

# RECENT ECONOMIC DEVELOPMENTS, 110

## January–June 2005

### Part 1: Review of current developments

#### Main developments

In January–June 2005 (the period reviewed) the increase in economic activity continued, albeit at a slower rate than that which prevailed in 2004. In particular, the rate of growth of exports slowed, and in the first quarter of the year investment in fixed assets declined (Table 1). The continued growth was reflected in the positive trends evident in the labor market: in the first quarter employment rose and the rate of unemployment fell, with a rise in the rate of participation in the labor force. With regard to macroeconomic policy, fiscal discipline was maintained; the Bank of Israel cut the published (“headline”) interest rate at the beginning of the period, related also to the reduction in Israel’s risk premium, and the short-term interest-rate differential between the NIS and the dollar went down to an unprecedented low level. The Consumer Price Index (CPI) rose in the first half of the year at a rate close to the lower limit of the inflation target. Inflation expectations, after rising at the beginning of the year, remained almost unchanged, slightly below the midpoint of the target inflation range. The upward trend in the money supply persisted as did the liquidation of the public’s asset portfolio.

Part 2 of this review contains a more extensive discussion of three current topics.

#### Aggregate real and industry-specific activity

In the period reviewed (January–June 2005) there were indications of a slowdown in the rate of growth compared to the rapid expansion that occurred in 2004. In 2004, especially in the first half of the year, growth was led by the increase in exports, whereas in the period reviewed exports increased more slowly than they had a year earlier.

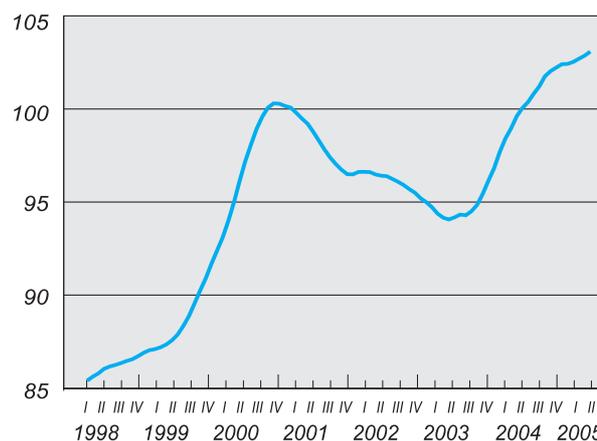
Several factors acted in support of continued growth: (1) Continued global growth and the expansion of world trade that resulted in increased demand for domestic production, and in particular for production of the high-tech industries (despite the recent slowdown in the rate of expansion of global demand in the light of high oil prices). Imports of

high-tech goods into the US expanded in the second quarter, and concurrently, to some extent, so did Israel’s exports of these items (Figure 1.4). (2) Relative calm in the security situation, to which the persistent improvement in incoming tourism may also be attributed. (3) Fiscal policy consistent with the attainment of the deficit target, which resulted in the decline of long-term interest rates to a low level, with a reduction in taxes and in the public debt. (4) Expansionary monetary policy operating against the background of price stability and stable financial markets. With the help of these factors, the increase in foreign direct investment (FDI) in Israel continued.

The Companies Survey for the second quarter of 2005 shows that economic activity continued to rise, and at a faster rate than in the first quarter. Based on the reports of participating companies, the increase encompassed all industries—manufacturing, trade and services, transport and communications, and hotels—except for construction, in

Figure 1.1

Level of Economic Activity,\* 1998–2005\*\*  
(index: 2004 average = 100)

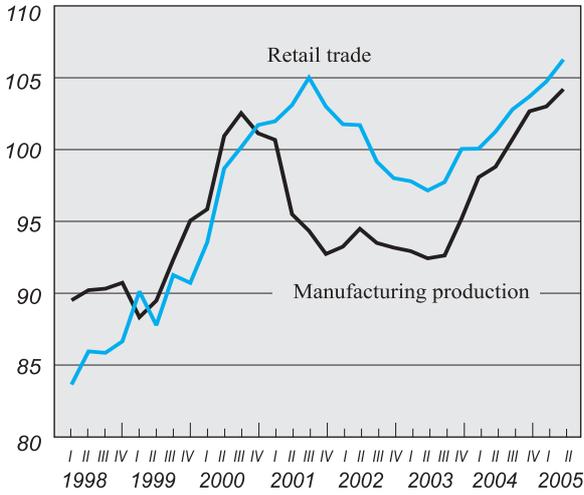


\* The level of economic activity is calculated as the sum of the long-term trend and a cyclical component, defined as the cumulative change in the composite state-of-the-economy index.

\*\* Up to June 2005.

Figure 1.2

Manufacturing production\* (index, average 2004=100) and large-scale retail trade\*\* (index, average 2002=100), 1998–2005

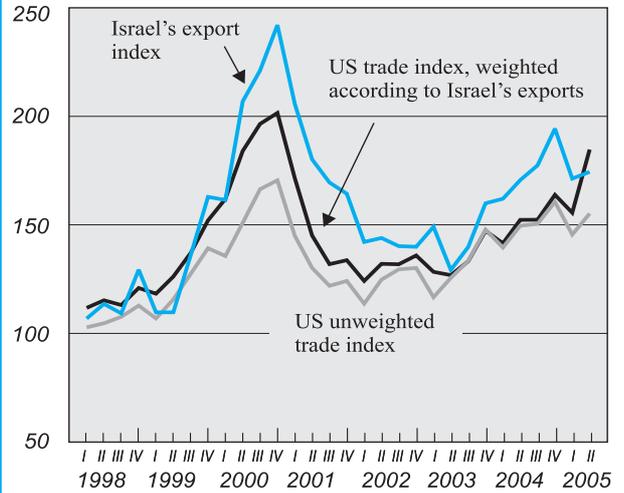


\* To May 2005.  
\*\* To June 2005.

which for the first time after a long period of decline, activity remained steady. According to the leading index—which indicates the level of activity for the following quarter—given in the Survey, expectations point to continued growth

Figure 1.4

Israel's exports of and US trade in electronic components, electronic communication equipment, and scientific and monitoring equipment, 1998–2005\*

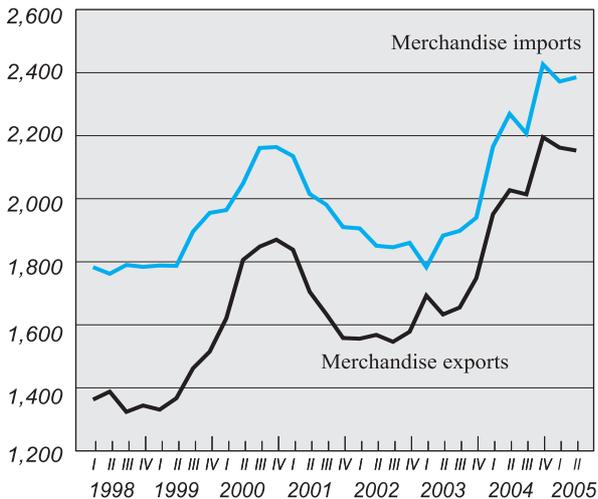


\* To June 2005. US trade data to May 2005.

of business-sector activity in 2005:III, expectations that were shared by all industries.<sup>1</sup> In manufacturing, it is expected

