Recent Economic Developments

120

July - December 2007

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Part 1: Review of Recent Economic Developments, July to December 2007

Main developments

During the period reviewed—the second half of 2007—the rapid economic growth that has been in evidence since 2003 continued. In 2007:Q3 GDP rose by 5.6 percent, led by the expansion of business-sector product, which was up by 7.3 percent. In contrast with previous periods, domestic resource use was predominant, its increase outstripping that of GDP and leading to a rise in imports and reduction of the current account surplus.

The expansion of domestic and global demand, expressed inter alia by a rise in energy and commodity prices, served to intensify inflationary pressures and accelerate the rate of price increases, so that during the period reviewed the CPI (Consumer Price Index) rose by an annual rate of 4.9 percent, exceeding the price-stability target.

The escalation of the subprime crisis in the US at the beginning of the period reviewed affected most of the financial markets throughout the world, giving rise to fears of a significant slowdown and financial instability. The Israeli economy, which was not exposed to a great extent to the repercussions of the crisis, was barely influenced by it directly. At the beginning of the period reviewed and towards its end, however, Israel's capital market was affected indirectly: volatility increased, risk spreads on government bonds rose, and share prices fell.

In the context of the crisis, the relative stability of the Israeli economy, especially its financial markets, is notable. This stability, which was upheld by a budget policy that adhered to a balanced budget and restrained expenditure, was expressed inter alia by the rise in Israel's credit rating and the OECD's decision to allow Israel's application for membership to go forward. Nevertheless, during the period reviewed the risk premium, measured by the interest-rate spread between Israeli and US government bonds, rose, as did the risk premium on government bonds in other emerging economies.

The second part of this review contains a more extensive discussion of three subjects: 1. Preliminary findings from the 'major unification of authorities;' 2. the implications for the labor force of predicted demographic developments; 3. the discouraged worker effect in Israel.

Aggregate and by-industry real activity

The improvement in economic activity in the period reviewed was due largely to external factors, and was supported by economic and political policy. The predominant factor was the persistence of global economic growth in spite of the effect of the subprime crisis. Fiscal policy, which acted to alleviate the tax burden and the public sector debt while maintaining a balanced budget, together with monetary policy, which kept the interest rate at a relatively low level, supported economic growth, and the security situation did not substantially restrict economic activity. In addition, the benefits of economic expansion were reaped by the public, as expressed in the strong income effect on saving and consumption. All these led to the greater expansion of domestic demand than of GDP, and hence to a steep rise in imports, as well as to the reduction of the current account surplus and real local-currency appreciation. Working against these trends was the increase in global energy and goods prices and the deterioration in the terms of trade, so that the negative effect on economic growth was slightly offset by the effect of the other background factors.[1]

GDP rose by 5.6 percent in the second half of 2007, being led by the expansion of business-sector product, which grew by 7.3 percent.[2] Domestic resource use rose by 5.7 percent in the period reviewed, continuing the 9.3 percent increase in the first half of the year (Table 1.1).

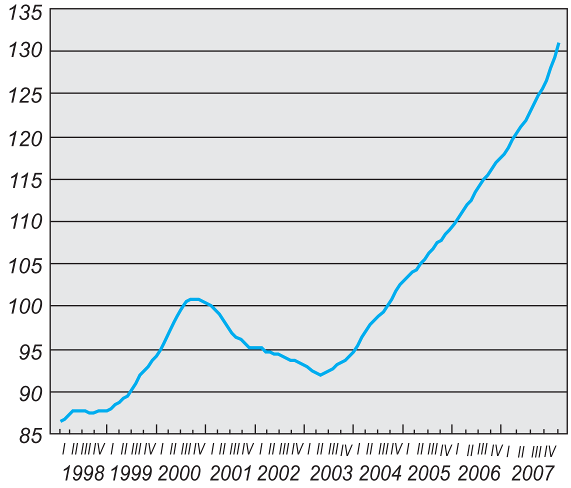
Exports, which expanded by 11.6 percent in the period reviewed (12.9 percent in 2007:Q3), continued to constitute a main factor behind economic growth. However, during the period reviewed, and in 2007 in general, domestic demand was entrenched, its overall contribution to economic growth being more significant than that of exports: the growth rates of investment in the principal industries and of private consumption accelerated. Public sector consumption also increased.

[1] The negative effect of the deterioration in the terms of trade on economic growth was limited. For a detailed account of the reasons for this, see Bank of Israel, Annual Report 2007, Chapter 2 (to be published at the end of March).

[2] In 2007:Q3 GDP rose by 5.4 percent and business-sector product by about 7 percent. The data for the second half of the year are preliminary estimates from the national accounts, while the data for 2007:Q3 are final. All the growth rates are presented in annual terms in this section.

Figure 1.1

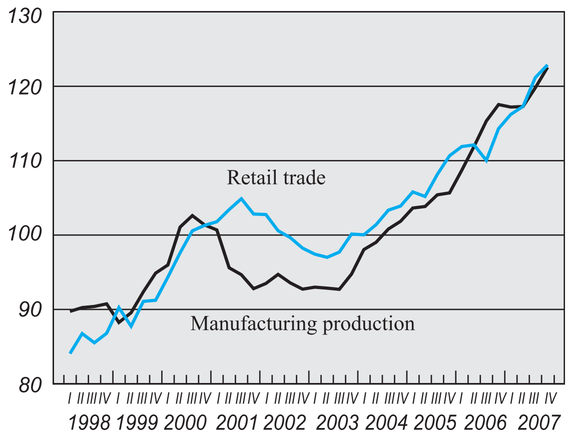
Level of economic activity,* 1998-2007**
(index: 2004 average=100)



* The composite index including the change in economic activity trend growth.
**To December 2007.

Figure 1.2

Manufacturing production* (index, average 2004=100) and large-scale retail trade** (index, average 2002=100), 1998-2007
(Seasonally adjusted)



* To November 2007.
** To December 2007.

Most of the expansion of private consumption during the period reviewed stemmed from the steep rise in the consumption of durable goods. Alongside the wealth effect of individuals, this increase reflects changes in taxation (the cancellation of purchase tax, the reduction of taxation on vehicles, and a change in the registration of the year of manufacture of vehicles). The expansion of consumption also had a significant effect on imports, as a large proportion of the products whose consumption rose were imported.

Gross domestic investment was up by 7.1 percent in the period reviewed over the first half of the year. Most of the increase derived from the rise in investment in the principal industries, which grew by 27 percent in the period reviewed, continuing its marked increase in previous quarters. The expansion of investment also reflects the rise in factor inputs, on which economic growth was based in 2007.

The indices of manufacturing production accelerated during the period reviewed, after moderating in the first half of the year (Table 1.1 and Figure 1.2). Manufactured exports also expanded substantially, with exports being diverted from the US to other markets, especially Europe. A similar picture emerges from the Companies Survey data for 2007:Q3 and 2007:Q4, attesting to the continued steep rise in output. Distribution by technological intensity indicates that during the period reviewed the growth rate of manufacturing production in the high-tech industries accelerated after a downward trend that began in 2006:Q4 and continued in the first half of 2007.

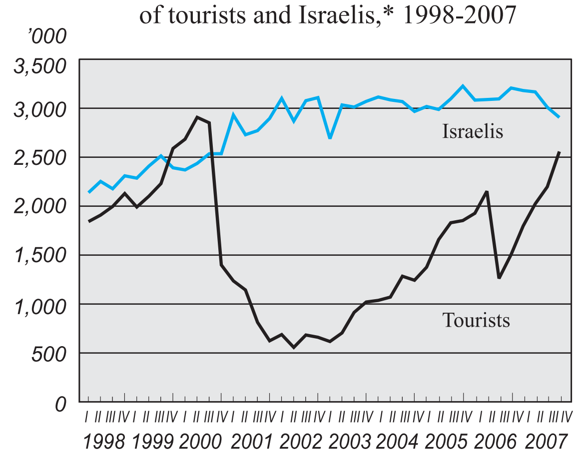
The trade and services revenue index also attests to the rapid expansion of industry revenue, albeit at a slower rate than in the first half of the year. The expansion of the ‘catering and hospitality services’ (the result of the rise in tourism) and ‘personal and other services’ (due to the increase in wealth) industries was particularly rapid.

Favorable background factors, among them the relatively tranquil security situation in the country’s central region, led to a marked rise in the demand for tourism, and hence to a notable increase in activity in the industry (Table 1.2 and Figure 1.3). During the period reviewed the number of tourist bed nights and tourist entries, as well as the extent of hotel occupancy, expanded significantly. The number of Israeli bed nights declined, however. The increase in tourism was also expressed in the high level of exports of tourism services (most of the rise in the export of tourism services occurred in the first half of the year, remaining stable in 2007:Q3 without a further increase).

The extent of activity in the construction industry continued to remain at a low level during the period reviewed despite background conditions which served to increase demand, among them rapid economic growth, the steep rise in consumption and investment in the principal industries, the expansion of wealth, and the increase in nonresidents’ demand for homes in Israel. The industry supply responded hardly at all to the sharp rise in demand: the number of building starts and completions remained in the doldrums,

Figure 1.3

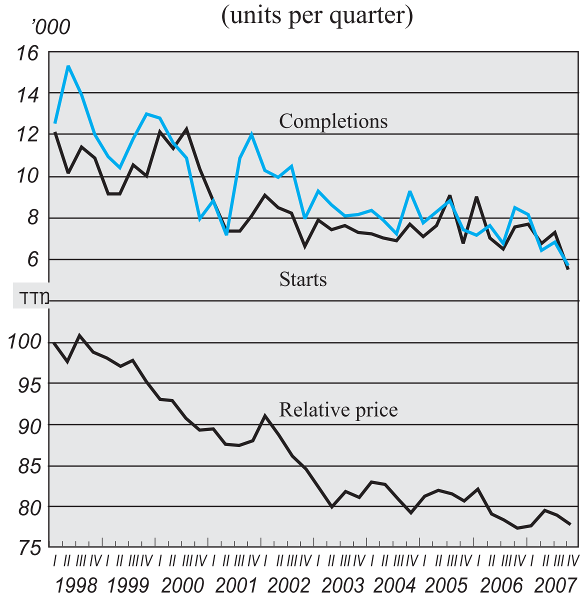
The hotel industry: monthly bed nights of tourists and Israelis,* 1998-2007



* To December 2007. Seasonally adjusted.

Figure 1.4

Housing starts and completions,* and relative price,** 1998-2007 (units per quarter)



* Original data, to October 2007. Third quarter 2007 extrapolated.
** Prices of owner-occupied dwellings relative to CPI. To October 2007.

at the low level reached in the wake of the ongoing slump, as was the case with all the other parameters of activity in the industry (Table 1.2, Figure 1.4). The persistence of the slump in industry activity was also expressed in the significant drop in the number of new housing units for sale, which was 20 percent lower in November 2007 than in November 2006. The national index of housing prices rose relatively moderately, reflecting extremely wide variance in the development of prices in different areas—a marked surge in prices in areas of high demand compared with a fall in prices in peripheral areas. The low level of construction activity was also reflected in the Companies Survey data: companies reported a decline in the extent of building starts and completions, and the leading index of activity in the industry declined despite companies' reports of a marked rise in the extent of construction work in the second half of the year.

The labor market

The rapid economic growth in the period reviewed was also reflected in the ongoing improvement in the labor market. According to the CBS Labor Force Survey for 2007:Q3 the employment rate continued to rise and stood at 52.5 percent, due to a slight increase in the participation rate, which reached 56.7 percent (continuing the marked rise in the first half of the year), and a decline in the unemployment rate, which fell to 7.3 percent[3] (Table 1.3 and Figure 1.5). Parallel to this, the depth of unemployment (the rate of unemployed persons seeking work for over six months) also contracted considerably. The decline in both the unemployment rate and the number of persons unemployed was also reflected in the marked reduction in the number of work-seekers and claims for unemployment benefit and income support payments.

