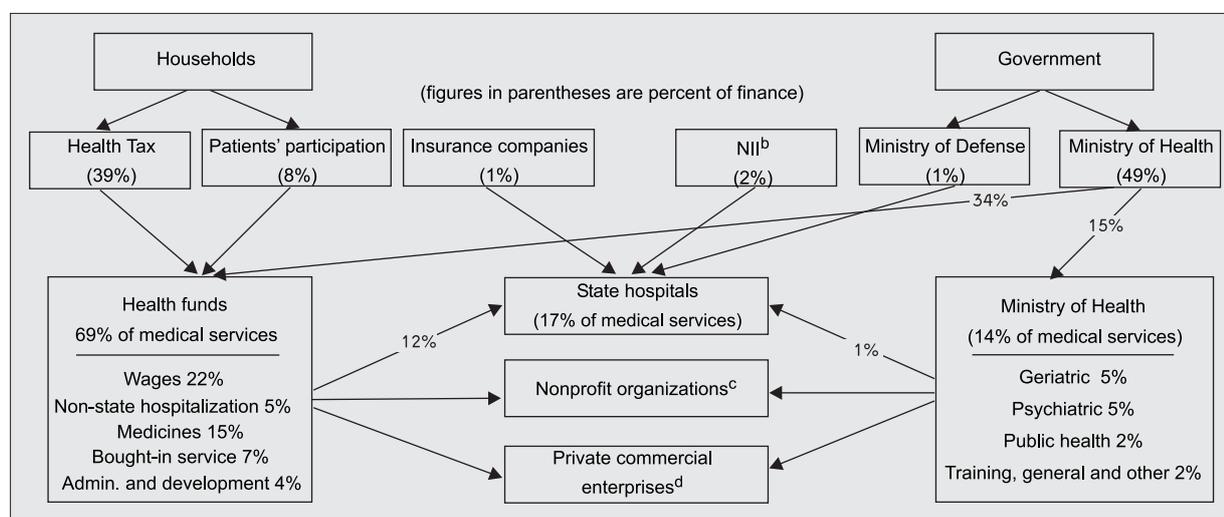
	2002	2003	2004	2005	2006	2007	Cumulative
Cost-of-health index	0.7	-2	2.2	1.5	2.5	1.6	5.8
Price of hospitalization day index	5	-1	2.9	5.6	3.9	2.9	15
CPI	5.7	0.7	-0.4	1.3	2.2	0.4	4.2
Wages in the public sector	0.6	-3.5	4.4	1.5	2.7	2	7.2
Wages in the health sector	-0.6	-1.8	3.9	1.5	2.4	2	8.2
University wages	1.1	-2.5	0.2	3.4	1.2	-1	1.3
Doctors' wages	2.5	-4.5	-0.2	7.8	2.8	-1.5	4.1

in the entire public sector. However, this seems uncertain in view of the exceptional circumstances of the physicians' wage agreement and the state of the economy. Other estimates were higher, based on claims that in addition to the physicians' wages, the agreement would also bump up the cost of the health basket, the price of a hospitalization day, and the cost-of-health index. In fact, these calculations

constitute a duplication of costs, stemming from the structure of the public health system, which segregates the sources of financing from the performing entities (the sick funds, hospitals, market producers and nonprofit organizations). Fig 2.5 describes the segregation between the funding entities, the insurers (sick funds, Ministry of Defense, and National Insurance Institute) and the performing entities.

Figure 2.5

Public expenditure on health, the flow of money from the sources of finance to the public entities performing the medical services^a



^a The monetary data and percentages refer to 2007. Public expenditure on health was NIS 34.5 billion. The NII indemnifies hospitals for birth-related expenses, and the Ministry of Defense pays for treatment administered at state hospitals for those serving in the IDF (drafted and career soldiers).

^b National Insurance Institute.

^c Hospitals, charitable organizations, Magen David Adom, and others.

^d Private clinics and hospitals, private doctors, institutions, clinics and more, that render services to the public health system.