Figure 1.3

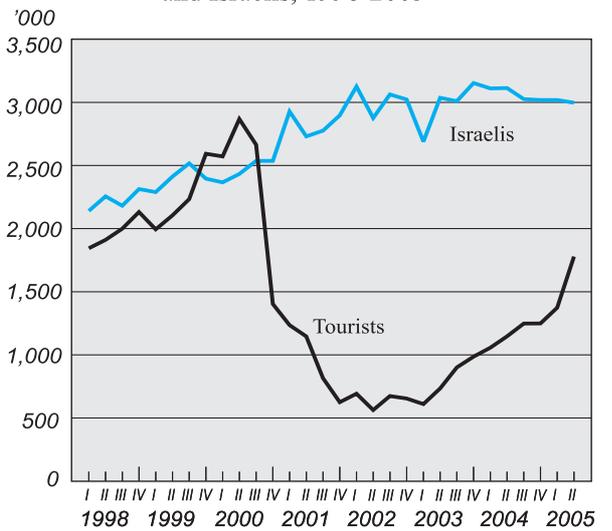
Foreign trade,\* 1998–2005\*\*  
(\$ million per month)



\* Excluding ships, aircraft, diamonds, and fuels. Seasonally adjusted.  
\*\* To June 2005.

Figure 1.5

The hotel industry: bed nights of tourists and Israelis, 1998–2005\*



\* To June 2005. Seasonally adjusted.

<sup>1</sup> See Bank of Israel, Companies Survey for 2005:II.

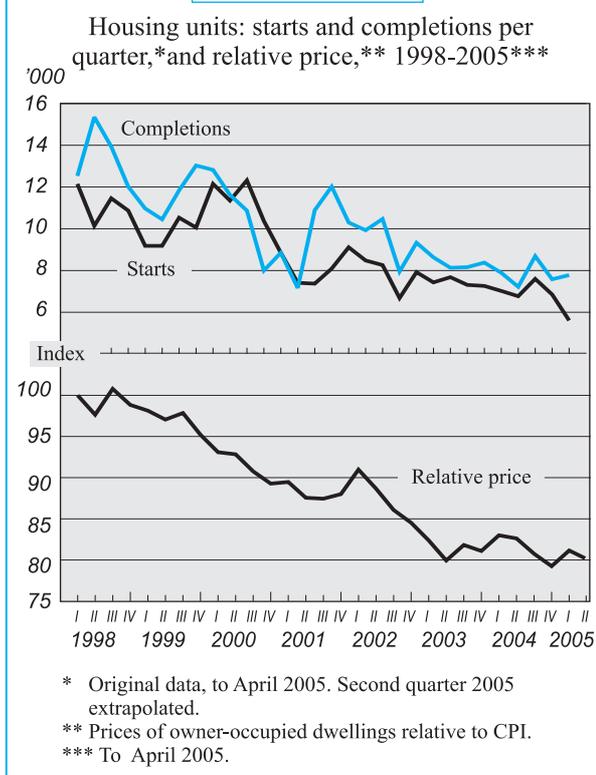
that production will expand, both for exports and for the domestic market.

Some indicators, such as manufacturing production and in particular the production of high-tech goods, and data of investment in information technology (IT) companies, are consistent with the results derived from the Companies Survey regarding continued growth (Table 2 and Figures 1.1 and 1.2). On the other hand other indicators, such as the composite state-of-the-economy index and trade and services turnover, suggest a slowing of the rate of increase of activity, while the developments relating to production inputs and imports of investment goods even suggest a small decline in activity from the first to the second quarter of the year.

### Construction

In the construction industry, based on National Accounts data, activity continue to decline in 2005:I, unlike in the other principal industries (Table 2.2 and Figure 1.6). The Companies Survey gives an indication of stability in 2005:II. In 2005:I, based on National Accounts data on investment in construction, activity was lower than in 2004:IV and also lower than in 2004:I. The slight reduction in employment (of Israelis, foreign workers and Palestinians) is consistent with the data on activity. The decline in activity occurred in

Figure 1.6



nonresidential construction, whereas activity in residential construction in the first quarter of the year stayed at the same level as in the previous quarter.

Other indicators of construction activity in the period reviewed do not paint a clear picture: cement sales in the first four months of 2005 indicate a small rise in activity relative to the whole of 2004 and relative to the first four months of 2004; demand for new apartments continued its downward trend, reflected in a reduction in the number of new apartments sold, starting from 2004:III; in January–April 2005 the number of building starts, both residential and nonresidential, was again below the equivalent period in 2004; in contrast, the extent of building projects carried out and contractors' expectations regarding future output (according to the Companies Survey for 2005:II) indicate stabilization for the second consecutive quarter.

### The labor market

An improvement was noted in the labor market in 2005:I. A rise in employment was expressed in a decline in the rate of unemployment, with a small increase in the participation rate in the labor force (Table 3 and Figures 1.7 and 1.8). The number of Israelis employed continued to rise; however, the number of non-Israelis employed also went up.

The rise in the number of Israelis employed in the first quarter—continuing the trend that started in 2003:II—consists of only a moderate increase in the number employed

Figure 1.7

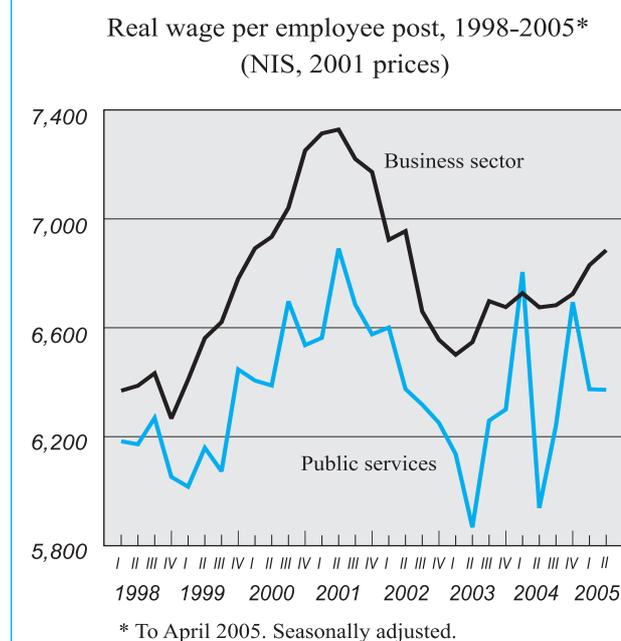
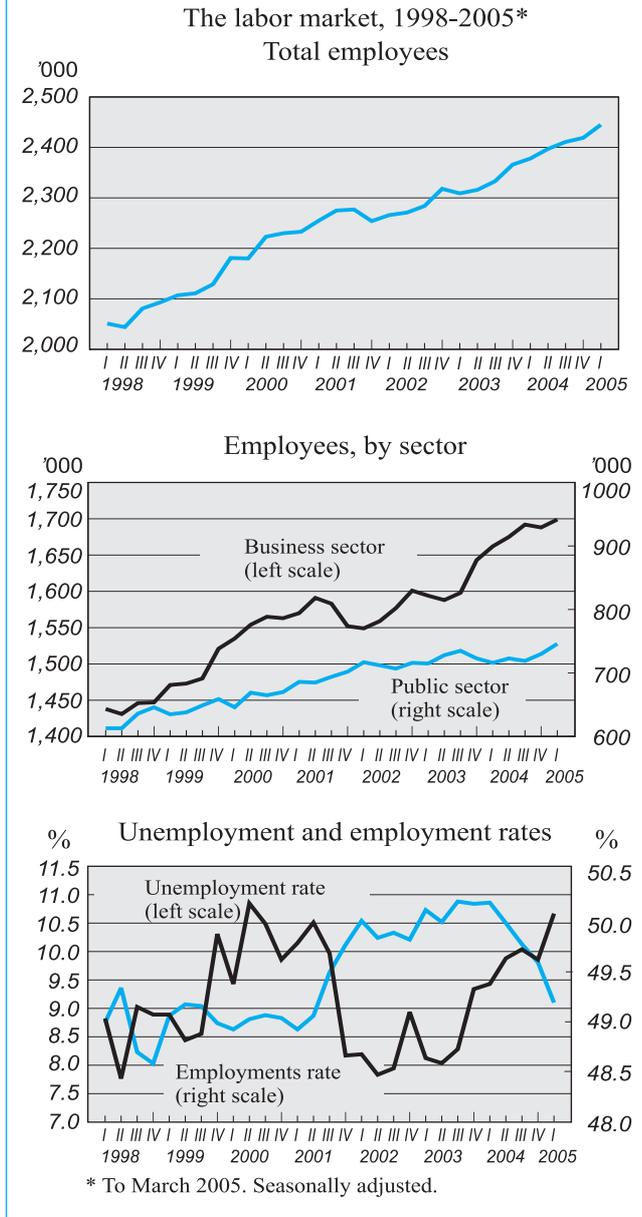