However, an examination of the 2007:Q3 data indicates that the number of employed persons rose primarily in the public services, while in the business sector the increase was only moderate. Similarly, most of the rise in the number of employed persons derived from the increase in the number of part-time positions, so that their share in total employment grew. The average number of hours worked remained unchanged, so that labor inputs in the business sector grew only moderately in 2007:Q3.[4]

As stated, the increase in employment in 2007:Q3 was concentrated in the public services, where there was an increment of 26,000 employees, accounting for 3.3 percent of all employment in this sector, and this contributed to

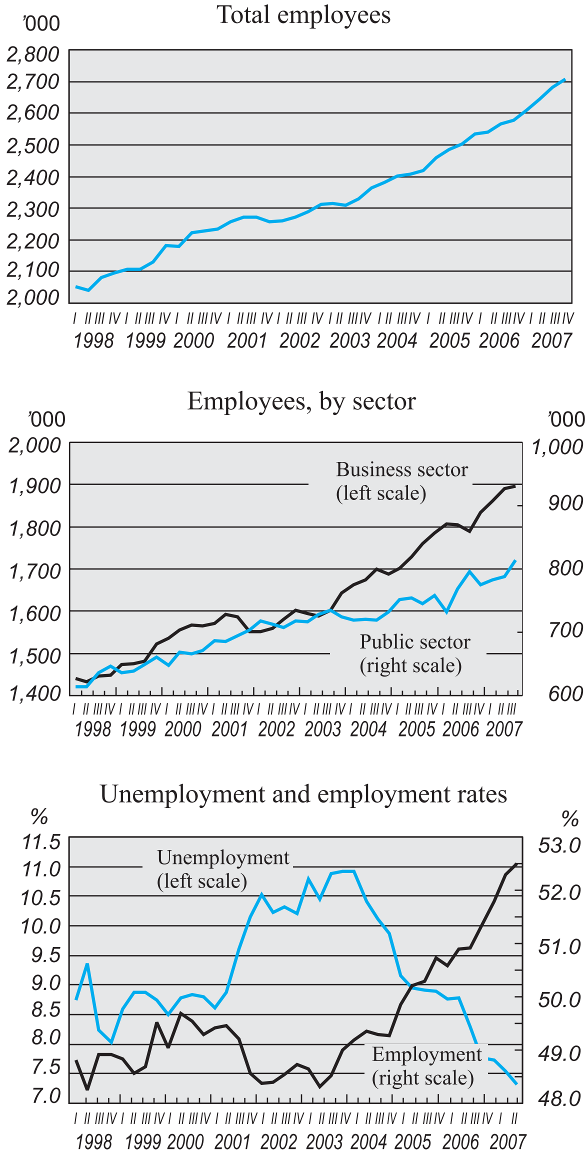
[3] Trend data (a partial sample from the Labor Force Survey) attest to a further decline in the unemployment rate in November, to 6.6 percent.

[4] Note that the high growth rate of labor inputs shown in the table is in comparison with 2006:Q3 and is influenced by the exceptional (declining) data for labor inputs during the Second Lebanon War. Note, too, that the developments described in 2007:Q3 came in the wake of the significant expansion of employment in the business sector in 2007:Q1 and 2007:Q2. It is still too soon to tell whether developments in 2007:Q3 constitute a trend change or a temporary respite.

Figure 1.5

The labor market, 1998-2007*

Total employees

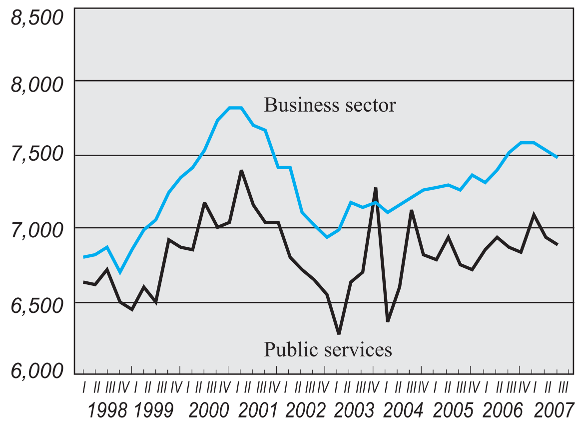


* To September 2007. Seasonally adjusted.

Figure 1.6

Real wage per employee post, 1998-2007*

(NIS, 2004 prices)



* To October 2007. Seasonally adjusted.

the decline in the unemployment rate. The most prominent increases in employment in 2007:Q3 were in education, construction, and catering and hospitality services. By contrast, employment contracted in manufacturing, after rising notably in 2007:Q1.

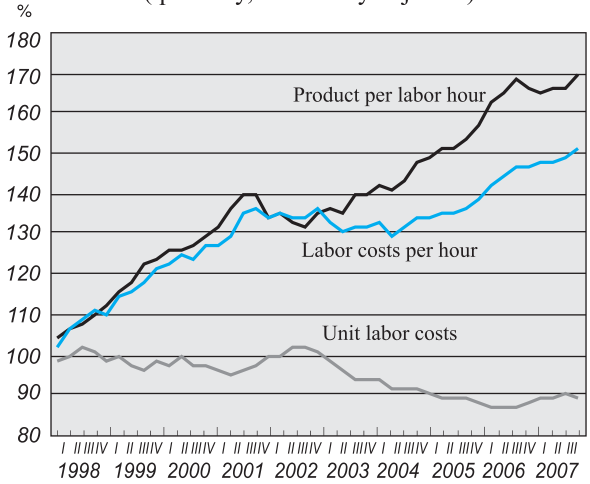
The number of foreign workers continued to rise in 2007:Q3, while the number of Palestinian workers continued to fall. The share of non-Israeli workers in the civilian labor force remained at 11 percent, similar to the share in the last two years. This stability reflects the difficulties encountered by economic policy in contending with the problem of foreign workers despite its negative economic implications.[5]

The increase in prices during the period reviewed eroded the rise in the real wage (Table 1.2, Figure 1.6). The average real wage in the business sector was up by only 1.6 percent during the period reviewed over the equivalent period in 2006, and by only 0.2 percent in the public services. The nominal wage also rose in the period reviewed, and in 2007 as a whole, at a relatively moderate rate which is not in step with the intensity of demand. There are several possible explanations for the low rate at which wages have risen. First, the growth rate of the average wage is also affected by changes in the composition of employment. Thus, for example, when a large number of new employees are taken on it is reasonable to assume that most of them will start at a lower wage than that of experienced workers. The increased share of new workers earning a low wage will skew the average wage downwards. In addition, the wage data represent gross wages, before income tax is deducted, and it is possible that the reduction in taxes, which serves to increase net wages without raising the gross wage, enables employers to raise the wage paid to workers by only a moderate rate. Note, however, that a comparison between disposable income in the gross wage in 2007 and 2006 shows that the change was minimal at all income levels (between 0.3 and 1 percentage points), and this does not explain the moderate increase in wages.

[5] See box in Chapter 5 of the Bank of Israel, Annual Report, 2007 (to be published at the end of March).

Figure 1.7

Index of nominal unit labor costs (gross) in the business sector, 1998-2007*
(quarterly, seasonally adjusted)



* To September 2007.

Unit labor costs dipped slightly in 2007:Q3 as a result of the increase in labor productivity and a smaller rise in costs per hour worked (Figure 1.7). This decline came after a long period in which labor costs rose very slowly, so that there still appears to be unutilized labor supply and potential growth that has not yet been taken up.

The protracted strike by high school teachers came to an end during the period reviewed. According to the agreement reached the teachers will receive an immediate 10 percent pay hike and another 26 percent if and when they agree to implement the extensive reform of high-school education. The strike of the senior university teaching staff, which began in October, ended in January 2008 with an agreement that grants them a 24.2 percent pay rise, to be paid in three stages starting from January 2008.

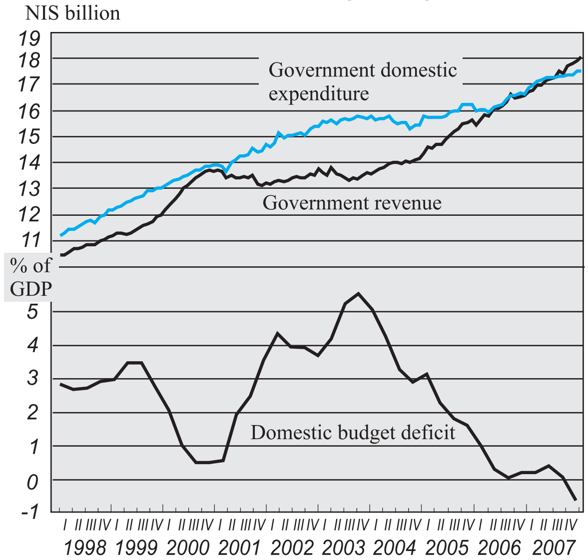
The government sector

The budget deficit amounted to NIS 1 billion in 2007, constituting 0.02 percent of GDP, far below the 2.9 percent of GDP ceiling set by the government (Table 1.4, Figure 1.8). The low deficit reflects the unexpected increase in revenues, which were NIS 15 billion higher than predicted. This increase in revenues primarily reflects tax receipts, which were NIS 11 billion more than forecast, and a NIS 2 billion surplus in National Insurance Institute revenue, which was expected at the time the budget was prepared. Adjusting for the change in legislation and one-off income, tax receipts were up by a real 9.7 percent over 2006. During the period reviewed (the second half of 2007) the growth rate of revenues (compared with the equivalent period in 2006) was higher than in the first half of the year.[6] The increase in tax receipts expresses the effect of the rapid economic growth alongside the increased profitability of firms and businesses, as well as the changes in taxation and the registration of the year of manufacture of vehicles, which led to a marked rise in purchases of new vehicles in 2007[7] and a surge in imports of durable goods, causing receipts from customs and VAT on imports to escalate.

In 2007, as in previous years, a large part of government consumption was implemented in December, but despite this increase there was significant underperformance of the budget, and actual expenditure was 97.3 percent of the planned amount. Most of the underperformance occurred in the first half of the year, and was smaller in the second half. In contrast with previous years, budgetary performance was relatively high in the ministries concerned with social

Figure 1.8

Government revenue and expenditure, 1998-2007*
(12-month moving average)



* To December 2007.

[6] The growth rates of tax receipts during this period were affected by the exceptionally low revenues during the Second Lebanon War, in 2006:Q3.

[7] The estimated rise in vehicle purchases in 2007 is also influenced by the postponement of such purchases from 2006 to 2007, so that the number of vehicle purchases in 2006 was relatively low.

welfare—99.1 percent—and in some ministries it even exceeded the planned amount because expenditure planned for 2008 was brought forward. The persistence of budgetary underperformance reflects ministries' difficulties in bringing their activities into line with the various administrative restrictions, and their inflexibility is expressed in their inability to transfer budgetary allocations from one item to another. This could adversely affect both the government's operating efficiency (since the hasty implementation of expenditure at the end of the year could lead to the inefficient use of resources), and primarily the ability to implement its policy priorities as expressed in the budget that was approved, since the strong effect of administrative practices could hamper the budgetary performance of the various ministries.

The deficit in the government's foreign account was up by NIS 2.0 billion over the planned amount as a result of increased defense imports and the early repayment of loans (Israel Bonds), as included in the deficit via the interest servicing item. Most of the foreign deficit, NIS 1 billion, was recorded in December; this was in contrast with the two previous years, when there was a surplus on the foreign account in December.

The government's activity to finance the deficit (including net credit extended) amounted to a surplus of NIS 3.2 billion. This surplus primarily reflects high privatization receipts from the sale of the Haifa Refineries and the Pi Glilot company.

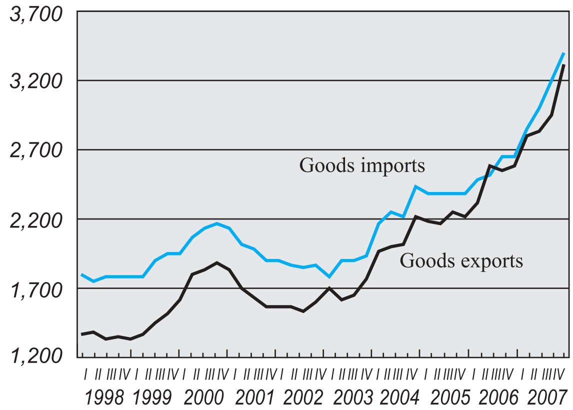
The balance of payments

The current account surplus during the third quarter of 2007 totaled $0.7 billion as compared to $1.5 billion during the second quarter. The narrowing of the current account surplus is a reflection of the growth in the goods account deficit and a decline in the surpluses of the services account and the income account, which were partially offset by an improvement in the current transfers account. The narrowing of the current account surplus continued a year-long trend that reflects, among other things, the sharp rise in imports as a result of the expansion of local demand at a higher rate than GDP.

The export of goods and services (without ships and planes and diamonds) grew by 3.1 percent during the third quarter, which is the result of a 3.5 percent increase in the export of goods and an increase of 2.3 percent in the export of services. Foreign trade figures (see Table 1.5 and Figure 1.9) show an increase of 11 percent in exports during the second half of 2007 relative to the first half. The increase in exports reflects both the growth in hi-tech exports at a

Figure 1.9

Foreign trade,* 1998-2007
($ million per month)



* Excluding ships, aircraft, diamonds, and fuel.
Seasonally adjusted. To December 2007.

rate of 8 percent during the period reviewed and, to an even greater extent, the increase in mixed technology exports at a rate of 20 percent in hi-tech–mixed technology exports and 9 percent in traditional-mixed technology exports.

The import of goods and services grew by 9 percent in the third quarter. Foreign trade figures show an increase of 13 percent in imports during the second half of the year, which was the result of a sharp increase in all of its components, particularly the import of investment assets. The terms of trade index (excluding diamonds, ships and planes and fuel) worsened during the third quarter, due to the significant rise in import prices.

The reduction in the current surplus—together with background factors to be described below—contributed to the small real depreciation in the third quarter and an appreciation of a similar magnitude in the fourth quarter. It should be noted that despite changes of this type in the short run, the real exchange rate is low relative to the past and the current account surplus remains at a high level.

Net export of capital totaled some $300 million in the third quarter, which reflects a drop both in the import and export of capital. The decrease in the export of capital in the third quarter—beyond it being the mirror image of the decrease in the current account—reflects global developments that worked to increase volatility and uncertainty and as a result the risk premium. These factors worked to offset long-term factors that tend to increase the economy's inflows and outflows.