Ways of financing the outcome of the arbitration

It seems that, most of the physicians are not directly employed by the state, but are employed by independent corporations (the sick funds) and state business enterprises (state hospitals). Nevertheless, the arbitration ruling entails a considerable budget cost. If we divide the physicians among the various employers, we find that 9,900 physicians are employed by the sick funds, 10,285 by state hospitals, and 750 are employed by the Ministry of Health.

This increase will be realized through four channels: 1) direct wage supplements for physicians who work for the Ministry of Health – approximately NIS 40 million; 2) a higher cost-of-health index, which will increase the cost of the health services basket that finances the sick funds' operations; 3) an increase in the price of a hospitalization day; 4) an increase in the average wage in the economy resulting from an increase in physicians' wages. The increased cost of a hospitalization day, together with a higher average wage in the economy, will in turn raise public expenditure by a further NIS 120 million by increasing NII and Ministry of Defense payments.¹¹

A. Increase in the price of the health basket

The government's contribution to the sick funds is set according to the level of the health basket for which the funds are responsible. The basket is financed by the health tax (53.4 percent), government participation (41.2 percent) and patients' participation in the cost of services (5.4 percent). The cost of the basket is determined jointly by the Ministry of Health and the Finance Ministry and it changes to meet changes in health costs and in the make-up of the population as well as in line with the adoption of new medical technologies. The health tax and patients' co-payments are defined as a percentage of wages and of the product/service, respectively, and the government finances the difference between these sources and the cost of the basket.

An increase in physicians' wages will result in a 6 percent increase in wages in the health sector and a one percent increase in the wages of public sector employees¹² (Table 3).

¹⁰ As mentioned, the arbitration does not apply directly to 2,900 doctors employed by the Maccabi and Meuhedet sick funds, but the calculation assumes that their wages will increase.

¹¹ NII and the Ministry of Defense pay NIS 1.1 billion each year for hospitalization.

¹² The calculation was prepared according to the weighted frequencies of doctors and their wage in the health sector and in the entire public sector, based on data provided by the Tax Authority's data processing service. Assuming that an increase in doctors' wages will not lead to any further increase in public sector wages over and above that agreed in the labor agreement for public sector employees from April 2008.

Table 2.5
Composition of the cost-of-health index

Component	Weight in the index (percent)
CPI	40
Index of health sector wages	35.96
Index of public sector wages	22.04
Index of building inputs	2

Consequently, if the arbitration ruling is fully implemented, the cost-of-health index, on which the government's bases its revision of the financing of the health basket, will increase 2.4 percent. The cost of the health basket in 2008 is estimated at NIS 26.5 billion, so that the budgetary cost through this channel is NIS 650 million. If we include in this cost only the wages of those physicians included in the agreement, the cost will be reduced to NIS 500 million.

B. Raising the price of a hospitalization day

Hospital revenues are determined on the basis of the price per hospitalization day.¹³ Payment according to this method compensates the hospitals for the duration of the patient's stay (in days), without taking into account the type of treatment that the patient receives. A differential rate is defined for 36 different areas¹⁴ where the duration of the hospitalization does not reflect the complexity of the treatment: the hospitals are compensated on the basis of the number of treatments administered and the rate for each activity. According to the formula for calculating the price of a hospitalization day, it is expected to increase by ten percent following implementation of the arbitration ruling. It is worth noting that although a substantial share of the sick funds' expenses are for hospitalization, they do not receive direct compensation for the price of a hospitalization day, rather by including the components of its cost in the cost-of-health index.

Although the sick funds are the public hospitals' principal customer, they also have revenues from the National Insurance Institute (NIS 850 million),¹⁵ from the Ministry of

¹³ As of August 1, 2008, the average rate for a general hospitalization day is NIS 1,855: in internal medicine departments the price is NIS 1,511; in intensive care it is NIS 1,855; in geriatric departments it is NIS 1,124; in the maternity department it is NIS 8,283.

¹⁴ In all, more than 130 different treatments, including: surgery, transplants, catheterization, invasive tests, organ resection, oncology treatment, and more. The most expensive treatment is a liver transplant, the cost of which is NIS 796,734.

¹⁵ The NII pays hospitals a hospitalization grant to finance birthing and maternity expenses for the hospitalization of mothers and newborns.