Figure 1.8



in the business sector, and a relatively large increase in the public sector. This is in contrast to the situation in 2004, when the business sector led the improvement in employment. In 2005:I the number of employees in the business sector started rising again, following its decline in 2004:IV, with almost all industries apart from construction showing an increase.

The number of non-Israeli employees rose in 2005:I, the result of a considerable increase in the number of Palestinians employed and the number of foreign workers remaining stable. This represents a deviation from the government's declared policy of reducing their numbers, a policy that was pursued successfully in the last two years—a deviation that

is likely to have an adverse effect on the employment of Israel's with low income levels.

The real wage (including foreign workers) in January–April 2005 remained at the same level as in the equivalent period in 2004. The real wage in the business sector continued to rise slowly from 2004:III, apparently due to higher demand for workers. The wage in the public sector hardly changed in the first four months of 2005 compared to its average level in 2004.

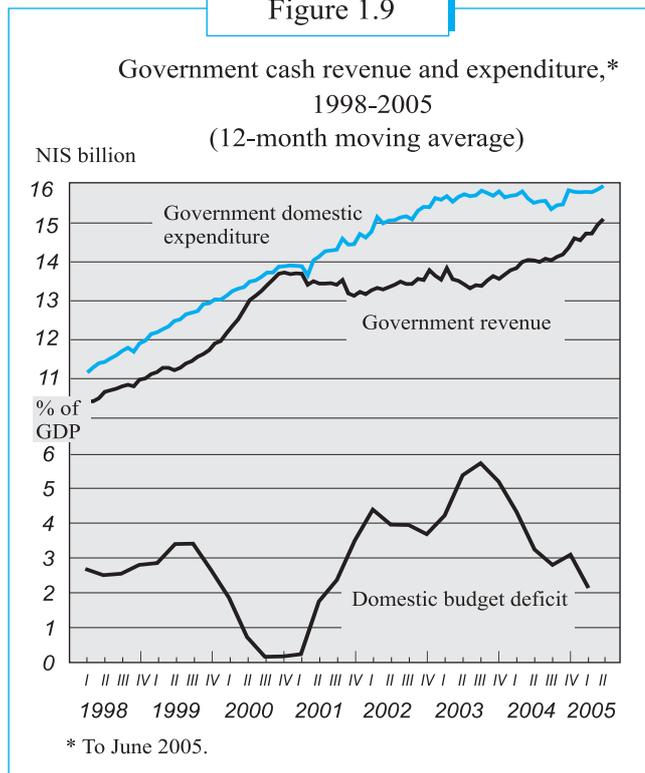
The first employment center started operating in July, and three more are due to open in August, as a pilot scheme for the program proposed by the Tamir Committee (the “Wisconsin Project”). The program is intended to bring those in receipt of income support—whose number rose again in 2005:I—back into the labor force. The pilot scheme started operating after numerous delays, and represents an important aspect of the government's policy of encouraging employment by providing positive incentives for employment, following the cuts in the income-support grants.

### The public sector

The **budget** for 2005 was confirmed in March. For the first time the budget is subject to the long-term targets set by the government—a ceiling of 3 percent of GDP for the deficit, and a real increase of no more than 1 percent a year in expenditure. It was decided, however, to raise the target deficit for 2005 to 3.4 percent of GDP in order to finance the disengagement from Gaza and part of Samaria. In the first half of the year the domestic deficit, cash basis, was lower than the level consistent with the achievement of the annual target, mainly due to underperformance on the expenditure side.

**Domestic government expenditure** (excluding credit) in the first half of 2005 was below the seasonal path and slightly higher, in real terms, than in the first half of 2004 (Table 6 and Figure 1.9). The underperformance with regard to expected expenditure encompassed all the government ministries, as it did in 2004—with the exception of the Ministry of Defense, apparently due to preparations for the disengagement—and the delay in obtaining approval for the budget was responsible for part of the underspending. The decline in government expenditure was reflected in public consumption, which went down again in 2005:I following its continuous decline since 2004:II. The reduction in the National Insurance pensions and benefits was the result of the implementation of another stage of the change in legislation that came into force in January 2005, which cut children's allowances and raised the retirement age for men and women, and of the continued cuts in income support, but was also the result of the rise in employment that greatly reduced the number of recipients of unemployment benefits. The reductions in National Insurance payments reflects

Figure 1.9



the government's policy of encouraging employment and reducing dependence on pensions and benefits, a policy that should be buttressed by a program of direct encouragement of employment.<sup>2</sup>

**Government revenue** in the first half of 2005 was a real 9.5 percent higher than in the first half of 2004 and higher than the seasonal path. Tax revenue in the period reviewed was in line with the seasonal path. Income-tax revenue exceeded expectation, due mainly to one off receipts resulting from two publicity campaigns encouraging taxpayers to settle their long-standing debts. Income from indirect taxes were lower than the seasonal path. Government non-tax revenue was higher than the seasonal path due essentially to nonrecurring factors such as withdrawing money from the surplus of the government-backed Avner insurance cartel. On the other hand, the surplus transferred to the government by the National Insurance Institute in the period reviewed fell short of the expected level.

### The balance of payment

The seasonally adjusted surplus in the current account in 2005:I was similar to that in each of the four quarters of 2004. In the goods and services account the minimal

<sup>2</sup> With regard to the inception of the Wisconsin Project see also the section on the labor market, above.

deficit that had prevailed in the previous three quarters was maintained, the outcome of small increases in imports and exports. Income from labor inputs and from investments declined slightly from its level in 2004:IV, as did the surplus in current transfers (Table 4).