The direct investment by foreign residents in Israel grew significantly during the third quarter, particularly in the form of shares. The direct investment by foreign residents in Israel during the last two years has been at very high levels and is part of recent global trends. From the Israeli economy's point of view, this can be seen as a sign of confidence among investors in the Israeli economy in general and in the high tech sector in particular. On the other hand, there was selling by foreign residents in their portfolios of Israeli securities, particularly debt instruments, due to the subprime crisis, an end to cuts in the interest rate and an increasingly inflationary environment.

The investment by Israelis in foreign securities, particularly corporate bonds, declined significantly during the third quarter while direct investments continued to grow at a rapid pace. The decrease in investment by Israelis in foreign securities primarily reflects selling by institutional investors against the background of the credit crisis. This followed a significant and long-lasting uptrend in institutional investment abroad, as a result of the pension reform and the tax changes in favor of investment abroad. The growth in direct investment, which is part of an ongoing trend in recent years, is part of the process of expansion of Israeli firms abroad. According to the Department for Foreign Exchange Activity of the Bank of Israel, investment abroad in 2007 was primarily in the real estate sector.

Global developments

During the period being reviewed, global growth was stable despite the concern over a slowdown in the US and to some extent in Europe. The credit crisis in the US had a major influence on the capital markets; however, its influence on world trade and growth has so far been limited (Table 1.6).

The rate of growth in the third quarter in the US was 4.9 percent in annual terms, which is the highest in the last four years. The drop in housing investment significantly affected GDP (by about one percentage point); however, the rest of its components, and in particular exports, indicated a continuation of growth. However, indicators for the fourth quarter point to a slowdown. A rapid and stable rate of growth continued in the euro zone. Its rate of unemployment fell and the crisis until now has only had a moderate effect there. Nonetheless, the preliminary indicators for the fourth quarter show signs of a slowdown. In Japan, surveys carried out by the central bank point to a continuation of recovery in economic activity and a growth in investment. In addition, companies are reporting a shortage of workers, which is an indication of improvement in the labor market. In Britain, there was moderate growth in the fourth quarter; however, consumption and investment accelerated and led to an increase in imports. It appears that the fluctuations in the capital market have not affected GDP. However, according to a survey of the credit situation, the access to credit has been adversely affected. In Asia, rapid growth has continued, which has led to an awakening of local demand and the rapid expansion of exports.

The dominant events during the second half of the year were related to price trends and the capital markets. Thus, at the beginning of the period reviewed, there was a renewed upward trend in energy prices and a significant increase in the prices of goods, which created inflationary pressure in most countries. Against the background of the credit crisis and the government and trade deficits in the US, the dollar weakened significantly against the other currencies. The fear of a slowdown in the US, which would lead to a contraction in world trade and thus adversely affect other developed economies, increased uncertainty and volatility in capital markets. The fallout from the crisis also left its mark on financial institutions outside the US.[8]

As a result of the crisis and the liquidity problems in world financial markets, the central banks urgently sought to provide liquidity to the markets in order to reduce the risk to world financial stability. In addition, the Fed reduced the interest rate in the US by a cumulative amount of one percent point.

In January 2008, following the period reviewed, the shocks to global financial markets intensified and, among other events, there was a significant cut of 0.75 percentage points in the US interest rate.

Prices, monetary policy and the money and capital markets

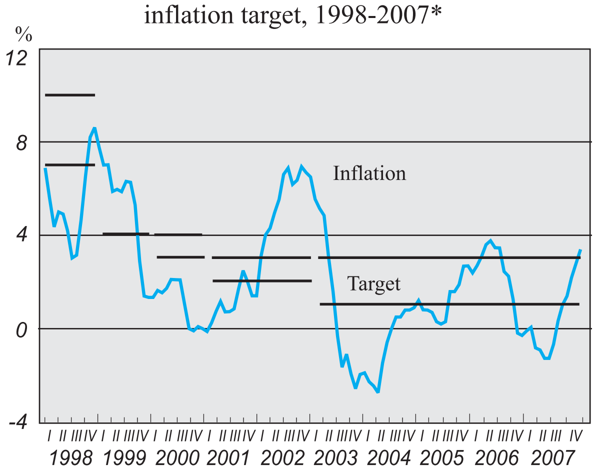
During the period reviewed, the CPI rose by 2.4 percent (4.9 percent on an annual basis). Thus, for 2007 as a whole, the rate of inflation was 3.4 percent which exceeds the price stability target range of 1–3 percent (see Table 1.7 and Figure 1.10). The main factor behind this increase was the rise in the prices of energy and food worldwide, as well as the increase in housing prices. Without these components, the CPI during the period reviewed would have risen by only one percent, which in annual terms is located in the center of the target range.[9] The changes in the exchange rate were reflected in the CPI primarily in the short run, particularly

[8] For a detailed description of the subprime crisis and its implications for the global and Israeli economies, see Chapter 4 of the Bank of Israel Annual Report for 2007 (to be published at the end of March).

[9] For a description of the components that influenced the CPI and the extent to which they contributed to the rise in prices, as well as a detailed analysis of monetary policy, see Inflation Report 21.

Figure 1.10

Inflation in previous 12 months and the inflation target, 1998-2007*



* To December 2007.

at the start of the period when the increase in the exchange rate contributed to a rise in the Housing Price Index, which in turn increased the CPI.

The Wholesale Price Index rose during the period being reviewed by the unusually high rate of 7 percent, which reflects the increasing cost of raw materials and inputs for local production in most manufacturing sectors. This index may be an indication of future increases in the CPI, although various tests of this theory in the past did not yield unambiguous evidence of this.

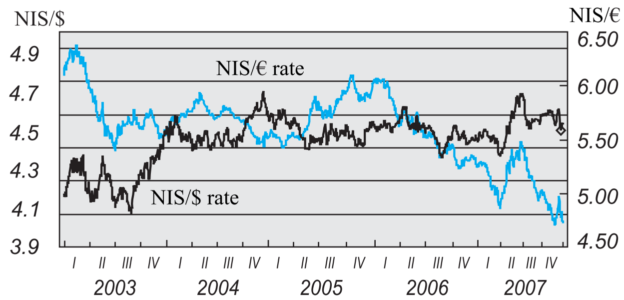
The NIS/$ exchange rate experienced a major appreciation during the period reviewed though its trend was not uniform throughout the period (Figure 1.11). At the beginning of the period (during the month of July) the exchange rate continued to rise from the low point it reached in May. The weakening of the shekel during this period, simultaneous with that of the dollar worldwide, was the result of the reduction in the interest rate which created a negative spread with the US and a negligible long term yield spread. The global shock in mid-July led to an accelerated depreciation during the second half of July but at a moderate rate relative to similar events in the past.[10] From August until the end of the period, the shekel strengthened against the dollar (apart from a temporary rise in the exchange rate in December), which mainly reflected the accelerated weakening of the dollar worldwide during the period as a result of the subprime crisis.

[10] For a detailed analysis of the trend in the foreign exchange rate during the period reviewed, see Inflation Report 21.

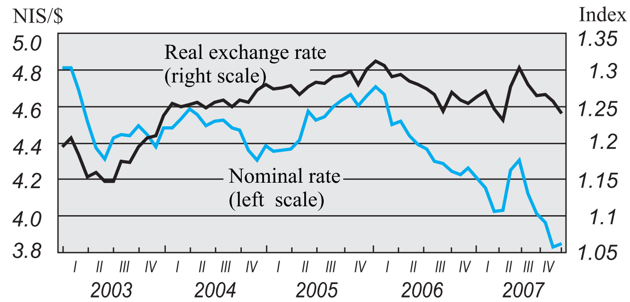
Apart from the worldwide weakening of the dollar, the exchange rate was influenced by other local and global factors during the period reviewed, some of which supported the strengthening of the shekel and some of which had the opposite effect. Among the factors that strengthened the shekel were the improvement in the economy's fundamentals and the increasing confidence in macroeconomic policy, which was reflected in the an improved credit rating for Israel, and an announcement by the OECD of Israel's candidacy for membership in the organization. These factors provided support for the continued increase in direct investment by foreign residents in Israel. The high levels of direct investment and the surplus in the current account (although it has diminished in size) created fundamental pressure for an appreciation of the shekel. The narrowing of the negative interest rate spread with the US to a level close to zero (as a result of the rise in the interest rate in Israel and the reduction in the interest rate in the US) contributed further to the strengthening of the shekel. On the other hand, there were factors acting to weaken the shekel, including the shock to global financial markets as a result of the subprime crisis and the continuing process of international diversification of investment portfolios by institutional

Figure 1.11

The nominal NIS/$ and NIS/€ exchange rates,* 2003-07



The real** and nominal NIS/$ exchange rates,* 2003-07



* To December 2007.

** The real exchange rate is calculated on a monthly basis.

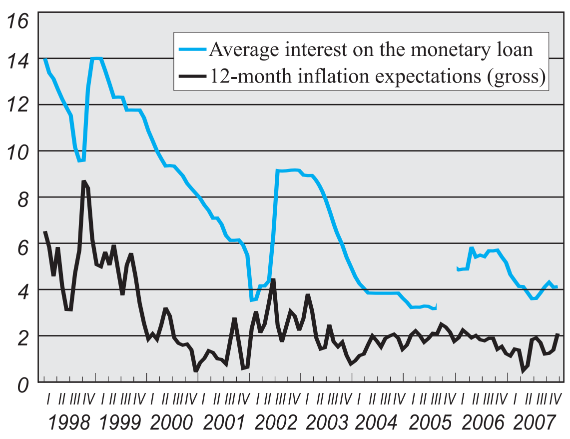
investors (following the tax reform which increased the attractiveness of investment in foreign assets).

The Bank of Israel's assessment of an increasingly inflationary environment—based on the sharp depreciation in the exchange rate, the worldwide increase in the prices of energy and other goods and the continuing rapid growth of the Israeli economy—led the Bank to raise the interest rate at the beginning of the period reviewed (during the months July–August) at a cumulative rate of 0.5 percent points to a level of 4 percent. During the period September–December, the interest rate remained unchanged in view of the Bank's assessments of the opposing forces acting on the inflationary environment. These included the continued increase in the prices of energy and goods and continued growth which was accompanied by a reduction in the output gap, that acted to increase prices. The local factors that worked to strengthen the shekel, the global factors that worked to weaken the dollar and the concerns over the effects of the credit crisis on the global economy tended to offset the increase in prices. In December, the Bank of Israel announced an increase in the rate of interest for January in the amount of 0.25 percent against the background of inflationary pressures that were reflected in the actual inflation rate and in expected inflation (Figure 1.12).

The means of payment (M1) and the broad money aggregate (M2) grew significantly during the period being reviewed and at a much faster rate than the growth rate plus the rate of inflation (Table 1.8 and Figure 1.13). In recent years, the short-term transmission mechanism from the money supply

Figure 1.12

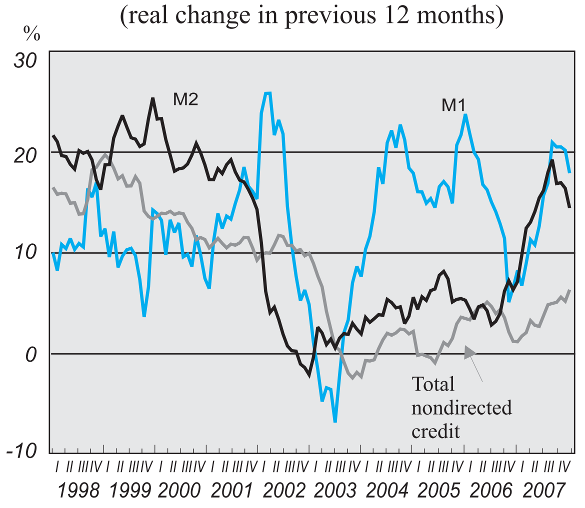
Interest and inflation expectations, 1998-2007*



* 12-month inflation expectations as calculated by the Bank of Israel Monetary Department. To December 2007.

Figure 1.13

Monetary aggregates and credit, 1998-2007*
(real change in previous 12 months)



* To December 2007.

to prices has weakened and therefore the weight of this aggregate in determining policy is secondary in importance. Total credit to the private sector also continued to grow rapidly in 2007, which was primarily due to non-bank credit. An analysis of the components of credit shows an increase in non-indexed shekel credit and CPI-indexed credit, as well as a reduction in foreign currency credit and credit linked to foreign currency, which were primarily due to changes in the exchange rate. The weight of non-bank credit also continued to grow during the period reviewed, which was the result of structural changes in the capital market, constraints on credit to large borrowers and to groups of borrowers and the relatively low rate of interest.

Real yields to maturity on bonds rose at the beginning of the period reviewed for all terms to maturity and again fell in the fourth quarter. The yield curve shifted upwards significantly in the third quarter and its slope increased, which reflected expectations of a moderate increase in the rate of interest. In the fourth quarter, there was another upward shift in the curve, though more moderate and in the short terms to maturity only (up to 9 months). The curve's slope flattened, which reflects investors' expectations that the rate of interest will not be raised in the near future.

The value of the public's asset portfolio remained almost unchanged, following a rapid and large increase during the first half of the year. This development is explained by the drop in the volume of shares and bonds issued during the second half of the year relative to the first half and by the influence of global and local shocks that acted to reduce share prices and to increase bond spreads. However, as a result of the developments in the market for private bonds and the resulting unprecedented volume of corporate bonds issued in 2007, the share of traded corporate bonds in the asset portfolio rose while the share of non-traded private bonds and of investment by Israeli residents in foreign bonds fell.