Defense and the IDF (NIS 200 million), and from consumers of other private services (NIS 500 million)—mainly services utilized by the insurance companies. An increase in the price of a hospitalization day will increase the expenses of the Ministry of Defense and the NII by NIS 110 million.

Interim review since Israel's Earned Income Tax Credit (EITC) program was activated in September

- Follow-up questionnaires in the official research on Israel's EITC program found that one-fourth of participants had known about the program before it was activated.
- By the end of the first stage of the program, January 2009, 25,770 applications for income-tax credits were approved—a 38.5 percent take-up rate, similar to rates in corresponding programs in other countries in their initial stages of implementation.
- In the United States, the percent of income tax credit recipients rose over time in response to a significant improvement of the terms of EITC programs many years after they were first implemented.

General remarks

An Earned Income Tax Credit (EITC) program has been up and running in selected parts of the country—the areas where the welfare-to-work program is in effect¹⁶—since October 2008. The program awards up to NIS 400 per month to low-income workers. The largest benefits accrue to families with three children or more and those with two breadwinners whose total monthly gross income does not surpass NIS 10,000.¹⁷ According to the relevant legislation, the program will become countrywide in 2010. To take part in it, citizens living in the areas of implementation who believe that they are entitled to a benefit must submit a claim to the Israel Tax Authority, using an application form that they can obtain at post offices around the country.

It is worth emphasizing that based on assessments by policymakers and research around the world, the system selected in Israel, based on payment of the benefit directly to the eligible claimant is more effective than systems based on paying the benefit via employers in achieving the objectives

¹⁶ Jerusalem, Ashkelon and Sderot, Nazareth and Upper Nazareth (including 'Ein Mahal) and Hadera (including Baka-Jatt, Mishmarot, 'Ein 'Irron, 'Arara, Kefar Pines, Kafr Kara, Or Akiva, Hadera, Pardes Hanna-Karkur, Basameh), and Netanya.

¹⁷ By international standards, Israel's program is rather generous for two-breadwinner families. See Recent Economic Developments 122, pp. 22–25

of the program—to reduce of poverty and raise the rate of participation in the labor market. This is because the system of transferring the tax credit directly to the employee lowers the amount of the benefit that ends up with the employers rather than the employees, compared with the “seepage” in systems where payment is made via the employers. In Israel too it was found that in operating similar systems, granting the credit directly to the eligible employee achieved the objective and prevented seepage to the employer.¹⁸

Take-up rate of Israel's EITC program as of January 2009

Submission of the forms began in September 2008, and at the end of the first stage, based on incomes in 2007, 52,593 applications for tax credit had been submitted, of which 25,770 were found to be eligible. Among those found ineligible, 70 percent failed to meet the qualifying terms (mainly the income test) and 30 percent were disallowed for other reasons (e.g., employers' failure to report their income). As the number shown above of those ineligible includes about 5,000 applications regarding which employers' data have not yet been received, it is reasonable to assume that the number of those eligible will rise. Table 2.6 shows the distribution of claims by a breakdown of the Tax Authority's collection centers; Table 2.7 shows the monthly distribution of those eligible by numbers and by benefits approved. Thus far, NIS 64.3 million in benefits has been approved on the basis of applicants' income in 2007.

Table 2.6
Distribution of Claims and Eligibles

Applicants' place of residence	Claims submitted to Tax Authority	Thereof: eligible
Nazareth	8,674	3,749
Hadera	8,983	4,494
Netanya	5,045	3,018
Jerusalem	19,824	11,337
Ashkelon	7,952	3,171
Unknown	2,115	1
Total	52,593	25,770

The benefit figure relates to the sum owed to those eligible on the basis of their income in 2007. Thus far, only part of the benefit (NIS 30.5 million) has actually been paid out.

¹⁸ See: E. Toledano and N. Zussman, “Earned Income Tax Credit and Subsidy Shifting: The Case of Grants to Employed Army Veterans.” National Insurance Institute Research and Planning and Administration, June 2008.