Imports and exports in current dollar terms, which had risen considerably in the first and second quarters of 2004, hardly changed from their level in the last quarter of 2004. In 2005:I import prices rose while export prices remained unchanged, so that the terms of trade (excluding ships, aircraft and fuels) deteriorated by 1.2 percent compared to their level in 2004:IV. Raw material imports went down slightly in the period reviewed, and imports of capital and consumer goods remained essentially unchanged. High-tech exports rose slowly in the first half of 2005, declining in the first quarter and rising in the second. Prices of high-tech exports dropped markedly in the first quarter, so that in volume terms high-tech exports rose in that quarter.

In 2005:I nonresidents' investments in Israel, both direct and portfolio, rose considerably. Part of the rise in portfolio investment is a reflection of the boom in Israeli companies' raising capital abroad. In 2005:II nonresidents' investments, mainly portfolio, dropped below the high level that had prevailed in 2005:I.

In the first quarter of 2005 Israelis' investment abroad rose, particularly portfolio investment. This was due in part to the tax reform that brought taxation on Israelis' investment abroad into line with that on investments in Israel, and to the continued contraction of the interest-rate differential between Israel and abroad.

### Global issues

National accounts information of various countries and economic indicators show that global growth continued, although at a slower rate than in 2004. Following growth of 5.1 percent in 2004, global GDP is expected to rise in 2005 by 4.3 percent according to the IMF forecast. World trade is expected to increase by 7.4 percent according to that forecast, after rising by 9.9 percent in 2004. A further increase in oil prices may reduce world growth, which is led by the US and China while growth in the eurozone and Japan is at a lower rate (Table 5).

### Prices, monetary policy and the money and capital markets

**The CPI** went down in 2005:I and went up again in 2005:II, giving a rise over the period as a whole of 0.5 percent (Table 7). The rise in prices excluding housing, seasonal items (fruit and vegetables, and clothing and footwear) and prices under government control was 0.8 percent in the period reviewed.

Figure 1.10

Inflation in previous 12 months and the inflation target, 1998-2005\*



The low rate of inflation in the period despite economic growth and the increase in oil prices can be explained in part by the moderating effect of housing prices. The depreciation of the NIS against the dollar that started in June and stopped recently has not yet been reflected in full.

Twelve-month **inflation expectations**, which had dropped at the end of 2004 and risen again in the first quarter of 2005 (Table 9), remained almost unchanged in the second quarter, just below the midpoint of the target inflation range of 1–3 percent a year (Figure 1.11). According to the Companies

Figure 1.11

Interest and inflation expectations, 1998-2005\*

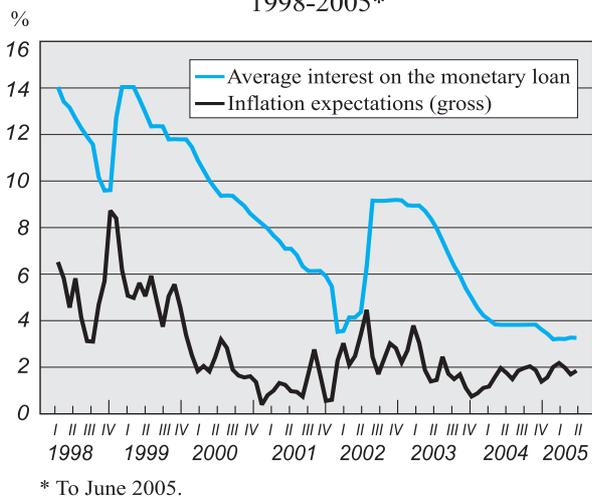
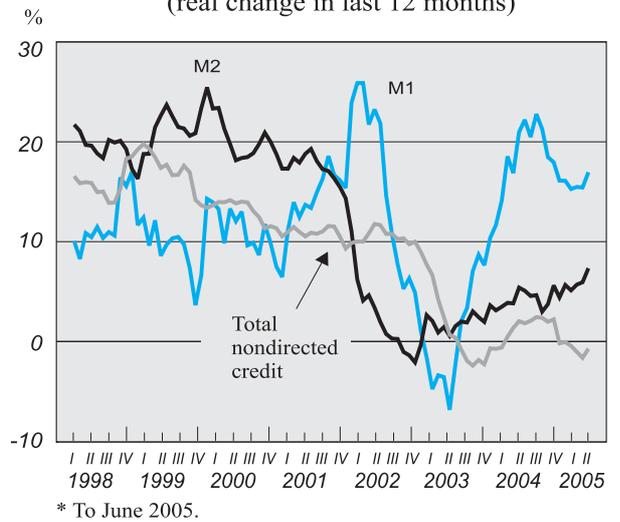


Figure 1.12

Monetary aggregates and credit, 1998-2005\* (real change in last 12 months)

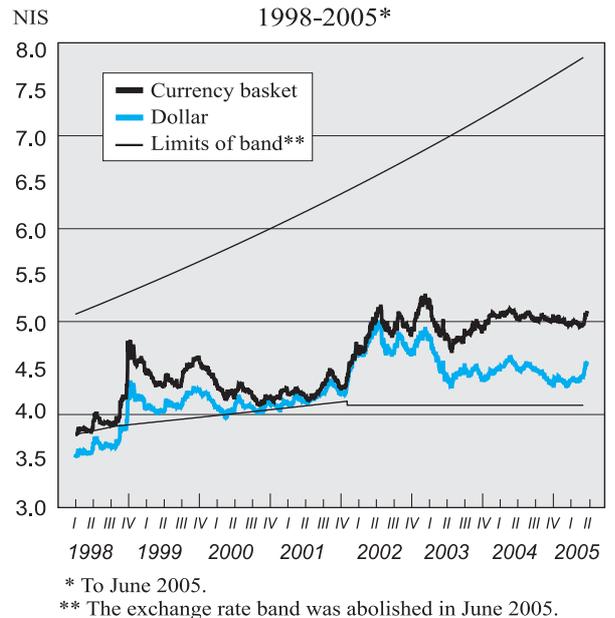


Survey, inflation expectations rose in the last few months. Longer term inflation expectations, for periods of more than a year, rose in the first quarter and remained virtually unchanged in the second.