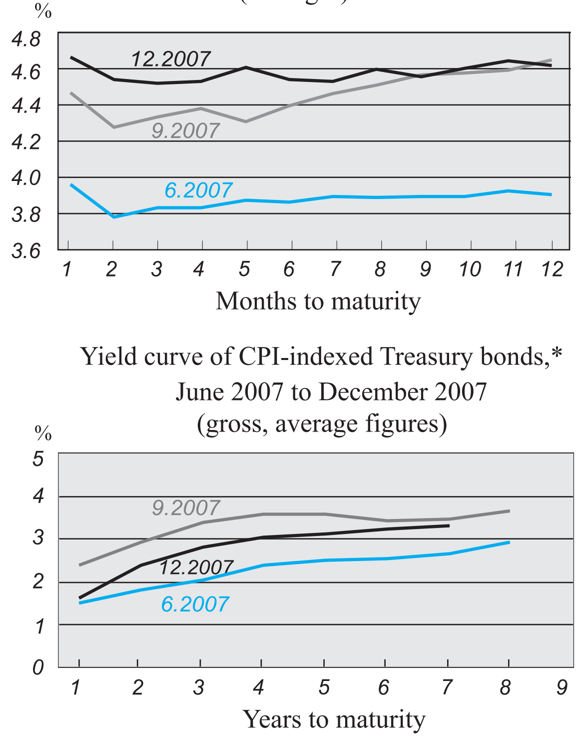
The first half of 2007 saw record levels reached in the financial markets, which characterized both the primary and secondary markets: the increase in share prices and volume continued; the issuing of shares increased significantly; and there was an unprecedented amount of capital raised in the corporate bond market. In contrast, the second half of the year was influenced to a great extent by global developments, including increasing volatility, increased risk premiums on bonds and falling share prices at the start of the period and at the end. These developments reflect intense opposing forces: the positive effect of continuing rapid growth, corporate profitability and reforms in the capital market and the negative effect of increasing oil prices, the subprime crisis and the volatility in world capital markets, which acted to increase uncertainty, to raise the risk premium and to reduce share prices. Already during the last week of July, against the background of the worsening credit crisis in the US, the prices of financial assets also fell in Israel. From the last week of July until mid-August, the main share indexes of the Tel Aviv Stock Exchange fell, which was a reflection of what was occurring in many stock exchanges worldwide; however, the fall in share indexes was interrupted in mid-August and prices began to increase again. The indexes again began to fall in November, as they did on stock exchanges worldwide due to concerns over the effects of the credit crisis. There was a similar trend in the yields on government bonds. Thus, bond yields, both indexed and non-indexed, rose significantly during August and fell again during the fourth quarter (Table 1.9 and Figure 1.14). The increase in bond yields in Israel resembled the changes in yields in emerging economies while in the US and other developed economies government bond yields declined as a result of the transition from high-risk assets to assets perceived as being more secure. Despite all this, the effect of the subprime crisis on the Israeli economy and the Israeli capital market was limited in scope. Bank Hapoalim was the only bank that reported significant losses as a result of exposure to the crisis and was forced to write off $290 million of its investments during the second half of 2007.

The most positive developments this year occurred in the bond market, which was influenced to a large extent by the reduced amount of capital raised by the government (as a result of the reduction in the public debt) and to an even greater extent by the pension reform (which involved changes in the structure of investment by pension funds and provident funds and the cessation of the issue of designated bonds to the pension funds).

Figure 1.14

Makam yield curve, June 2007 to December 2007 (averages)

Yield curve of CPI-indexed Treasury bonds,* June 2007 to December 2007 (gross, average figures)



* Excluding the yield on CPI-indexed 10-year bonds.

Table 1.1. National Accounts,[a] 2006-07

		2006	2007			2007	
	2006	IV	I	II	III	III[b]	Last month for which data available
GDP	5.2	7.7	6.0	5.6	5.4	6.2	Sep
Busines sector product	6.5	9.8	7.0	6.7	7.0	7.6	Sep
Private consumption	4.5	6.6	10.1	5.0	7.6	7.3	Sep
Gross domestic investment	5.3	116.0	-16.0	47.5	-5.8	26.0	Sep
Fixed investment	10.1	7.5	8.5	14.0	42.7	17.4	Sep
Goods and services exports[c]	5.9	12.3	7.6	11.4	9.7	10.2	Sep
Goods and services exports							
excl. diamonds	10.1	11.5	7.9	8.7	12.9	10.2	Sep
Goods and services imports[d]	3.3	47.1	4.4	20.5	8.9	19.2	Sep
Goods and services imports							
excl. diamonds	5.1	24.0	20.1	19.4	8.5	17.9	Sep
Public sector consumption	2.3	3.4	-0.3	6.0	2.2	2.8	Sep
Public sector consumption							
excl. defense imports	1.5	0.6	4.9	1.6	3.6	2.7	Sep
Domestic use of ressources	3.9	17.3	4.7	11.0	2.5	8.7	Sep

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

[b] Compared with 2006:III

[c] New calculation - excluding subsidies.

[d] New calculation - excluding taxes.

SOURCE: Central Bureau of Statistics.

Table 1.2. Indicators of Business Activity,[a] 2006-07

		2006	2007					
	2006	IV	I	II	III	IV	Jul 07-Dec 07[b]	Last month for which data available
Composite state-of-the-economy index	3.7	6.6	8.1	8.8	8.9	12.6	8.9	Dec
Large-scale retail trade	4.3	16.5	6.8	3.8	13.9	5.8	8.8	Dec
Manufacturing production								
(excl. diamonds)	8.3	7.9	-1.2	0.3	8.8	9.5	4.8	Nov
Index of revenue in commerce	5.5	12.4	12.2	7.9	5.5	1.9	8.5	Nov
Index of commerce and services revenue	8.3	12.8	14.2	8.5	4.4	1.0	9.0	Nov
Index of export - services	-2.1	-14.7	120.0	4.2	14.5	48.2	26.6	Dec
Tourist arrivals	-3.7	126.6	113.1	5.3	59.7	93.0	65.2	Dec
Residential construction[b]								
Starts	-1.5	11.5	-14.3	-3.8	11.7		2.1	Oct
Completions	-7.0	14.2	13.2	-15.7	1.2		-9.2	Oct
Nonresidential construction[b]								
Area of starts	54.7	-10.0	-53.1	-34.1	-24.8		-24.8	Sep
Survey of companies (net balance, percent)[c]								
Weighted balance of the business sector	28	33	24	30	40	38		Dec
Output of manufacturing firms	29	27	26	24	34	25		Dec
Sales by trading firms	33	39	31	36	47	42		Dec

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

[b] Change from equivalent period one year earlier.

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

SOURCE: Central Bureau of Statistics.

Table 1.3. Indicators of Labor Market Developments,[a] 2006-07

	2007		2006	2007					
	III	IV	IV	I	II	III	IV	Jul 07-Dec 07[b]	Last month for which data available
	('000s)		percent change from previous quarter						
Civilian labor force	2,920		0.7	1.3	1.2	0.6		3.5	Sep
Israeli employees	2,706		1.2	1.3	1.4	0.9		4.9	Sep
Of which: in general government	814		-2.7	1.0	0.8	3.3		2.6	Sep
in business sector	1,894		2.5	1.5	1.5	0.3		5.9	Sep
Foreign workers and Palestinians									
(unadjusted)	364		2.2	0.0	-1.3	3.9		4.8	Sep
Average hours worked weekly per									
employee	36.3		2.2	0.0	-1.4	0.0		-0.6	Sep
Labor input in business sector									
(incl. foreign workers and									
Palestinians)	92,165		3.5	0.7	0.5	1.2		5.9	Sep
Of which: Israelis	81,331		4.0	0.7	0.8	0.9		5.3	Sep
Labor input in general									
government (Israelis)	16,915		-1.8	5.7	-4.0	2.0		-1.1	Sep
Unemployed	214		-5.7	0.9	-1.4	-2.4		-10.7	Sep
Work seekers	198	193	-2.2	-1.6	-1.3	-2.5	-2.6	-8.1	Nov
Claims for unemployment benefit	63	58	-2.5	-2.5	-0.8	-3.1	-8.1	-11.1	Dec
	Nominal NIS (unadjusted)[c]								
Real wage per employee post[c]	7,348	7,040	0.9	0.2	1.2	-1.2	0.9	1.0	Oct
In general government	7,117	6,685	-1.0	-0.4	3.6	-2.1	-0.7	0.0	Oct
In business sector	7,449	7,197	1.8	0.8	0.1	-0.8	-0.5	1.5	Oct
Nominal wage per employee post[c]	7,718	7,395	0.0	0.4	1.3	0.1	1.2	2.3	Oct
In general government	7,475	7,022	-1.9	-0.1	4.0	-1.0	-0.3	1.2	Oct
In business sector	7,824	7,559	1.0	0.9	0.2	0.6	-0.1	2.7	Oct
				percent					
Participation rate			55.6	56.1	56.6	56.7			Sep
Employment rate			51.3	51.8	52.3	52.5			Sep
Unemployment rate			7.8	7.7	7.5	7.3			Sep
Depth of unemployment[d]			36.7	42.1	36.2	33.8			Sep

[a] Seasonally adjusted.

[b] Compared with July 2006 - December 2006 (unadjusted).

[c] Including foreign workers and Palestinians.

[d] 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, 2006-07

	2006	2006	2007				Jul 07-Dec 07	Last month for which data available
		IV	I	II	III	IV		
Domestic deficit as percent of GDP	0.2	-3.6	5.1	1.1	2.2		2.2	Sep
Deviation from domestic budget path, excl. credit[a]	NIS billion, current prices						NIS billion[b]	
Revenue	10.0	0.7	4.1	3.6	4.1	3.2	3.6	Dec
Expenditure	0.3	-0.1	-2.2	-2.1	-0.7	-0.6	-5.4	Dec
Deficit	-9.6	-0.8	-6.3	-5.7	-4.8	-3.8	-9.0	Dec
Total deficit excluding credit	-5.5	-8.1	6.4	-0.8	2.2	-7.9	4.4	Dec
Government tax revenue	6.9	7.2	7.3	5.4	6.7	5.0	5.1	Nov
of which: income tax, net	12.3	8.1	10.6	4.0	-3.2	4.5	-2.2	Nov
VAT, gross	4.6	6.5	0.4	2.3	10.5	9.6	10.1	Dec
Government expenditure	3.4	6.5	9.0	3.8	0.8	1.0	0.9	Dec
National insurance allowances	3.2	8.8	4.8	4.5	1.5	-5.4	-0.5	Oct
of which: Unemployment benefit	-3.8	-0.9	-7.4	-7.9	-8.5	-28.1	-12.0	Oct
Income support	-7.1	-5.9	-6.6	-5.8	-9.3	-9.0	-9.0	Oct
National Insurance contributions received from the public	2.3	6.3	2.9	6.1	7.7	-1.1	5.5	Nov

[a] The path was determined on the basis of a deficit of 3.0 percent of GDP.

[b] Change from respective period, previous year. Does not relate to seasonal path.

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

Table 1. 5. Foreign Trade, Balance of Payments, and the Reserves,[a] 2006-07

		2006	2007					
	2006	IV	I	II	III	IV	Jul 07-Dec 07[b]	Last month for which data available
	percent change from previous period[c]							
Trade in goods[d]								
Goods imports	8.0	0.2	7.2	5.3	6.8	6.3	23.9	Dec
Of which: Consumer goods	10.6	-0.6	19.1	3.0	6.3	4.2	30.3	Dec
Capital goods	4.4	-0.4	6.5	8.1	10.7	6.6	31.0	Dec
Intermediates	8.6	0.7	3.7	5.2	5.5	7.0	19.3	Dec
Goods exports	13.8	1.6	8.3	1.1	3.8	12.4	20.4	Dec
Of which: Manufacturing	14.3	1.6	7.4	1.8	4.2	11.8	20.1	Dec
Of which: High-tech	20.4	0.5	3.9	3.1	-0.2	12.8	12.1	Dec
	$ million							
Balance of payments								Sep
Goods and services exports	62,992	16,322	16,636	17,199	17,738			Sep
Goods and services imports	61,892	16,537	16,782	17,899	19,228			Sep
Balance of trade in goods and services	1,100	-215	-146	-699	-1,491			Sep
Current account surplus	7,990	1,832	1,392	1,451	712			Sep
Financial account (excl.								Sep
foreign exchange reserves)[e]	-2,091	-1,798	-714	-1,483	-32			Sep
Of which: Nonresidents' direct investment[e]	3,575	4,168	2,866	2,086	3,030			Sep
Nonresidents' portfolio investment[e]	2,023	1,561	1,018	910	-755			Sep
Residents' direct and portfolio investment								
abroad[e]	5,509	3,699.0	3,881.0	4,395.0	1,867.0			Sep
Net foreign debt (precent of GDP)[e]	-23.0	-23.1	-21.0	-20.9	-20.2			Sep
Bank of Israel reserves, end-period[e]	29,055	29,055	30,504	28,969	29,130	28,410		Dec

[a] Seasonally adjusted.