The Israel Tax Authority estimates the total population of those entitled to EITCs at 67,000. Thus, the current take-up rate of the program is around 38.5 percent—similar to the current rate in previously established programs in other countries. The rate of submission of applications is rising (Table 2.7, and it received an additional boost in December due to a special effort by the Tax Authority to enhance awareness of entitlement; one may therefore predict that in the second stage of the program, which started on 1 February 2009 and which is based on applicants' income in 2008, participation rates will exceed the rates in corresponding phases of previous experiments abroad. The Authority's effort included the sending of letters to potential recipients of EITCs in the last few months of 2008, and the extension of the application deadline to the end of January 2009.

Table 2.7
Monthly Distribution of Benefits in Israel*

	Sept.	Oct.	Nov.	Dec.(up to Jan. 5, 2009)	Total
Number of eligibles	4,113	2,671	5,185	11,317	25,770
NIS million	11.6	6.9	13.2	27.3	64.3

* The benefit figure relates to the sum that eligibles are owed on the basis of their income in 2007. Thus far, only part of the benefit (NIS 3.4 million) has actually been paid out.

EITC take-up rates—the American experience

Figure 2.6 shows the change in the number of participants in the U.S. Federal EITC program. Initially, the number of participants was typified by ups and downs and increased by only 2.4 percent in the program's first ten years. Only in 1987, after the terms of the program were expanded and improved (first by indexing the benefit to the inflation rate and later, among other measures, by increasing the credit for large families), did the take-up rate surge to today's level. The take-up rate in 2001 was estimated at 75 percent.¹⁹

The U.S. has many EITC programs at the state level. In 1992, California's EITC program attained a participation rate of 23 percent of welfare recipients—the population whose income entitles it to earned income tax credit—and since then it has risen (Table 2.8).

¹⁹ The U.S. General Accounting Office calculated the estimate by cross-tabulating data from the IRS and the Income Survey.

Figure 2.6

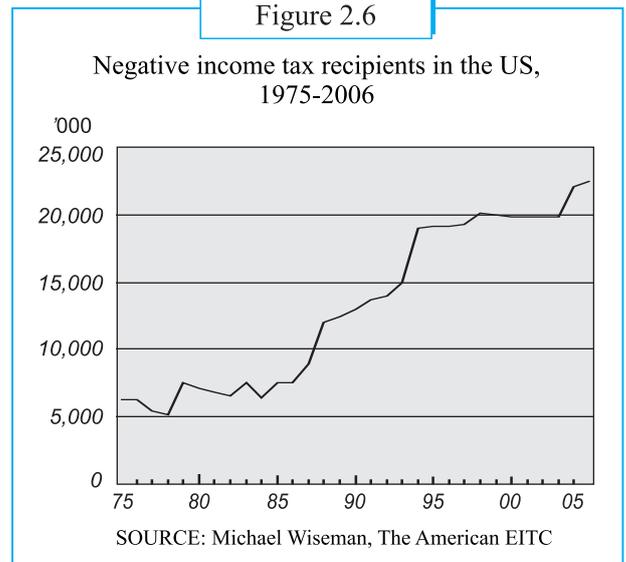


Table 2.8
Increase in Participation in California's EITC
(based on Holz et al., 2003)*

Year	Participation rate (pct.) among persons with income/earnings (posi- tive)	Participation rate (pct.) among welfare benefactees
1992	50	23
1993	50	24
1994	56	30
1995	62	37
1996	64	40
1997	69	47
1998	70	51
1999	73	56
1992–1999 pct. increase	46	140.6

* Hotz, Mullin, and Scholz, "Trends in EITC Take-up and Receipt for California's Welfare Population," unpublished manuscript, 1992–1999.

Hotz, Mullin, and Scholz, "Trends in EITC Take-up and Receipt for California's Welfare Population," unpublished manuscript, 1992–1999.

The table shows that the number of participants in California's EITC program increased steadily. Even seven years after the implementation of reforms that boosted labor-force participation (in 1992), the participation rate continued

rising year after year instead of leveling off. In 1992–1997, the rate of increase in participation ranged from 46 percent (of recipients who had wages or positive earnings) to 141 percent (of welfare recipients).