The **NIS/dollar exchange rate** hardly changed in the period from January to May 2005 (Figure 1.13), but in June there

Figure 1.13

The NIS exchange rate against the currency basket and the dollar and the exchange-rate band, 1998-2005\*



was rapid depreciation, against the background of increased purchases of foreign currency by households. Unlike in the first five months of the year, when changes in the NIS/dollar exchange rate were attributed mainly to world events, the depreciation in June was essentially caused by domestic factors.<sup>3</sup>

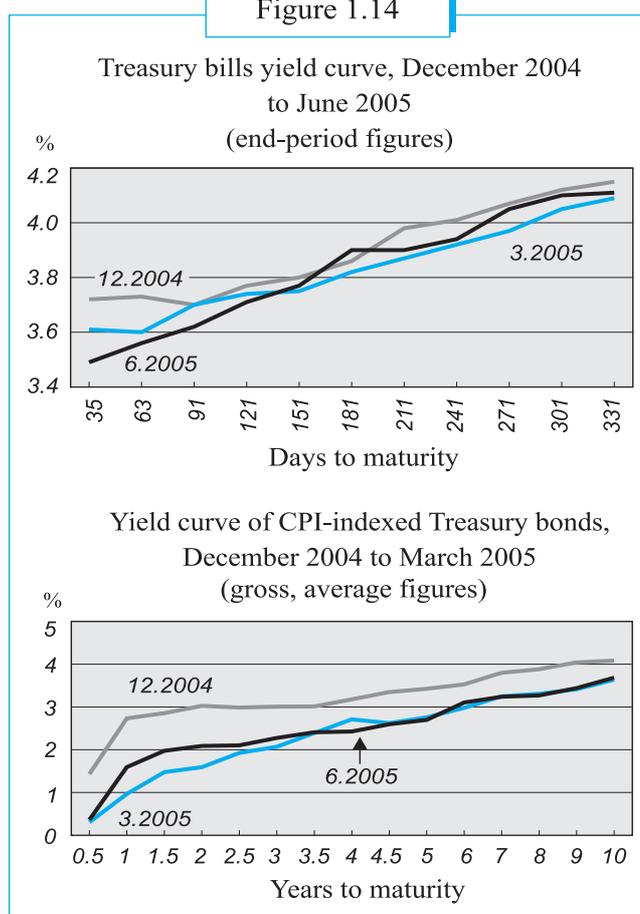
In the light of the low level of actual inflation in the period reviewed, which was below the target, the calm in the financial markets, and the relative stability of the foreign currency market, the Bank of Israel followed an expansionary monetary policy: it reduced the headline rate of interest by 0.2 percentage points each month from December 2004 to February 2005, since when it has been held unchanged at 3.5 percent.<sup>4</sup> In the period reviewed the US central bank continued to raise the interest rate, so that the interest-rate differential narrowed to an unprecedented low level, 0.25 percentage points, at the end of the second quarter.

The M1 money supply continued expanding rapidly. It increased faster than did M2, so that assets became more liquid (Table 8 and Figure 1.12). This greater liquidity is consistent with low interest and with moderate inflation expectations. It also probably indicates the credibility of monetary policy: the public is not deterred from holding considerable amounts of unindexed assets.

**Nondirected bank credit** decreased in the first and second quarters of 2005 despite the expansion of economic activity. Some companies raised capital or credit via alternative means such as flotations on the stock exchange or bond issues. The Companies Survey shows that the severity of the liquidity constraint on implementing planned activity was very low, and went even lower in the second quarter. Section 2 of this review contains a discussion of the question whether credit contracted because of lower demand from companies in the light of the possibilities of raising capital and debt via alternative means, or because of a cutback in the supply of credit from the banks, which motivated companies to raise credit from nonbank sources.

Nominal yields to maturity on 1-year Treasury bills as well as real long yields (on 5- and 10-year bonds) continued to decline in the period reviewed. The risk premium, as reflected by the 5-year credit-default-swaps (CDS) market, declined throughout the period to reach 0.29 percent in June (Table

Figure 1.14



9). The drop in interest rates and the risk premium supported real activity, and apparently reflected the confidence of the public and of the international financial organizations in the government's policy regarding the budget deficit.

The General Share Price Index rose modestly during the first half year (Table 9), and declined at the end of the period. This was apparently due to a drop in growth expectations, a contraction in the NIS/dollar interest-rate differential, and the approach of the date for the start of the disengagement process. Trade turnover continued to increase throughout the period.

<sup>3</sup> See the Bank of Israel Inflation Report 16, January to June 2005.

<sup>4</sup> At least until August.

Table 1. National Accounts,<sup>a</sup> 2004–2005

	2004				2005		Last month for which data available
	2004	II	III	IV	I	I <sup>b</sup>	
GDP	4.3	4.1	3.4	4.5	3.3	3.8	Mar
Business-sector product	6.1	5.7	4.8	6.6	3.5	5.1	Mar
Private consumption	5.7	3.2	2.5	11.8	0.8	4.5	Mar
Gross domestic investment	6.4	10.9	53.0	-1.9	9.8	16.3	Mar
Investment in fixed assets	-1.7	-9.3	-0.5	12.4	-10.6	-2.4	Mar
Goods and services exports	14.9	11.7	2.3	4.1	2.0	4.9	Mar
Goods and services exports excl. diamonds	16.2	16.3	3.3	0.0	1.3	5.0	Mar
Goods and services imports	12.0	8.6	10.5	2.2	-2.4	4.6	Mar
Goods and services imports excl. diamonds	12.9	14.5	-0.6	9.6	-1.0	5.4	Mar
Public sector consumption	-1.9	-0.1	-2.9	-5.4	-3.9	-3.1	Mar
Public sector consumption excl. defense imports	-1.3	-1.0	-5.7	-5.7	-4.9	-4.3	Mar

<sup>a</sup> Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted.

<sup>b</sup> Compared with 2004 I.

SOURCE: Central Bureau of Statistics.

Table 2. Indicators of Business Activity,<sup>a</sup> 2004–2005

	2004	2004				2005		Jan–Jun 05 <sup>b</sup>	Last month for which data available
		II	III	IV	I	II			
Composite state-of-the-economy index	4.3	6.0	3.7	3.5	-0.4	-1.6	2.2	Jun	
Large-scale retail trade	3.8	4.8	6.3	3.5	4.1	6.0	4.8	Jun	
Manufacturing production (excl. diamonds)	7.2	2.9	7.9	8.0	1.4	4.5	5.5	May	
Index of trade revenue	6.7	0.5	6.9	9.9	8.7	2.4	6.7	May	
Index of trade and services revenue	7.9	4.6	7.2	7.1	7.6	3.2	6.6	May	
Tourist arrivals	42.8	73.7	-6.7	2.5	57.5	66.7	26.5	Jun	
Residential construction <sup>c</sup>									
Starts	-5.4	-5.5	-11.9	4.8	-5.5		-10.2	Apr	
Completions	-6.2	-8.6	-11.2	6.0	-9.8		-6.3	Apr	
Nonresidential construction									
Area of starts		-24.8	-33.3	34.1	-32.4		-32.4	Mar	
Survey of companies (net balance, percent) <sup>d</sup>									
Weighted balance of the business sector		17	19	15 <sup>e</sup>	22	22		Jun	
Output of manufacturing firms		21	23	26	20	21		Jun	
Sales by trading firms		15 <sup>e</sup>	18 <sup>e</sup>	39	29	34		Jun	

<sup>a</sup> Percentage change from previous period, in annual terms, at constant prices, seasonally adjusted except for construction industry data.

<sup>b</sup> Compared with January–June 2004.

<sup>c</sup> Change from equivalent period one year earlier.

<sup>d</sup> 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.

<sup>e</sup> Not significant at 10% level.

SOURCE: Central Bureau of Statistics.