[b] Compared with July 2006 - December 2006 (unadjusted).

[c] The change relates to the dollar values of imports and exports, not to their volumes.

[d] Data on trade in goods do not include ships, aircraft, diamonds, and fuel.

[e] Unadjusted data.

SOURCE: Central Bureau of Statistics.

Table 1. 6. Indicators of Economic Development in Advanced and Developing Countries[a] (annual rate of change, percent)[b]

					Estimated	Projection
	2003	2004	2005	2006	2007	2008
World GDP	4.0	5.3	4.8	5.4	5.2	4.8
Advanced countries	1.9	3.3	2.5	2.9	2.5	2.2
Developing countries	6.7	7.7	7.5	8.1	8.1	7.4
World trade	5.4	10.6	7.5	9.2	6.6	6.7
Advanced countries						
Imports	4.1	9.1	6.1	7.4	4.3	5.0
Exports	3.3	8.9	5.8	8.2	5.4	5.3
Developing countries						
Imports	10.3	16.4	12.1	14.9	12.5	11.3
Exports	10.8	14.6	11.1	11.0	9.2	9.0
Commodity prices (US$)						
Oil[c]	15.8	30.7	41.3	20.5	6.6	9.5
Nonfuel	6.9	18.5	10.3	28.4	12.2	-6.7
Inflation (CPI) in advanced countries	1.8	2.0	2.3	2.3	2.1	2.0
Short-term interest[d] (%)						
Dollar deposits	1.0	1.4	3.8	5.3	5.2	4.4
Euro deposits	2.3	2.1	2.2	3.1	4.0	4.1
Unemployment rate in advanced countries	6.5	6.3	6.0	5.6	5.3	5.5

[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.

[c] Average price per barrel in 2006 was $64.27.

[d] Six-month Libor rate for US dollar deposits, and three-month Libor rate on euro deposits.

SOURCE: World Economic Outlook (IMF), October 2007.

Table 1.7. Selected Price Indices,[a] 2006-07

	2006	2006 IV	2007 I	2007 II	2007 III	2007 IV	Jul 07-Dec 07[b]	Last month for which data available
	Rate of change during quarter							
CPI	-0.1	-0.9	-0.2	1.2	1.3	1.1	2.4	Dec
CPI excl. housing, fruit and vegetables	0.9	-0.7	-0.1	1.7	0.1	2.0	2.1	Dec
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	1.4	-1.4	0.6	1.2	0.6	1.3	1.9	Dec
Housing price index	-6.1	-2.9	-0.3	-0.1	4.7	-2.3	2.3	Dec
Wholesale price index	2.1	-2.8	1.6	2.5	1.9	5.0	7.0	Dec
NIS/$ exchange rate	-8.9	-3.5	0.0	-0.4	-2.3	-4.5	-6.7	Dec
NIS/Euro exchange rate	1.5	0.2	0.2	0.9	1.0	0.3	1.3	Dec
	Rate of change over previous twelve months							
CPI	2.1	-0.2	-0.6	-1.1	0.9	0.9	2.3	Dec
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.6	1.0	0.5	0.0	0.7	0.7	2.4	Dec

[a] Rates of change during period, percent.

[b] Change in last six months. In half-yearly terms.

SOURCE: Central Bureau of Statistics.

Table 1.8. Monetary Aggregates and Nondirected Bank Credit, 2006-07
(annual terms, percent)

		2006	2007						
	2006	IV	I	II	III	IV	Comulative in previous 12 months	Jul 07-Dec 07	Last month for which data available
Rates of change							During period		
M1[a]	13.7	-1.3	21.0	23.3	38.4	2.1	19.3	17.5	Dec
M2[b]	4.9	9.5	22.8	19.3	21.1	2.3	14.7	9.1	Dec
M3[c]	7.4	6.9	19.8	13.7	22.2	4.6	14.0	11.2	Dec
Nondirected bank credit	3.6	-0.5	3.8	7.0	10.1	1.8	6.4	4.5	Dec
Unindexed local-currency credit	12.3	18.0	20.0	17.3	3.3	8.7	12.1	6.9	Dec
CPI-indexed credit	1.1	-7.1	-6.3	1.4	14.0	4.2	4.1	7.3	Dec
Credit in and indexed to foreign currency	-7.6	-23.7	-13.0	-7.7	22.3	-18.4	-3.7	-6.6	Dec

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

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

[c] M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

Table 1.9. Interest Rates. Yields. and the Share-Price Index. 2006-07
(quarterly average, percent)

		2006	2007					
	2006	IV	I	II	III	IV	Jul 07-Dec 07[a]	Last month for which data available
Nominal interest on								
SRO deposit[s]	4.1	4.1	3.3	2.8	2.8	3.0	2.8	Sep
Nondirected local-currency credit	8.4	8.3	7.8	6.9	7.9	7.9	7.9	Nov
Effective local-currency credit	5.3	5.5			3.7	4.1	3.9	Dec
LIBID 3-month dollar intrest	5.1	5.2	5.2	5.2	5.3	4.9	5.1	Dec
Yield to maturity on:								
12-month bonds	5.5	5.1	4.5	3.8	4.5	4.5	4.5	Dec
5-year bonds	3.7	3.6	3.2	2.9	3.4	3.3	3.3	Dec
Risk premium[b]	0.3	0.3	0.2	0.2	0.2	0.3	0.2	Dec
12-month inflation expectations[c]	1.8	1.4	1.3	1.0	1.6	1.5	1.6	Dec
General Share-Price Index (change)	5.4	7.5	10.1	11.0	-0.7	1.7	0.9	Dec

[a] Compared with July 2006 - December 2006.

[b] As measured by the 5-year credit-default-swap (CDS) market.

[c] 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.

Preliminary findings regarding the consolidation of local authorities

As part of the 2003 Recovery Plan for the Israeli Economy, twenty-three local authorities were consolidated into eleven larger ones through a legislative process. The goal of this move was to reduce their dependence on the central government for funding through the exploitation of economies of scale. An examination of the budget data for the consolidated local authorities shows that the hoped-for increase in efficiency has not yet been achieved. Thus, for example, the ratio of expenditure per resident in local authorities that were consolidated to that of similar local authorities that were not rose between the two years before consolidation and the two years after. In most of the cases, the opposition of the residents to the consolidation and the lack of coordination with government ministries were the factors that led to the increase in this ratio, particularly among the non-Jewish local authorities.

Similar studies in Israel and other countries have found that in the longer term as well, the consolidation of local authorities leads to budget savings only if it has the support of the residents and creates economic opportunities that did not exist previously or if it leads to the dismantling of less efficient local authorities. In many cases, the consolidation leads to an increase in expenditure along with an improvement in the services provided to the residents; however, this occurs without the expected increase in efficiency in expenditure categories that are subject to economies of scale.[11]

An analysis of the effect of the consolidation on the local authorities' revenues and expenditures in the relatively short run is liable to be problematic since the initial years following the consolidation are characterized by one-time expenses resulting from the dismissal of employees and organizational changes. Nonetheless, it is in the public interest to analyze the results of the consolidation even in the short run in order to draw conclusions that can be implemented in the consolidation of additional local authorities in the future. [12]

Consolidation of local authorities and economies of scale

The effort on the part of the government to consolidate local authorities is based on the lack of economies of scale in small local authorities. Economies of scale are concentrated in expenditures that have a large fixed component. An example would be expenditure from the "General and Administrative Expense" budget calculated per resident, which is up to four times larger in small local authorities (less than 10,000 residents) than in large ones. Expenditure on salaries for elected positions in the local authorities is also subject to economies of scale and thus decreases with the size of the local council when calculated per resident. As a result, the burden of the salaries of elected positions is 12 times higher in small local authorities than in large ones (Table 2.1). These findings are particularly significant in view of the large number of small local authorities.

The consolidation of local authorities was carried out against the background of a budget crisis, which particularly affected the weak local authorities. The crisis was the result of poor management in some of the local authorities and of a sharp cut in equalization grants, which amounted to more than NIS 800 million (about 19 percent), as part of the 2003 Economic Plan. The cut disrupted the supply of many municipal services. Some of the local authorities were on the verge of a liquidity crisis which led to delays in the payment of salaries and expenses for an extended period. This was particularly true for the local authorities in the lower socioeconomic groupings, for which the grants are the principal source of revenue, and in particular non-Jewish local authorities in the four lowest clusters. [13]

[11] Davidovich-Martin, R, and A. Tabac (2005). "Consolidation of Local Authorities—Documentation, Conclusions and Recommendations," Ministry of the Interior, position paper. See also the recommendations of the Local Authorities Group at the Caesarea Conference, "Reform of Local Government: Decentralization for the Strong and Reorganization for the Weak," the Institute for Democracy, July 2004.

[12] In January 2006, the local authority Menahemya was consolidated with the Beit-Shean Regional Council. Recently, the Ministry of the Interior published an updated plan for the consolidation of additional local authorities, according to the government decision made on September 2006 regarding the continuation of the process to consolidate local authorities

[13] Navon, G., (2006). "The Budget Dynamics of the Local Authorities," Bank of Israel Survey 79, 139–172.

Table 2.1. Characteristics of the Local Authorities, 2005

	Number of local authorities	Residents (thousands)	Regular budget expenditure per resident (shekels)	General and Administrative expense per resident (shekels)	Salaries of elected positions per resident (shekels)
Size of the authority					
50+	23	3,731	5,160	172	10
20–50	47	1,534	4,887	230	36
10–20	43	615	4,427	272	59
5–10	52	362	5,035	332	74
5–0	32	91	6,784	603	170
Regional Councils	54	609	7,007	699	63
Jewish	171	5,574	5,196	203	21
Arabs	80	1,368	4,129	262	61

[1] The Jewish local authorities that were consolidated are compared to small Jewish local authorities (less than 10,000 residents) that were not. The non-Jewish local authorities that were consolidated are compared to the rest of the non-Jewish local authorities. A number greater than 100 indicates higher expenditure relative to the reference group.

Budget data for 2004–05: initial findings

Below is a comparison of data on budget performance for the consolidated local authorities relative to similar unconsolidated local authorities for the years 2001–02 (before the consolidation) and 2004–05 (after the consolidation). The reference group of Jewish local authorities includes all 73 local authorities whose population was less than 10,000 prior to the consolidation while the reference group of non-Jewish local authorities includes all 43 non-Jewish local authorities that were not consolidated.

The ratio of expenditure per resident in the local authorities that were consolidated to the expenditure per resident in the local authorities that were not rose during the two years following the consolidation (2004–05) in comparison to the two years previous to the consolidation (2001–02; Table 2.3) in most of the cases. This means that the drop in expenditure per resident in the local authorities that were consolidated was more moderate than in the parallel local authorities that were not. An exception is the consolidation of Modi'in with Maccabim–Reut where there was no significant change in expenditure per resident relative to the reference group, which reflected an 11 percent decrease in expenditure per resident (achieved through the dismissal of 42 percent of senior employees and the transfer of the Maccabim–Reut Council to the consolidated Modi'in Local Authority). The real expenditure per resident in the City of Carmel and the consolidated municipality of Baka–Gat rose by 17 percent and 6 percent, respectively, during the two years following the consolidation, despite the dismissal of employees. This was a result of the opposition of residents, which prevented the organizational change.

In this context, it is important to mention the findings of the committee that monitors the implementation of the consolidation, according to which the consolidation of local authorities is worthwhile in two extreme cases: if the consolidation leads to the dismantling of a failing local authority and its assimilation within a nearby stable local authority or if it produces a stable economic revenue infrastructure in the consolidated local authority over time.

Another important comparison is related to the collection of municipal tax. In 2005, the rate of collection of municipal tax in Arab local authorities was 30 percent on average, as compared to 65 percent in Jewish local authorities. This difference is the result of the hamula structure that makes collection difficult in the Arab local authorities and the difference in socioeconomic levels. In addition, residents are less willing to pay for local services out of a feeling of discrimination and lack of trust in the government authorities. Even when socioeconomic characteristics are controlled for, the collection of municipal tax in the Arab local authorities is lower by 20 percent on average than in parallel Jewish ones. [14]

A comparison of the rates of municipal tax collection during the two years prior to the consolidation (2001–02) to the two years following (2004–05) show that in the Jewish local authorities that were consolidated the rate remained almost

[14] Brender, A. (2004). "Do Minorities Respond to Discrimination with Intensified Self Effort or with Alienation? Tax Collection in the Arab Local Authorities as a Case Study," Falk Institute, Discussion Paper 04.03, September 2004.

Table 2.2. Expenses per Resident relative to Similar Local Authorities that were not Consolidated[a]

	Before the consolidation		Year of the consolidation	Following the consolidation	
	2001	2002	2003	2004	2005
Jewish local authorities					
Kadima–Zoran	83	68	79	79	82
Binyamina–Givat Ada	93	78	84	94	89
Yehud–Neve Ephraim	99	81	93	94	94
Modiin–Maccabim–Reut	77	61	69	70	66
Non-Jewish local authorities					
City of Carmel (Dalyat el Carmel–Ossifieh)	89	85	103	89	117
Baka–Gat	79	80	86	83	87
Shagur (Bana, Dir el Assad and Majad el Krum)	84	81	80	77	79

[a] The Jewish local authorities that were consolidated are compared to small Jewish local authorities (less than 10,000 residents) that were not. The non-Jewish local authorities that were consolidated are compared to the rest of the non-Jewish local authorities. A number greater than 100 indicates higher expenditure relative to the reference group.