Awareness of the Israeli program: findings of follow-up research

As part of its socioeconomic agenda, the government established an inter-ministerial research team to analyze the expected effects of the implementation of an Israeli earned income tax credit program on poverty and labor-force participation. The research will also analyze the program’s take-up rate. The team is made up of researchers from the Bank of Israel, the Brookdale Institute, and the National Insurance Institute, along with representatives of the National Economic Council at the Office of the Prime Minister, the Economics and Research Department of the Ministry of Finance, and the Israel Tax Authority, which is charged with applying the program in Israel.

For the purpose of the research, a sample of approximately 2,000 people was chosen among those who dwell in areas where the program is in effect, including Jerusalem, Ashkelon and Sderot, Nazareth, Upper Nazareth, and Hadera. A control group in areas where the first phase of the program will not be operative (in 2008 and 2009) was also selected. The research method will make it possible to examine the reasons for the take-up/non-take-up of the program and the effect of EITCs on employment and poverty by comparing the employment and income of participants in the program with those of non-participants with similar economic characteristics. The research will also attempt to determine whether workers who participate in more than one program (EITC and welfare-to-work) respond to the incentives of the new policy more strongly than those who are treated by the EITC program only or by no program at all.

The research data gathered thus far, by means of telephone questionnaires, were used to examine the awareness level of respondents in the treatment group, those who live areas where the program is operative. (Most but not all members of this group fall into the income range that qualifies them for EITCs.) The questionnaires showed that 25 percent of respondents knew about the program in the summer of 2008 (when the telephone questionnaires were administered), i.e., about two months before the program was activated. This relatively low rate was apparently due to scanty awareness of the program among potential participants at the time preceding its implementation. It should be borne in mind that the actions mentioned above to enhance awareness of the program had not been taken at that time.

In the future, the participation rate will be affected by the efforts being made by governmental and nongovernmental entities to increase awareness of the program and the rate of realization of entitlement by those eligible. To bring this about, nongovernmental organizations such as Agam Mehallev, which runs the welfare-to-work program in Nazareth, and the Yedid association are active at present, and these activities are expected to expand in the future. In the United States, too, the activities of NGOs (nonprofit and for-profit alike) have been expanding vigorously, raising the coverage rate of the EITC programs significantly.²⁰

²⁰ See, for example, Dodd, Poplawski, and Zochowski (2008), “EITC Take-up: A Look at Earned Income Tax Credit Take-Up Rates by Low-to Moderate-Income Individuals, as Determined by Tax Preparation Firms’ Locations and Services,” Dept. of Economics, University of Oregon.

Diary of Events from September to December 2008

Month	Date	Event	Details
September	8	Fannie Mae and Freddie Mac are nationalized.	The Fannie Mae and Freddie Mac mortgage giants were nationalized in an attempt to stop the loss of confidence in these firms, which account for about half the \$ 12 trillion US mortgage market. The US government will provide the mortgage firms with liquid funds until end-2009.
	9	Tax concessions for new immigrants and returning residents are approved.	Benefits and tax concessions for new immigrants and returning residents were approved. The concessions apply to all types of income, including that from interest, dividends, rent, business, occupation, and wages abroad, as well as capital gains from the sale of assets held abroad for up to 10 years.
	15	Lehman Brothers collapses.	Lehman Brothers, the fourth-largest investment bank in the US, declared bankruptcy and requested protection from its creditors.
	21	The Prime Minister, Ehud Olmert, tenders his resignation to the President.	
	22	The President of Israel asks Zippi Livni to form a coalition government.	
October	2	The privatization of the Engineers Advanced Study Fund Management Company Ltd. is completed.	The government completed the sale of all its holdings in the Engineers Advanced Study Fund Management Company Ltd., together with 20 % of its holdings in the Engineers Association, thereby transferring control of the company to Menorah-Mivtahim Finances Ltd.
	2	A permit is issued allowing money to be transferred between provident and pension funds.	A permit was issued enabling savings to be transferred between provident and pension funds as part of the policy to increase mobility between the long-term savings instruments (provident funds, pensions, managers' insurance) as of the beginning of 2009. The pension funds benefit from the fact that during a decline their yields are better than those of the provident funds because 30% of their assets are invested in earmarked bonds which guarantee a return of 4.86%. However, when money is moved from a provident fund to a pension fund it switches from being capital savings to unfunded (illiquid) savings, even if it was saved before 2008.