Table 3. Indicators of Labor Market Developments,<sup>a</sup> 2004–2005

	2005		2004			2005		Jan– Jun 05 <sup>a</sup>	Last month for which data available
	I	II	II	III	IV	I	II		
	('000s)								
Civilian labor force	2,694		0.6	–0.2	–0.1	0.6		1.0	Mar
Israeli employees	2,449		1.0	0.2	0.3	1.4		3.0	Mar
Of which: in general government	746		0.9	–0.4	1.5	2.1		4.4	Mar
in business sector	1,699		0.8	1.0	–0.2	0.7		2.3	Mar
Foreign workers and Palestinians (unadjusted)	232		–5.1	6.9	–0.6	2.7		3.6	Mar
Average hours worked weekly per employee	36		–0.3	–0.8	–0.3	–1.4		0.5	Mar
Labor input in business sector (incl. foreign workers and Palestinians), weekly	83,205		–1.5	0.9	–0.1	3.7		2.9	Mar
Of which: Israelis, weekly	72,896		–1.0	0.0	0.1	3.9		3.7	Mar
Labor input in general government (Israelis), weekly	18,142		0.1	–0.4	0.1	2.2		1.9	Mar
Unemployed	245		–2.8	–3.7	–3.2	–6.7		–15.5	Mar
Work seekers	230	232	–1.1	2.7	–3.1	1.2	0.9	–1.0	Jun
Claims for unemployment benefit	70	73	–11.7	–2.8	–3.4	0.3	4.3	–9.8	Jun
	Nominal NIS (unadjusted)								
Real wage per employee post <sup>c</sup>	6,716	6,669	–4.0	1.5	2.0	–0.6	0.4	0.0	Apr
In general government	6,331	6,079	–12.7	5.1	7.2	–4.8	0.0	–4.7	Apr
In business sector	6,901	6,950	–0.8	0.1	0.6	1.6	0.8	2.2	Apr
Nominal wage per employee post <sup>c</sup>	7,099	7,094	–3.8	1.9	2.4	–0.9	0.4	0.7	Apr
In general government	6,692	6,467	–10.8	4.8	6.4	–5.2	0.2	–4.0	Apr
In business sector	7,295	7,393	–0.4	0.4	1.0	1.2	0.7	2.8	Apr
	Percent, seasonally adjusted								
Participation rate			55.2	54.9	54.6	54.7		–0.8	Mar
Employment rate			49.4	49.3	49.2	49.7		1.1	Mar
Unemployment rate			10.5	10.1	9.8	9.1		–16.2	Mar
Depth of unemployment <sup>d</sup>			42.6	39.7	42.6	41.0		5.9	Mar

<sup>a</sup> Seasonally adjusted.<sup>b</sup> Compared with January–June 2004 (unadjusted).<sup>c</sup> Including foreign workers and Palestinians.<sup>d</sup> Percent of unemployed seeking work for more than six months.

SOURCE: Central Bureau of Statistics, Labor Force Survey, except for data on Israelis, non-Israelis, and labor input in the business sector, and total Israelis employed, which are the Central Bureau of Statistics' National Accounts estimates.

Table 4. Foreign Trade, Balance of Payments, and the Reserves,<sup>a</sup> 2004–2005

	2004				2005		Jan– Jun 05 <sup>a</sup>	Last month for which data available
	2004	II	III	IV	I	II		
	percent change from previous period <sup>c</sup>							
Trade in goods <sup>d</sup>								
Goods imports	20.8	4.8	-2.7	9.9	-2.2	0.5	7.3	Jun
Of which: Consumer goods	17.4	-1.5	-1.6	13.0	-4.1	7.8	10.0	Jun
Capital goods	15.2	4.3	-2.2	3.3	-0.2	-0.3	2.8	Jun
Intermediates	24.2	6.9	-3.3	11.6	-2.4	-1.4	8.1	Jun
Goods exports	21.6	3.9	-0.6	9.0	-1.5	-0.4	8.5	Jun
Of which: Manufacturing	21.6	4.6	-0.2	8.1	-2.1	0.0	8.1	Jun
Of which: High-tech	21.8	5.6	1.1	3.0	-2.3	6.4	7.9	Jun
	\$ million							
Balance of payments								
Goods and services exports	51,445	12,758	12,958	13,750	13,819			Mar
Goods and services imports	52,040	12,595	13,125	13,719	13,847			Mar
Balance of trade in goods and services	-595	163	-167	32	-28			Mar
Current account	1,474	492	360	646	531			Mar
Financial account (excl. foreign exchange reserves) <sup>e</sup>	-570	-1,905	296	93	-2,016			Mar
Of which: Nonresidents' direct investment <sup>c</sup>	416	738	-368	775	1,840			Mar
Nonresidents' portfolio investment <sup>c</sup>	1,391	1,134	563	1,725	2,677			Mar
Residents' direct and portfolio investment abroad <sup>c</sup>	1,375	608	695	1,069	1,641			Mar
Net foreign debt (percent of GDP) <sup>e</sup>	-9.6	-8.6	-7.8	-9.2	-13.6			Mar
Bank of Israel reserves, end-period <sup>e</sup>	26,632	25,712	25,839	26,632	26,704	26,203		Jun

<sup>a</sup> Seasonally adjusted.

<sup>b</sup> Compared with January–June 2004 (unadjusted).

<sup>c</sup> The change relates to the dollar values of imports and exports, not to their volumes.

<sup>d</sup> Data on trade in goods do not include ships, aircraft, diamonds, and fuels.

<sup>e</sup> Unadjusted data.

SOURCE: Central Bureau of Statistics.

**Table 5. Indicators of Economic Development in Advanced and Developing Countries<sup>a</sup>  
(annual rate of change, percent)<sup>b</sup>**

	2002	2003	2004	Projection 2005
World GDP	3.0	4.0	5.1	4.3
Advanced countries	1.6	2.0	3.4	2.6
Developing countries	4.7	6.4	7.2	6.3
World trade	3.3	4.9	9.9	7.4
Advanced countries				
Imports	2.6	3.6	8.5	6.5
Exports	2.2	2.8	8.1	5.9
Developing countries				
Imports	6.1	8.9	15.5	12.0
Exports	6.7	10.7	13.8	9.9
Commodity prices (US\$)				
Oil <sup>c</sup>	2.5	15.8	30.7	23.2
Nonfuel	0.8	7.1	18.8	3.8
Inflation (CPI) in advanced countries	1.5	1.8	2.0	2.0
Short-term interest <sup>d</sup> (%)				
Dollar deposits	1.9	1.2	1.8	3.3
Euro deposits	3.3	2.3	2.1	2.3
Unemployment rate in advanced countries	6.4	6.6	6.3	6.1

<sup>a</sup> According to "World Economic Outlook" Israel is classified as an advanced country. The advanced countries include the industrialized countries and some emerging markets.

<sup>b</sup> Except for unemployment and interest rates.

<sup>c</sup> Average price per barrel in 2004 was \$37.76 .

<sup>d</sup> Six-month Libor rate for US dollar deposits, and three month Libor rate on euro deposits.

SOURCE: "World Economic Outlook" (IMF), April 2005.