Table 2.3. Rate of Collection of Municipal Tax in Local Authorities that were Consolidated[a]

	Before consolidation		Year of consolidation	Following consolidation	
	2001	2002	2003	2004	2005
Jewish local authorities					
Kadima–Zoran	80	80	69	83	84
Binyamina–Givat Ada	84	84	70	80	83
Yehud–Neve Ephraim	89	89	58	74	69
Modiin–Maccabim–Reut	91	83	85	88	85
Non-Jewish local authorities					
City of Carmel (Dalyat el Carmel–Ossifieh)	60	60	29	54	47
Baka–Gat	57	57	16	43	21
Shagur (Bana, Dir el Assad and Majad el Krum)	61	61	15	33	36

[a] Includes municipal tax on residences and non-residences less doubtful debts.

unchanged,[15] as expected, while in the Arab local authorities that were consolidated the rate of collection dropped significantly, even relative to other Arab local authorities. This finding is particularly noticeable in the consolidation of Baka–Gat and of Shagur where there was strong opposition to the consolidation among the residents and the heads of the local authorities.

The above analysis yields conclusions that are relevant to the implementation of plans for the consolidation of additional local authorities in the future: in order for a consolidation to succeed, it is important to explain its rationale to residents and to coordinate the move with them in the hope that they will convince the heads of the local authorities of its necessity. In the literature, the involvement of the local authorities being consolidated is a significant factor in the achievement of increased efficiency. In addition, consolidations should be closely monitored in order to identify problems at an early stage.[16] There should be continued monitoring of the performance of consolidated local authorities in the longer term and the findings of the monitoring committee

[15] An exception is the consolidated town of Yehud–Neve Ephraim where there was a decrease in the rate of municipal tax collection.

[16] See the recommendations of the report prepared for the 2004 Caesarea Conference (see footnote 11 above).

Table 2.4. List of Towns in the Consolidation of Municipalities and Local Councils[a]

	Primary Local Authority			Secondary Local Authority			Consolidated Local Authority		
	Name	Population	Cluster	Name	Population	Cluster	Name	Population	Cluster
1	Majad el Crum	11,125	2	Bana	6,535	2	Shagur	25,672	2
				Dir el Assad	8,012	2			
2	Baka el Garbiya	19,224	3	Gat	8,388	2	Baka–Gat	27,612	3
3	Dalyat el Carmel	13,099	4	Ossifieh	9,381	4	Dalyat el Carmel–Ossifieh	22,480	4
4	Kadima	8,733	7	Tsoren	5,452	7	Kadima–Tsoren	14,185	7
5	Benyamina	6,044	8	Givat Ada	2,452	7	Binyamina–Givat Ada	8,496	7
6	Yehud	21,578	7	Neve Monoson	2,560	9	Yehud–Monoson	24,138	7
7	Modiin	30,996	8	Maccabim–Reut	10,663	9	Modiin–Maccabim–Reut	41,659	8
8	Kochav Yair	4,903	9	Tsur Yigal*	6,630		Kochav Yair	11,533	8
9	Savion	2,488	10	Ganei Yehuda*	740		Savion	3,228	10

[1] The Central Bureau of Statistics, "Characterization of Local Authorities and their Socioeconomic Grouping" (2004).
* Tsur Yigal and Ganei Yehuda were prior to the change in the local councils in the South Sharon Regional Council district.

Table 2.5. List of Towns in the Consolidation of Regional Councils[a]

	Before Consolidation			Incoming Local Authority		Outgoing Local Authority		After Consolidation	
	Name	Population	Cluster	Name	Population	Cluster	Population	Number of Towns	Population
10	Hof Carmel	43,388	6	Atlit*	4,477			22	47,865
11	Emek Hayarden	9,211	6	Kinneret*	469			21	9,680
12	South Sharon	24,316	8	Ramot Hashavim*	1,069	Tsur Yigal	6,630	29	18,015
						Ganei Yehuda	740		
13	Mateh Asher	16,399	5	Shavei Zion*	648			32	17,047

[a] The Central Bureau of Statistics, "Characterization of Local Authorities and their Socioeconomic Grouping" (2004).
* Local councils that joined regional councils as local boards.

should also relate to the changes in the level of services to residents.

It is important to also consider a policy based on the multi-organizational approach, i.e., the development of inter-municipal organizations for the supply of joint services in the areas of education, welfare, water and sewage. Experience in other countries shows that the consolidation of local authorities does not, in general, lead to budget savings in the long term if not accompanied by comprehensive change, since expenditure per resident in the absorbed local authority rises to the level in the absorbing local authority.[17] The multi-organizational approach emphasizes the importance of cooperation between local authorities and of providing optimal service.

An exceptionally large-scale municipal reform was carried out in Denmark in 2007. As part of this reform, the number of local authorities was reduced from 271 to 98 and the number of districts from 14 to 5 with the goal of exploiting economies of scale and increasing the efficiency of service to residents. As part of the consolidation, it was decided that a local authority would not include less than 30,000 residents. In addition, the consolidations were chosen by the local authorities themselves and negotiations were held between them in order to arrive at the most appropriate matches. The reform also included agreements for cooperation between neighboring local authorities, primarily in the same metropolitan area, for the supply of various services, as advocated by the multi-organizational approach.

Labor-Force Implications of Projected Demographic Developments

The age composition of the population affects the economy in many ways, foremost in the growth rate, public expenditure, and how it is financed. These effects originate mainly in changes that occur in the labor-force participation rate during the life cycle and the extent of recourse to public services—especially education and healthcare—and transfer payments. An increase in the proportion of children and elderly in the population has a slowing effect on the growth rate of the labor force and, accordingly, on the rate of economic growth. The growth of these groups also generates upward pressure on general-government expenditure and downward pressure on tax revenue. Therefore, it presents a challenge to fiscal policy.

To discuss the economic implications of demographic processes, a long-term frame of reference is needed. This is because the processes unfold slowly and can be predicted, with much certainty, to a term ranging from one decade to two.[18] Furthermore, long-term planning and preparations for coping with their implications are crucial because these processes may have momentous cumulative effects over time. Therefore, one may easily understand why the developed countries are concerned about analyzing the economic implications of the accelerated aging of their populations—a process that is expected in the decades to come and that in some countries has already begun.

Below we present an analysis of the effects of projected demographic developments on the labor force in Israel. We analyze three scenarios and illustrate the possible effects of a policy that stimulates employment in sectors that exhibit low labor-force participation. A crucial measure in such a policy is action to raise the levels of education, and especially of higher education, among members of the relevant sectors.

The analysis is based on population projections to the year 2025 calculated by the Israel Central Bureau of Statistics. The projections are based on the population in 2000 and the trends in fertility, mortality, and migration in 1995–2000. The projections have three variants that are distinct in terms of assumptions about the components of population increase. All the calculations that follow pertain to the medium variant.[19]

According to the demographic projections, until about 2010 the economy is expected to benefit from a declining dependency ratio; afterwards, the trend is expected to turn around. Table 2.6 describes the development of Israel's actual dependency ratios and continues with the projections to 2025: the ratio of children (aged 0–14) and elders (65+) to working-age population (15–64) and the sum of the two first-mentioned groups, i.e., the total dependency ratio. Until 2010, the total dependency ratio is expected to decline steadily due to a proportional decrease in the populations of both children and the elderly. Afterwards, the trend will change: the dependency ratio will begin to rise because even though the proportion of children will continue to decline, that of the elderly will rise. These changes will originate, among other things, in the continuing decrease in birthrates, a strong increase in the number of people reaching retirement age, and the continued prolongation of life expectancy.

[17] Dollery, B. E. and L. Crase (2004). "Is Bigger Local Government Better? An Evaluation of the Case for Australian Municipal Amalgamation Programs", Urban Policy and Research, 22(3), 265–276.
Sancton, A. (2000). Merger Mania: The Assault on Local Government, Montreal and Kingston: McGill–Queen's University Press.

[18] Needless to say, large-scale immigration, such as that of the early 1990s, does not lend itself to prediction and may disprove demographic outlooks.

[19] Central Bureau of Statistics, 2005, Projections of Israel's Population until 2025, Publication 1238.

Table 2.6
(Dependency Ratio of Children (0–14) and Elders (65+
Percent of population aged 15–64

	1995	2000	2005	Projections[a] 2010	2015	2020	2025
0–14	48.3	46.2	45.7	45.1	44.5	43.2	41.6
65+	16.3	15.9	15.9	15.5	17.5	19.3	20.6
Total dependency ratio	64.6	62.1	61.6	60.6	62.0	62.5	62.2

[a] Source: Central Bureau of Statistics, Projections of Israel's Population until 2025.

These developments will bring Israel's dependency ratio closer to that in the developed countries, although a material difference between them will persist during the outlook period. Israel has a higher dependency ratio than the developed countries today, despite its small proportion of elders, because of its high share of children. This state of affairs will continue during the outlook period, but a rapid decrease in the proportion of children coupled with a gentle upturn in that of the elderly will bring the relative size of both groups and, in turn, the dependency ratio, closer to those of the developed countries.

The relative size of the working-age population does not tell the entire story of expected developments in the labor force due to the large variance in participation rates among different sectors. Changes in the relative size of sectors may have a substantial effect on the size of the labor force. Two sectors that have especially low participation rates and whose share in the working-age population is expected to rise are the ultra-orthodox Jews and the Arabs. Therefore, the analysis of their projected development may illustrate both the effect of changes in population composition and the possible contribution of a policy that focuses on improving the standing of specific sectors.

The ultra-orthodox account for around 10 percent of the Jewish population today.[20] Some 45 percent of the ultra-orthodox are children aged 0–14. Accordingly, this is a very young population and its share in the working-age Jewish population is expected to increase. There are no agreed-upon projections of the number of ultra-orthodox in the future.[21] In regard to the Arab population, however, there are agreed-upon data and the CBS publishes outlooks about the expected size and age composition of this population group. Accordingly, our discussion of the effects of the sectoral composition and its implications for policy will focus on the Arab population. Just the same, the lessons are more widely applicable.

Table 2.7
Labor-Force Participation Rate, by Age Group and Nationality, 2006

	15-24	25-34	35-44	45-54	55-64	65+
Jews	34	81	84	82	63	11
Arabs	27	54	56	43	20	3

Source: Central Bureau of Statistics, Labor Force Survey 2006, and Bank of Israel calculations.

Table 2.7 presents Israel's labor-force participation rates in 2006. The rates are rather strongly differentiated by age and nationality: they rise commensurate with age at first, peak in the 35–44 age cohort, and then decline gradually. The participation rates of Arabs are substantially lower than those of Jews in all age groups.

Table 2.8 presents three scenarios for the development of the labor force by 2025. The scenarios take account of the expected increase in each of the age and nationality groups shown in Table 2.7. The base scenario assumes that the participation rate of each of these groups will remain at its

[20] Current estimates of the number of ultra-orthodox vary, inter alia due to different criteria that are used to define this population group. For an expanded discussion, see, for example, Flug, K., and N. Kasir (2001), "Poverty, Employment, and the Gulf between Them," Economics Quarterly 48:4, pp. 516–543, and Gottlieb, D. (2007). "Poverty and Labor-Market Behavior in Haredi Society," Van Leer Jerusalem Institute, Policy Studies Series no. 4 (both in Hebrew).

[21] The Central Bureau of Statistics population projections are itemized by nationality and religion but do not refer to the ultra-orthodox population separately.

2006 level.[22] This assumption is meant to establish a point of reference for continued discussion and the comparison of alternatives: it allows us to present the net effect of the demographic changes only (the changes in age composition and proportion of Arabs) absent behavioral or policy changes, which are discussed below.[23]

The base scenario shows that in the coming years Israel will continue to benefit from the faster growth rate of its labor force relative to the population at large and the corollary of this development: that the share of its labor force in the population will continue to rise.[24] This trend originates in two processes: the faster growth rate of the working-age population than of the dependent population groups (Table 2.6) and changes in the relative size of age cohorts that have different participation rates (Table 2.7). Between 2010 and 2015, however, a mild deterioration will ensue: the growth rate of the labor force will fall behind the growth rate of the population and, therefore, the share of the labor force in the total population will edge downward. Although the decline during the outlook period will be moderate and the proportion will remain higher than in the preceding decade, it will denote a change in trend and signal the onset of a process that many developed countries are already experiencing.

The change in trend will originate mainly in the expected changes in the age composition of the population. However, some of the decline in the growth rate of the labor force will trace to an increase in the proportion of Arabs in the working-age population, from 18 percent in 2005 to 24 percent in 2025. The base scenario, as stated, assumes that the participation rates of each age and nationality group will remain where they are today, and since these rates are significantly lower among Arabs than among Jews, this will have a downward effect on the size of the labor force.