Month	Date	Event	Details
October	5	A budget supplement of NIS 350 million for old-age pensions is approved.	The special cabinet committee for the legislative amendment of the 2009 budget approved an increase in old-age pensions as part of the government's policy of reducing income disparity and aiding Israel's aged. The increase is part of an overall amount of NIS 1 billion for raising old-age pensions paid by the National Insurance Institution and on which the government decided in November 2007. In the framework of the increase, NIS 500 million was added to the 2008 budget for persons aged 80 or more, and in 2009 another NIS 350 million will be paid to persons aged between 70 and 80. In 2010 pensions will be augmented by another NIS 150 million.
	6	Resolutions regarding earned income-tax credits are approved.	The extent of the credit and the level of wage eligible for it were determined in accordance with the number of wage-earners and children in a household. An employee aged 23 or more with 1–2 children is entitled to a tax credit of NIS 290 a month; an employee with 3 children is entitled to a tax credit of NIS 420 a month; an employee aged 55 or more, even if he or she has no children or the children are over 19, is entitled to the same tax credit as one with 1–2 children.
	7	The Bank of Israel reduces its key interest rate.	The Bank of Israel announced the reduction of the interest rate by 0.5 percentage points as of 12.10.2008, bringing the rate to 3.75%. The decision to reduce the interest rate at this stage was made in view of the steep increase in uncertainty in global financial markets and its repercussions on domestic financial markets.
	8	World interest rates are reduced.	The Fed cut the US interest rate by 0.5 percentage points, bringing it to 1.5%. At the same time, other central banks cut their rates to a similar extent. This step was led by the ECB, which reduced the European key interest rate to 3.75%, and the B.o.E., which cut the UK interest rate to 4.5%.
	8	The UK government introduces a rescue package for the banking sector.	This measure was intended to prevent the collapse of British banks. The package involved the purchase of bank shares by the government and the provision of loans to the amount of £ 200 billion. 8 banks were involved in the package, including HSBC, Barclays, Lloyds TSB, and RBS.

BANK OF ISRAEL RESEARCH DEPARTMENT

Month	Date	Event	Details
October	12	A rescue plan of \$ 186 billion is approved in Russia.	The Russian lower house of parliament (the Duma) approved legislation regarding the implementation of a \$ 186 billion rescue plan aimed at helping the banks cope with the credit crisis. In the framework of the plan the government will inject capital into the banks, guarantee deposits, buy shares of banks in difficulties, and cut taxes.
	13	The leaders of the Eurozone approve an aid package for the banks.	The leaders of the 15 countries of the Eurozone agreed on a plan to inject billions of dollars into banks in difficulties and to temporarily guarantee interbank loans, in an attempt to restore confidence in the financial system.
	26	Zippi Livni fails in her efforts to form a government.	
	27	The Bank of Israel's key interest rate for November is reduced.	The Bank of Israel's key interest rate for November was lowered by 0.25 percentage points, bringing it to 3.5%.
	28	Amendments to the Capital Investments in Agriculture Law are approved.	The Knesset Finance Committee approved an order amending the Capital Investments in Agriculture Law. Israel was divided into 15 regions, graded as A, B, C on the basis of three criteria: the supply of agricultural produce, the potential distribution of settlement, and ecological contribution. The innovation relates to areas which scored low grades regarding the supply of agricultural produce and the distribution of settlement but were designated as development areas B because of their ecological contribution. The order will remain in effect until end-2009, when it will be reviewed.
	29	The US reduces its key interest rate.	Interest in the US was reduced by another 0.5 percentage points, bringing it to 1 percent, in line with expectations.
	30	The forecast of Israel's credit rating is revised.	The S&P rating company revised the forecast of Israel's credit rating from 'Positive' to 'Stable,' leaving the A rating in place.
November	2	The national budget for 2009 is tabled.	The Minister of Finance put the national budget for 2009 on the Knesset's agenda.
	6	A rescue plan for the US automobile industry is approved.	A \$ 15–17 billion financial plan to help US auto manufacturers was approved. The amount involved was substantially lower than that requested by the manufacturers.
	11	The Bank of Israel lowers its key interest rate.	The Bank of Israel reduced its key interest by another 0.5 percentage points, bringing it to 3% as of 14.11.2008.