Table 6. Government Budget Performance vis-à-vis Deficit Target, 2004–2005

	2004	2004			2005		Jan– Jun 05 <sup>a</sup>	Last month for which data available
		II	III	IV	I	II		
Domestic deficit as percent of GDP	-2.8	-3.4	-1.3	-5.8	3.5		3.5	Mar
Deviation from path <sup>b</sup> (domestic budget, excl. credit extended) (NIS billion)								
Government revenue	-1.5	-2.5	-2.3	2.8	1.7	-1.0	0.9	Jun
Government expenditure	-3.4	-2.1	-4.5	3.1	-2.6	-3.4	8.3	Jun
Domestic deficit	-1.9	0.4	-2.2	0.3	-4.3	-2.4	7.4	Jun
Total government deficit	20.4	7.4	3.3	9.8	-3.7	4.7	-18.0	Jun
percent change from respective period, previous year								
Government tax revenue	4.7	5.6	0.3	5.0	3.8	3.4	4.1	Apr
<i>Of which:</i> income tax, net	3.1	1.7	-0.9	1.5	6.6	7.7	6.1	Apr
VAT, gross	5.5	9.2	4.1	4.8	1.2	3.3	2.2	Jun
Government expenditure	0.2	-5.2	-4.4	11.7	-1.0	4.2	1.5	Jun
National insurance allowances	-4.9	-7.6	-4.6	-0.5	-3.4	0.7	-1.9	Apr
<i>Of which:</i> Unemployment benefit	-12.8	-16.2	-18.3	-8.7	-18.4	2.8	-15.4	Apr
Income support	-9.7	-19.8	-4.4	6.9	-10.2	-0.2	-8.2	Apr
National insurance contributions								
received from the public	1.6	0.0	-0.7	4.5	2.1	4.0	2.8	May

<sup>a</sup> Compared with January–June 2004.

<sup>b</sup> The path was determined on the basis of a deficit of 4 percent of GDP in 2004, and 3 percent of GDP in 2005. Figures comparing Jan–June 05 with Jan–Jun 04 relate to the change in each item, not to the deviation from the path.

SOURCE: Ministry of Finance.

Table 7. Selected Price Indices,<sup>a</sup> 2004–2005

	2004	2004			2005		Jan– Jun 05	Last month for which data available
		II	III	IV	I	II		
CPI	1.2	6.2	-0.8	0.0	-2.4	4.5	1.0	Jun
CPI excl. housing, fruit and vegetables	2.1	8.5	-1.9	2.0	-1.5	5.1	1.7	Jun
CPI excl. housing, fruit and vegetables, price-controlled goods, clothing and footwear	2.5	7.2	0.7	-0.3	0.9	2.4	1.6	Jun
Index of housing prices	-2.5	5.8	0.4	-14.9	-4.8	6.4	0.7	Jun
Wholesale price index	7.6	11.1	2.4	7.7	4.0	6.3	5.1	Jun
NIS/\$ exchange rate	-1.2	1.2	-1.7	-13.1	-1.2	15.2	6.7	Jun
NIS/currency-basket rate	1.8	-0.5	-1.7	-1.4	-3.5	4.3	0.4	Jun

<sup>a</sup> Annual rates of change during period, percent.

SOURCE: Central Bureau of Statistics.

**Table 8. Monetary Aggregates and Nondirected Bank Credit, 2004–2005**  
 (annual terms, percent)

	2004	2004			2005		Jul 04– Jun 05	Jan– Jun 05	Last month for which data available
		II	III	IV	I	II			
Rates of change		Change from preceding period			During period				
M1 <sup>a</sup>	18.0	24.2	21.4	1.4	17.7	24.8	17.0	23.4	Jun
M2 <sup>b</sup>	4.2	–0.4	7.7	5.7	7.5	4.5	7.3	6.5	Jun
M3 <sup>c</sup>	4.6	4.2	5.7	5.1	9.8	7.3	8.1	9.2	Jun
Nondirected bank credit	1.2	1.8	–0.6	0.4	–2.4	–1.9	–0.7	–1.1	Jun
Unindexed local-currency credit	5.6	7.0	6.6	11.7	14.6	0.4	8.0	6.3	Jun
CPI-indexed credit	0.0	–3.4	–4.0	–6.9	–8.1	0.4	–4.4	–1.8	Jun
Credit in and indexed to foreign currency	–2.8	2.5	–5.2	–4.3	–17.1	–8.5	–7.8	–10.8	Jun

<sup>a</sup> Narrow money supply (cash in the hands of the public and demand deposits).

<sup>b</sup> M1 plus short-term local-currency unindexed deposits.

<sup>c</sup> M2 plus short-term CPI-indexed deposits.

SOURCE: Bank of Israel.

**Table 9. Interest Rates, Yields, and the Share-Price Index, 2004–2005**  
 (quarterly average, percent)

	2004	2004			2005		Jan– Jun 05 <sup>a</sup>	Last month for which data available
		II	III	IV	I	II		
Nominal interest								
SRO deposits	3.1	3.1	3.1	3.1	2.7	2.7	2.7	Apr
Nondirected local-currency credit	6.8	6.8	7.0	6.8	6.3	6.2	6.3	Jun
Effective interest in daily deposit auction	4.4	4.3	4.3	4.2	3.7	3.7	3.7	Jun
LIBID 3-month dollar interest	1.5	1.2	1.6	2.2	2.7	3.2	2.9	Jun
Yield to maturity on:								
Treasury bills	4.8	5.0	4.8	4.6	4.2	4.0	4.1	Jun
Yield on 10-year bonds	4.2	4.3	4.3	4.2	3.8	3.7	3.8	Jun
Yield on 5-year bonds	3.8	3.9	3.8	3.6	3.1	3.0	3.0	Jun
Risk premium <sup>b</sup>	0.5	0.6	0.5	0.4	0.4	0.3	0.4	Jun
Expected inflation	1.6	1.8	1.8	1.7	1.9	1.8	1.9	Jun
General Share-Price Index (change)	17.4	5.8	–9.7	12.5	6.6	–1.2	5.3	Jun

<sup>a</sup> Compared with January–June 2004.

<sup>b</sup> As measured by the 5-year credit-default-swaps (CDS) market.

SOURCE: Bank of Israel.

## Part 2: Broader Review of Selected Issues

### Macroeconomic Forecast for 2005 and 2006

GDP growth is expected to slow down somewhat in 2005, to 3.5 percent, and to revert in 2006 to the growth rate of 2004 of about 4 percent. These rates of growth will be led by the growth of business-sector product resulting from increased exports and private consumption. At the same time the relative share in GDP of investment in the business sector is predicted to drop in the next two years, which is likely to have an adverse effect on the economy's productive capacity over time. Developments during the two years will follow the same pattern as above, i.e., a slowdown in 2005 and resurgence in 2006. These fluctuations in the forecast rates of growth largely reflect fluctuations in business-

sector product. The forecast is partly based on a slow rate of growth in manufacturing industry in the first half of 2005 and continued decline in construction activity. The predicted increase in GDP in the next two years will go hand in hand with a rise in labor productivity and in the number of employed persons, that will lead to the stabilization of the unemployment rate in 2005 and another decrease in 2006.