Unlike demographic factors that affect the growth of the labor force and do not lend themselves to the effects of economic policy in any real way, the Arabs' participation rate is quite susceptible to government influence in the form of a long-term policy for the integration of Arabs into the labor force. Two important measures for this purpose are improving the quality of primary and secondary education and raising the rates of higher education among members of this group. This is because the labor-force participation rate of Arabs who have higher schooling approximates that

Table 2.8
Demographic Profile, 1995–2025

			Projections			
	1995-2000	2000-05	2005-10	2010-15	2015-20	2020-25
Population growth rate (percent per year)	2.6	1.8	1.6	1.5	1.4	1.3
Labor-force growth rate (percent per year)						
Base scenario	2.9	2.5	2.2	1.4	1.2	1.2
Education-policy scenario	..	..	2.3	1.4	1.3	1.3
Rapid integration scenario	..	..	2.4	1.7	1.6	1.7
Labor force as percent of population (average across period)						
Base scenario	37.9	38.7	39.7	40.2	39.9	39.7
Education-policy scenario	..	..	40.0	40.7	40.6	40.6
Rapid integration scenario	..	..	40.0	41.0	41.4	42.1

[22] With the exception of a correction for the raising of the retirement age: the retirement age for men and women is being raised incrementally to 67 and 64, respectively. After 2010, the retirement age for women will continue rising incrementally to 67. We assumed that the participation rates in the additional working years will resemble those in the 60–65 cohort today.

[23] The calculations examined the implications of the demographic processes and the possible effect of enhanced integration of Arabs in the labor market. For this purpose, we assumed that the participation rates of Jews in each age and schooling cohort will not change during the period. In particular, we do not analyze, as stated, the significance of the increase in the proportion of ultra-orthodox, who are typified by low participation rates today, on the participation rate of the Jewish sector at large.

[24] A distinction should be made between this ratio, which describes the size of the labor force relative to the population at large, and the participation rate, which describes the size of the labor force relative to the population aged 15+ and, accordingly, disregards children.

of Jews of similar age and schooling. Obviously, this path of action focuses on children and young people and its purpose is to boost their participation rates once they reach the labor force 10–20 years on. The high proportion of children and young people in the Arab sector today underscores the importance of education as a principal instrument for the raising of this sector's participation rate in the long term. The expected increase in the share of this sector in the total working-age population gives an indication of the utility that this may have for the economy at large.

The second scenario in Table 2.8 estimates the influence of a policy that raises the number of years of education among Arabs on the development of the total labor force. This scenario assumes that the policy will enhance the levels of education among Arabs who today are children or young people. The younger they are today, the more their level of schooling will rise in the future. This is because the younger children are when the change starts, the more potentially effective the policy will be. There is also a contrasting assumption: the level of education among those who already belong to the main working-age cohorts will not rise. Accordingly, the entire increase in the labor force in this scenario relative to the base scenario traces to the higher level of education among young Arabs and its presumed effect on their future participation rate, in view of the correlation that exists today between education and participation. Thus, despite the cautious assumptions about the increase in the rate of schooling—and, in turn, the participation rate—one may see that such a policy will not only expand the labor force relative to population but will also almost totally arrest the downward trend in this ratio up to the year 2025.

The low participation rate of Arab women reflects not only the paucity of schooling among them but also a lower participation rate at every level of education (Table 2.9). Accordingly, apart from improving the level of schooling among Arabs generally and Arab women specifically, a long-term policy to enhance the labor-force integration of Arab women at every level of education is needed.[25] A policy that focuses on increasing their participation rate may reinforce the trend that has been observed since the beginning of the previous decade; it would also dovetail with social and behavioral changes that are expected to continue acting in the same direction. Thus, enhancing the labor-force integration of Arab women may raise the participation rate

Table 2.9
Arabs' Labor-Force Participation Rate, by Schooling and Gender
Percent, 2006

	0-10	11-12	13-15	16+	Total
Men	70	84	81	92	78
Women	10	22	57	76	26

Source: Central Bureau of Statistics, Labor Force Survey 2006, and Bank of Israel calculations.

of the Arab sector to a level exceeding that described in the previous scenario.

The third scenario in Table 2.8 assumes a stronger convergence of the Arab sector's participation rate toward that of the Jewish sector due to the increase in education plus enhanced integration at all levels of schooling. According to this scenario, the labor force to population ratio will rise continually throughout the outlook period. Thus, enhancing Arabs' labor-market integration may serve as a meaningful counterweight to the other demographic forces that are expected to reduce the relative size of the labor force.

The discouraged worker effect in Israel[26]

In the first three quarters of 2007 there were about 47,000 discouraged workers in Israel, constituting about 1.6 percent of the civilian labor force.[27] These people, although not part of the labor force, are still partially attached to the labor market, as they are still willing to work. It is thus reasonable to assume that policy measures aimed at raising the rate of participation in the labor force will be more effective among them. The longer they remain out of the labor force, the weaker their attachment to it, and the harder it becomes to bring them back into the employment pool.

In Israel the Central Bureau of Statistics (CBS) defines discouraged workers as follows:

> All those aged 15 years and above who are not part of the weekly civilian labor force, but who have looked for work in the twelve months prior to their participation in the survey. They are willing to work and could start working in the week in question if offered a suitable job ("availability for work"). They did not look for work in the four weeks prior to their participation in the survey for the following reasons: they think there are no suitable jobs for them in their profession or in the area where they live, with regard

[25] Such a policy should address itself, among other things, to the large disparity in women's participation between the urban sector and the rural sector and to the adverse effect of the closure of traditional industrial enterprises in villages (e.g., sewing shops) on sources of employment there. See, for example, the discussion in Fichtelberg, A. (2004). "Labor-Force Participation of Arab Women in the Past Decade," Manpower Planning Authority.

[26] Based on Peled, O. and N. Kasir (Kaliner), "The discouraged worker in Israel" (forthcoming).

[27] According to the Central Bureau of Statistics definition.

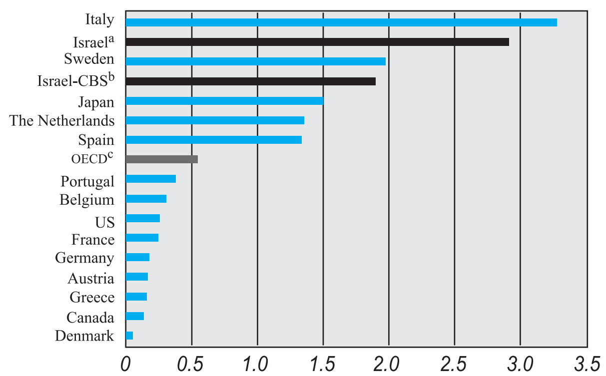
to the wage, work hours, or interest in the work; lack of experience or appropriate skill, or language difficulties, or inappropriate age (too young, too old).

The definition of discouraged workers differs from country to country; all definitions relate to those who want to work but nevertheless are not looking for jobs (in other words they are not part of the labor force), but the definitions differ in the way they relate to availability for work and the reasons for not looking for jobs. In Israel, as in the US and the Philippines, the definition of discouraged workers adds the requirement that they have looked for work for a certain period of time beforehand.

A comparison of the share of discouraged workers according to different definitions in the years 2001–06 shows that the differences are reflected mainly in the levels, whereas changes over time are quite similar for all definitions (Figure 2.1). For all definitions the share of discourage workers is to some extent anti-cyclical.[28] There was a high incidence of discouraged workers among the weaker groups in the population, such as those with low levels of education, older workers, and the Arab sector.

Figure 2.1

Share of discouraged male and female workers in Israel and selected countries, 2006 (percent)



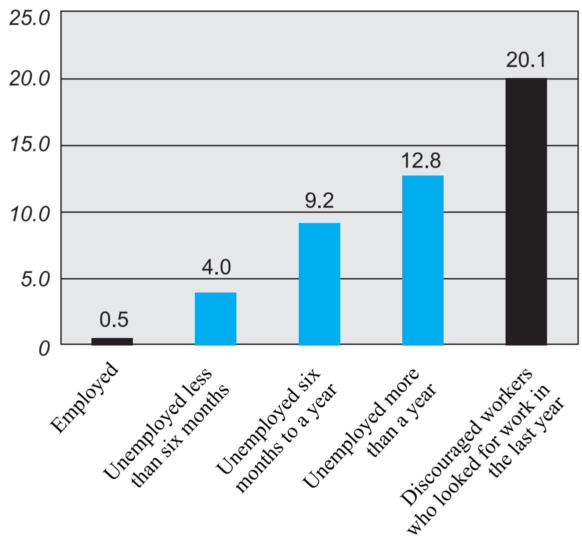
[a] A discouraged worker is defined here as one not in the labor force but willing to work. This definition and the countries shown in the comparison were selected according to the availability of data and the uniformity of the definition.
[b] Central Bureau of Statistics.
[c] Weighted average.
SOURCE: Israel - CBS; OECD countries - the OECD.stat website (http://stats.oecd.org/wbos).

The number of discouraged workers as a proportion of the labor force in Israel is high compared with that in other countries. That is partly due to the relatively high rate of unemployment, the low level of expenditure on an active policy to encourage employment, and the relatively stringent conditions governing eligibility for unemployment benefit (particularly the maximum period in which unemployment pay is granted, which is significantly shorter in Israel than in most other countries).

An analysis of the Manpower Surveys reveals changes in half a year in the employment situation of those in the sample; in other words the difference in the situation of the same person between one quarter and another can be followed.[29] It was found that the weaker the connection with employment, the greater the chances of a worker becoming discouraged from seeking work. Thus among those unemployed in a particular quarter, the share of discouraged workers is greater among those unemployed for a long time than among those

Figure 2.2

Share of discouraged workers[a] by employment situation in the previous quarter, 2005 and 2006 (percent)



[a] According to the CBS definition.
SOURCE: CBS Manpower Surveys and calculations from a study currently in progress.

[28] Thus, for example, the correlation between the share of discouraged workers (according to the CBS definition) and the rate of unemployment with a lag is about 30 percent.

[29] Households are sampled in the Manpower Survey four times: the first two in two consecutive quarters, and after half a year, in another two consecutive quarters. This method makes it possible to identify those sampled several times and to analyze the changes in their employment situation.

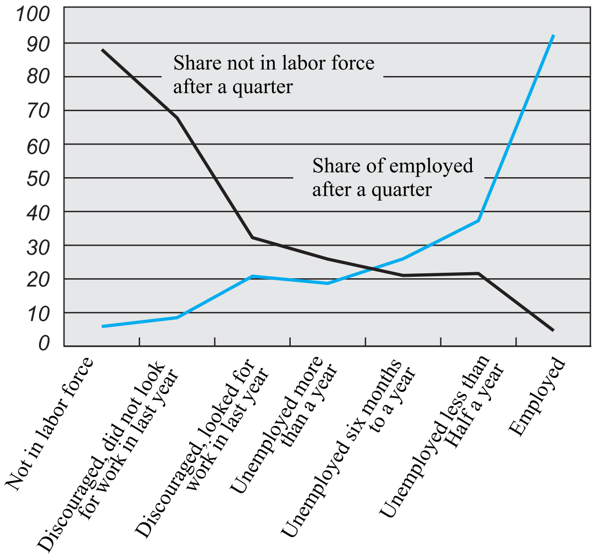
unemployed for a short time. This means that the longer the period of unemployment, the greater the share of discouraged workers (Figure 2.2).[30]

Moreover, the weaker the link with the labor market, the lower the chances being absorbed in employment or in the labor force, and the higher the chances of finally dropping out of the market (Figure 2.3). As expected, the great majority of those who were employed in a particular quarter were still employed in the next quarter; among those who were unemployed, a smaller proportion were employed in the next quarter, and among those outside the labor force, only a very small share were employed in the next quarter. On the other hand there is a marked difference between the discouraged workers who looked for jobs in the previous year (before stopping their search because they no longer thought they would find suitable work) and discouraged workers who did not look for work in the previous year: only 30 percent of the first group stopped wanting to work, compared with 70 percent of the latter group.

This shows that as far as discouraged workers are concerned, it is important to take advantage of the window of opportunity and encourage their participation in the labor force before they lose the will to work and totally drop out of the labor market. To do this requires extending the active policy to encourage employment, a policy that is currently inadequate. The programs will be more effective the more they are directed towards the group that has not yet severed its links with the labor market. For example, the Lights to Employment program, which is currently directed (similar to its predecessor the Mehalev (Wisconsin) program) only towards those in receipt of income support payments, most of whom have already broken contact with the labor market, should be extended so that discouraged workers who do not receive income support payments can also participate and enjoy the benefits of the program. In addition, the program for professional retraining, which has been heavily curtailed in the last few years, should be expanded so that the skills of the unemployed can be matched more closely to those required in the labor market, to prevent further dropping out of the labor force.

Figure 2.3

Share of employed persons and share of those not in the labor force (in the following quarter) in population groups differentiated by their connection with the labor market, 2005 and 2006 (percent)



[a] Not in labor force but willing to work. These are not discouraged workers according to the CBS definition, but this group complements the group based on the CBS definition and makes it consistent with the definition used in many countries.
[b] Discouraged according to the CBS definition.
SOURCE: CBS Manpower Surveys and calculations from a study currently in progress.

[30] O. Peled and N. Kasir (Kaliner), "the depth of unemployment in Israel," study in progress.