Month	Date	Event	Details
November	11	Tax concessions are granted to the US energy industry.	Entrepreneurs in the field of energy will be awarded tax concessions amounting to \$ 20 billion. The royalties paid to the government by firms in the oil and natural gas industries for deep-water drilling in the Gulf of Mexico will be reduced; the firms will be granted loan guarantees as well as assistance in laying a natural-gas pipe and producing renewable energies. A special paragraph instructs the Administration to increase the US's strategic oil reserve by 50%.
	11	A new aid package for the AIG company, amounting to \$ 150 billion, is approved.	The US Administration came to the aid of AIG, the biggest insurance company in the US, by means of a new aid package costing about \$ 150 billion, and constituting the biggest aid package ever granted to a private firm. \$ 40 billion of the total will be allocated to the partial nationalization of the insurance giant.
	24	The Bank of Israel's key interest rate for December is reduced.	The interest rate for December 2008 was reduced by another 0.5 percentage points, bringing it to 2.5%.
	30	The Bank of Israel continues to buy foreign currency	On 24 March 2008 the Bank of Israel introduced a plan to increase the foreign reserves. By 30 November 2008 the Bank had bought about \$ 10 billion, and the reserves stood at \$ 37 billion. The desired extent of the reserves was revised to \$ 40–44 billion, so that the purchases will continue at the rate of \$ 100 million a day.
December	4	Changes are made in the hours of trading of the Tel Aviv Stock Exchange.	The trading day on the Tel Aviv Stock Exchange was cut by one hour. Opening time will be 9 a.m. instead of 8.30 a.m., and trading will end at 4.30 p.m. Clearing-house activity will continue until 6.30 p.m.
	15	The economic stimulus package is approved.	In response to the deterioration in the state of the economy, in mid-December the Knesset Finance Committee approved a package to stimulate economic activity. The package includes the following, inter alia (amounts in parentheses, in \$ billions): expansion of multi-year infrastructure investment (10), augmentation of vocational training (0.4), increased budget for the Government Scientist in the Ministry of Industry, Trade, and Labor (0.25). In addition, in order to ease firms' credit constraints, loans were made available to small and medium-sized businesses, they were permitted to pay taxes in installments, and the guarantees required of government suppliers were reduced (0.8), investment funds for dealing with nonbanking credit were set up (5), and state guarantees were provided for financing by banks (6). Tax concessions were extended to nonresident investors.

BANK OF ISRAEL RESEARCH DEPARTMENT

Month	Date	Event	Details
December	16	The Fed reduces interest.	The US central bank reduced the interest rate from 1% to its lowest rate since 1954, 0–0.25%.
	24	A monetary plan to increase liquidity in the financial system and stimulate economic growth is proposed.	<p>The Bank of Israel announced a series of monetary measures aimed at improving the liquidity situation in the economy:</p> <ol style="list-style-type: none"> 1. As of January 2009 the Bank of Israel will reduce the absorption of excess liquidity via issues of Treasury bills (<i>Makam</i>). 2. The discount-window loan to the banking system via tenders, which are currently for a day or a week, will be supplemented by loans for longer terms. 3. The spread around the Bank of Israel's key interest rate (the 'corridor') in the credit window and the window for commercial bank deposits is reduced from $\pm 1\%$ to $\pm 0.5\%$. 4. Repo tenders for the commercial banks and institutional entities, currently offered for a week, will be offered for longer terms.
	27	The 'Cast Lead' military operation begins in Gaza.	
	29	The Bank of Israel's key interest rate for January is reduced.	The interest rate for January 2009 was reduced by 0.75 percentage points, bringing it to 1.75%.