Diary of Events from July 2007 to December 2007

Month	Date	Event	Details
July	1	Underwriting reform comes into force.	The main aim of the reform is to ease the process of making a public offer of shares and to encourage greater participation of foreign institutional investors and underwriters.
		Minister of Finance Hirschson resigns from the government.	
		The government approves a proposal by Prime Minister Ehud Olmert, called "Lights to Employment" to encourage those on welfare to return to work.	The plan implements the recommendations of the second Dinur Committee and replaces the Wisconsin (Mehalev—welfare to work) Plan. At the current stage the plan aims to cover individuals under 45 only, although in the Wisconsin Plan the under 45s were only half the target group.
	4	Prime Minister Ehud Olmert appoints MK Ronni Bar-On as Minister of Finance.	
	16	Summary report from the Shochat Committee and its recommendations are presented to the Prime Minister.	The report covers all aspects of higher education. Among other things, the report recommends changing the structure of tuition fees. Accordingly, tuition for a BA will consist of a cash payment of NIS 5,800, to be paid while attending college, and a further NIS 9,000 which students will receive as a loan. The loan will be repaid from one year following completion of the degree, provided that the borrower's income is more than a minimum amount. The committee also recommended raising tuition fees for an MA to NIS 15,000–18,500, at the university's discretion. The report also recommends spending NIS 800 million on research and creating an extra 600 posts to promote younger staff.
		The Capital Markets Commissioner and management of Bank Hapoalim agree on the gradual entry of the bank into the field of pension advice.	The agreement means that Bank Hapoalim can give pension advice to salaried workers in three years, and can advise the self-employed, minors and customers aged 55+ who are not salaried workers, after the bank has sold its provident funds.
	19	Employers and the Histadrut sign an agreement on compulsory pensions to be applied for all salaried workers in the economy.	The agreement will take effect on January 1, 2008, and will address approximately 500,000 salaried workers who have no pension arrangement. The provisions will be introduced gradually: in the first year, 2.5 percent will be set aside (one-third by the employees and two-thirds by the employers). The rate of the provision will increase gradually, by 2.5 percent each year, up to 15 percent in 2013.
	23	The Bank of Israel raises its key interest rate for August by 0.25 percentage points to 3.75 percent .	

Month	Date	Event	Details
July	25	Minister of Trade, Industry and Labor, Eli Yishai, intends to revoke the decision concerning deregulation of the price of bread.	Deputy Prime Minister and Minister of Trade, Industry and Labor, Eli Yishai, decided that he will not sign the order deregulating the price of bread. This decision was made following an announcement of a price hike by bakeries and bread suppliers, which takes into account past losses.
	26	The Ministry of Finance and the Histadrut reach agreement in principle on wage increases in the public sector.	The agreement includes a 5 percent wage increase. In addition, a sum will be allocated to correct distortions in the local government wage mechanism.
	29	The government adopted the key recommendations of the Brodet Committee to add NIS 46 billion to the defense budget for the period 2008–17.	The additional budget will be funded from three sources: the state budget, foreign aid, and an efficiency drive by the defense establishment.
		The Knesset approves amendments to the law on employment of women.	The main amendments are: 1) reducing maternity leave for a worker who has agreed to give her child up for adoption or for a surrogate mother (as defined by the law); 2) full rights of maternity leave for a male worker; 3) absence due to pregnancy that does not qualify for high-risk-pregnancy benefit; 4) rights of a nursing worker to be absent from dangerous work; 5) protection from harm to the number of hours worked or income.
	30	Special allowance to Holocaust survivors living in Israel was approved.	According to the decision the state will allocate NIS 120m in 2008, NIS 240m in 2009, and more than NIS 300m from 2011. These sums will be used to provide grants to Holocaust survivors.
August	1	Heftziba declares bankruptcy.	The Heftziba group, controlled by Boaz Yona, which includes three public companies, declares bankruptcy.
	5	The government of Israel adopts quantitative objectives in the fields of poverty and employment for the first time.	Two objectives approved are: 1) for employment (increasing the employment rate in the 25–64 age group to 71.7 percent––the average in OECD countries—by 2010, compared with 69.1 percent today); and 2) a reduction in poverty including an improvement in standard of living for the poorest sectors of society (establishing that income for the lowest quintile will increase by 10 percent more than the rise in per capita GDP). These aims will be added to the existing two macro objectives (of budget deficit and inflation).
	27	The Bank of Israel raises its key interest rate for September 2007 by 0.25 percentage points to 4 percent .	
September	5	Minister of Finance Ronni Bar-On signs an order to extend the law of assistance to Sderot and Western Negev communities.	Minister of Finance determines that the communities of Dorot, Bror-Hayil, Mavki'im, Zohar, Ohad, Talmei Elyahu, and Sde Nitzan will also be included in the emergency provisions setting various benefits for those living up to 7 km from the Gaza Strip border fence.

Month	Date	Event	Details
September	24	The Bank of Israel leaves its key interest rate for October unchanged.	
October	10	Minister of Finance Ronni Bar-On approves the Securities Authority proposal for a comprehensive reform of the mutual funds market, to enhance competition, increase the supply of financial instruments and to remove barriers in the sector.	The innovations proposed in the reform include: a fund of funds and money-market fund. The money-market funds may provide an alternative for competing with short-term bank deposits and develop a new channel for companies wishing to raise credit through bonds as a source for financing working capital. Additional instruments offered to the public are a special fund and a leveraged fund. As part of the reform, the new regulations also aim to ease the activity of the mutual funds in Israel. The funds will also be able to invest in securities traded on the Continuous Trading Platform for non-listed bonds dedicated for the institutional investors, the restriction on overseas investment in bonds rated BBB and above will be removed, the investment options for funds will be extended, and REPO activity will be permitted. The possibility of financing credit redemptions will also be available, and discounts will be given on Securities Authority fees and on distribution fees.
	17	The Bank of Israel will begin to perform REPO transactions with financial institutions and banking corporations.	Within the context of the REPO transactions, the Bank of Israel will acquire government bonds and short-term loans from the financial institutions and banks and will sell them back a week later at a pre-determined price. The purpose of such activity is to promote the development of the REPO market, thus advancing and deepening Israel's capital market.
	21	Senior university lecturers began a strike.	The senior academic staff at all universities in Israel began a strike. This was in support of their demand for a 20 percent wage increase for erosion of their wages and to create a mechanism that will prevent wage erosion in the future. The last wage agreement with the senior lecturers expired in 2001 and has not been renewed since. (The strike ended after the end of the period under review, on January 18, 2008.)
	29	The Bank of Israel leaves its key interest rate for November 2007 unchanged.	
November	4	The government approved a plan to assist the elderly and Holocaust survivors.	The government approved a comprehensive plan to assist the poor elderly and Holocaust survivors in Israel amounting to NIS 1 billion in 2008, to be increased to NIS 2 billion in 2010. The plan will add a billion shekels to old-age pensions. A further NIS 500 million will be allocated to help the poor elderly.

Month	Date	Event	Details
November	8	Bank Hapoalim announced that it is being forced to wipe $30 million off the value of its investments in the third-quarter reports. The bank's loss in the second half of 2007 due to the sub-prime crisis in the US will amount to $290 million. The net effect (after tax) of this provision on its net profit amounts to $180 million.	The wipe-off is due to the bank's exposure to the credit crisis in the US. It should be noted that Bank Hapoalim is the only bank in Israel that has reported substantial exposure to the credit crisis.
	22	Governor of the Bank of Israel, Prof. Stanley Fischer, and Minister of Finance Ronni Bar-On, appointed Director General of the Ministry of Finance, Yarom Ariav, to head a committee to develop and increase competition in Israel's capital market.	The committee, to be headed by Yarom Ariav, will review the measures required to develop Israel's capital market and to enhance its ability to attract foreign capital. The purpose is to position Israel's capital market as an important global player and increase its competitiveness and efficiency.
	26	The Bank of Israel leaves its key interest rate for December 2007 unchanged.	
		4800 new participants will be added to the Lighting the Path to Employment Plan.	The new participants will be from Netanya, communities belonging to the Basmah Municipality near Umm el-Fahm, from Ein Mahal near Nazareth, and from neighborhoods in Upper Nazareth, Jerusalem, and Ashkelon that were not previously part of the plan.
	27	Credit rating company S&P raised the credit rating for the State of Israel for the first time since 1995.	Israel's credit rating was raised from A– to A.
		The Annapolis conference began.	The conference took place on 27–28 November, 2007 in an effort to jump-start the peace process and pave the way to intensive negotiations for a permanent agreement between Israel and the Palestinians. The conference was attended by representatives of Israel, the Palestinian Authority, the Quartet (EU), the US, UN and Russia—representatives from most of the Arab League nations, including Egypt and Jordan as well as countries that have no diplomatic relations with Israel.
		The Labor and Social Welfare Committee approved the government's proposal in the Economic Arrangements Law to postpone by six months the third phase of the increase in the minimum wage.	The third payment of NIS 140 per worker should have been given on December 1, this year, and was postponed to July 1, 2008.

Month	Date	Event	Details
November	27	The Finance Committee approved the regulations to raise the use value of company cars for tax purposes.	Under the new regulations, the use value (for tax purposes) of a Group 2 vehicle will increase by NIS 1,120 to NIS 2,450. The additional payment will be divided so that in 2008 and 2009 those with company cars will pay an extra NIS 200 and NIS 360 a year in the following two years. The use value of a Group 3 vehicle will increase by NIS 1,410, a Group 4 vehicle by NIS 1,620, a Group 5 vehicle by NIS 2,200, a Group 6 vehicle by NIS 2,930, and a Group 7 vehicle by NIS 3,870.
December	13	The Ministry of Finance and the High-school Teachers' Union agreed upon an outline in principle which will lead to the implementation of a reform in high-school education.	The main understandings that have been reached are: from January 2008 onwards the teachers will receive a COL increment of 5 percent. They will also receive a 4 percent payment in respect of wage erosion during the period 2002–07; an advance on account of the education reform in the amount of 8.5 percent out of 26 percent on average to be paid in respect of an overall, agreed reform. This advance will be paid to teachers who state they will join the reform in return for an extra two hours of individual teaching. The school principal will be given powers to award tenure and to accept teachers. The Director General of the Ministry of Education will set up a committee to formulate a plan to reduce the number of pupils per class in high-school education.
	18	Deputy Prime Minister and Minister of Trade, Industry and Labor, Mr. Eli Yishai, signed a free-trade agreement between Israel and the Mercosur block, together with the foreign ministers of the four member states of the Mercosur block.	The four member states of the Mercosur block are Brazil, Argentina, Uruguay, and Paraguay.
		The Knesset approved two further measures from the Finance Ministry's plan to reduce social gaps—earned income tax credits and a more equal allocation of the tax burden (lowering of the income tax rates).	The introduction of earned income tax credits (EITC), in which workers with low salaries will receive a supplement to their wage, will help increase their disposable income and reduce the economic gaps between them and higher-paid workers. The EITC will thus serve as an incentive to encourage participation in the workforce and allow weaker socioeconomic groups to enjoy the fruits of growth and economic strength. Lowering of income-tax rates: further to approval of the regulations concerning the use value of cars, the Knesset Finance Committee approved the lowering of tax rates on income from personal exertion, which will focus on the middle classes. It aims to offset some of the additional tax that will be paid by the users of company cars and to reduce the high tax burden currently imposed on the middle classes.
	23	The law to encourage capital investments was extended for another year until December 31, 2008.	Under this law, some NIS 300m will be allocated in 2008 to the grants track and NIS 150m to the employment track.

Month	Date	Event	Details
December	24	The Technology Incubators Committee, headed by the Chief Scientist, approved the establishment of 5 new incubator companies, and will grant them NIS 8.8 million.	The Technology Incubators Committee, headed by the Chief Scientist Dr. Eli Opper, at its last meeting approved five new projects in the fields of life sciences, the environment and software. The projects include: selective biological medicines for cancer treatment; a pain-detection system using a multi-dimensional analysis of physiological signals; system to generate structured knowledge from generic information; a system for detecting and tracking video content.
		The Economic Arrangements Law and the state budget for 2008 were approved.	As part of the coalition agreements reached by the Treasury and four of the coalition partners—Yisrael Beytenu, Shas, Labor and the Pensioners—it was decided that MKs will remove their objections to some of the items in return for Ministry of Finance agreement to revoke its intention to tax housewives, suspend the freeze on National Insurance Institute benefits and cancel a planned 4 percent cutback in the benefits, and increase the basket of life-saving medicines by NIS 300m—from NIS 150m to NIS 450m in each of the years 2008 and 2009. It was also decided to increase the amount to be transferred in 2008 to the grants track of the Fund to Encourage Capital Investments, from NIS 150 million to NIS 300 million.
		The Bank of Israel raises its key interest rate for January 2008 by 0.25 percentage points, to 4.25 percent .	
		Management of the Bank of Israel, the Workers' Committee and the Histadrut, with the approval of the Ministry of Finance, signed a new wage agreement for Bank of Israel employees.	The new Bank of Israel wage agreement lays the foundation for organization of the central bank according to accepted standards in the developed countries, and to advance legislation of a new law for the Bank of Israel.
	30	Deputy Prime Minister and Minister of Industry, Trade and Labor, Eli Yishai, signed extension orders for a collective agreement for comprehensive pension insurance in the economy, in the presence of the chairman of the Coordination Bureau of Economic Organizations, Shraga Brosh, and Histadrut Chairman Ofer Eini.	The orders will take effect on January 1, 2008, pursuant to the compulsory pension agreement, that was signed on July 19.