The moderate growth in 2005 reflects mainly the steep drop in the growth of exports; this is only partly explained by the slower expansion of world markets, as measured by the extent of world trade, following its exceptional surge in 2004. The slowdown in Israel may have also been partly due to the deterioration in the terms of trade. In contrast to the fluctuations in the last two years, the forecast for 2006 is

Table 10. Economic Indicators, 2003 to 2006

Sources and uses	2003	2004	2005	2006
			forecast	forecast
	(volume change, <sup>a</sup> percent)			
1. GDP	1.3	4.3	3.5	4.0
2. Business-sector product	1.7	6.1	4.1	5.0
3. Private per capita consumption	-0.5	3.9	2.5	2.9
4. Public consumption excluding defense imports	-0.8	-1.3	1.1	0.7
5. Investment in fixed assets	-4.9	-1.7	0.3	3.0
6. Domestic uses excluding defense imports	-1.0	3.9	3.3	3.8
7. Goods and services exports	6.2	14.9	5.4	7.2
8. Civilian imports	-1.0	13.1	4.8	6.6
	Balance of payments (\$ billion, at current prices)			
9. Civilian import surplus, goods and services <sup>b</sup>	-0.1	-0.2	0.3	0.0
10. Current-account deficit <sup>b</sup>	-0.5	-0.4	0.2	-0.5
	Population, employment and prices (percent change)			
11. Average population	1.8	1.7	1.7	1.7
12. Unemployment rate (percent of labor force)	10.7	10.4	9.1	8.4
13. Total number of Israelis employed	2.0	3.0	2.5	2.6
<i>Of which:</i> In business sector	2.3	4.3	2.5	3.1

<sup>a</sup> At 2003 prices

<sup>b</sup> The data of the import surplus and the current account shown in this table are consistent with the National Accounts data. The export figure for 2004 was recently revised upwards without an equivalent adjustment to the National Accounts, and is therefore not shown here. In any case, most of the adjustment was offset by an equivalent drop in investment in inventories, and does not therefore affect GDP.

that the rise in exports will be in line with the rise in world trade.

The rate of increase of exports has slowed markedly since the second half of 2004, despite surplus capacity and the relatively favorable real exchange rate. This reversal is expected to cause a considerable reduction in the rate of growth of business-sector product in 2005. There is no clear explanation for this, and it greatly reduces the certainty of its forecast development. The assumption underlying the forecast, backed also by external sources of information that measure expectations (such as the Bank of Israel Companies Survey), is that exports will grow somewhat faster.

The recovery process hitherto was not accompanied by an increase in investment in the business sector, and investment in residential buildings even continued to fall, in contrast to recovery processes in the past. Moreover, although the capital market made available substantial funds for investment, these have not to date been directed into real investments. It was assumed nonetheless that there would be a positive turnaround in investment, particularly in residential construction, in the course of 2005.

Although the rise in private consumption slowed to some degree, this was due mainly to a slowdown in purchases of durable goods, whereas consumption of non-durables, which contributes significantly to domestic activity, is expected to grow in the next two years at a rate similar to that in 2004. This relatively fast growth rate of *per capita* consumption, more than 2 percent in each of the two years, is supported by the tax reductions and the continued improvement in the labor market. The planned reduction in direct tax will focus on the average income level, where the marginal propensity to consume is relatively high; in addition, it was assumed that about half of the planned reduction in VAT will be diverted into increased consumption. These tax cuts will add about half a percentage point to the rate of increase of private consumption. The continued recovery in the economic situation and the reduction that occurred in the rate of unemployment help to support the upward trend in private consumption.

Public domestic consumption is expected to grow relatively slowly in the next two years, although government expenditure may deviate to some extent from the targets, partly as a result of the disengagement process. *Per capita* public consumption will continue to decline, and the number of employees in public services will rise more slowly than the labor force.

Imports are expected to increase relatively rapidly, due to the stabilization of inventories following years of continued decline. Nevertheless, imports are expected to rise at the same rate as exports in 2005, and more slowly than exports in 2006, partly as a result of a relatively low level of investment in Israel. The forecast rise in imports is derived via the

import coefficients of uses,<sup>5</sup> under the assumption of slight depreciation of the NIS in 2005, due to a small reduction in per unit labor cost, and real appreciation in 2006.

The balance-of-payment current account is expected to deteriorate by about \$ 0.5 billion in 2005,<sup>6</sup> reflecting a slower real rate of increase of exports than of imports, and a deterioration in the terms of trade. This is expected to be corrected in 2006, with exports rising at a relatively high real rate.

The central assumption underlying the forecast is that of stability in the political-security situation and the implementation of the disengagement process without any significant effect on current economic activity. Any deviation from these assumptions, either with a rise in the number of terrorist incidents and victims, or the undermining of political stability, would have far-reaching economic implications: it would immediately strike a blow at the tourist industry and at private consumption and investment. In such a case, forecast growth for 2006 is likely to be about 2 percentage points lower than that presented above (depending on the seriousness of the events). Private consumption would rise at a very slow rate, contributing about a one percentage point reduction in GDP, while the expected reduction in tourism and in investment in the principal industries (instead of the forecast increases) would each cause a half a percentage point reduction.

### Estimate of the Increase in GDP Resulting from the Rise in Tourism in 2005<sup>7</sup>

An estimate is presented herein of the rise in GDP resulting from the increase in incoming tourism in 2004 and 2005 compared to its level in 2003. In 2003 1.06 million tourists entered Israel, in 2004, 1.5 million, and it is estimated that in 2005 about 1.9 million tourists will arrive.<sup>8</sup> These increases were expressed in, among other things, a rise of NIS 320 million in the product of hotels and guesthouses in 2005 compared with 2003, and a rise of NIS 380 million in the product of restaurants. In short, the increase in incoming tourism compared to the level in 2003 contributed about 0.3 percentage points to the rise in GDP in 2004, and is expected to contribute 0.2 percentage points in 2005.

<sup>5</sup> The coefficients from the input-output tables of 1995 were adjusted and changed in order to match actual imports in 2004.

<sup>6</sup> The basis presented here is not up to date, and therefore only changes are referred to.

<sup>7</sup> Thanks are due to S. Bar-Eliezer, L. Rivkin and L. Ostrovski of the Central Bureau of Statistics for their helpful comments and advice.

<sup>8</sup> This estimate is based on the 27 percent increase in tourism in the first half of 2005 compared with that in the first half of 2004, under the assumption that the second half-year will show the same increase.

Table 11. Exports of Tourist Services, percent of GDP

	2000	2001	2002
Cyprus	21.5	21.7	18.4
Greece	8.2	8.1	7.3
Morocco	6.1	7.5	6
Spain	5.6	5.6	5.1
Portugal	5	5	4.9
Turkey	3.8	5.1	4.9
Italy	2.6	2.4	2.3
France	2.4	2.3	2.3
Israel	2.9	1.4	1.2
Global (average)	1.5	1.5	1.5
UK	1.2	1.2	1.2
OECD countries (average)	1.3	1.1	1.1

SOURCE: World Bank, World Development Indicator

The tourist industry is very sensitive to the security situation in Israel and world wide, and is the first to suffer when the situation deteriorates. A deterioration in the security situation immediately causes a sharp drop in incoming tourism, and the recovery process is a slow one. With the outbreak of

the *intifada* at the end of September 2000, the number of tourists arriving in Israel slumped, and continued to decline as the terrorist incidents persisted. In 2003 Israel's security situation improved, and continued improving in 2004 and until the end of the period reviewed, June 2005. Exports of

Table 12. Product of Incoming Tourism at Current Basis Prices, <sup>a,b</sup>

	1995	2003	2004	2005	2004
					Employees serving incoming tourism <sup>c</sup> ('000)
					(NIS million)
Goods and services					
a. Goods and services characteristic of tourism	4,295	2,695	3,680	4,628	39
Hotels and guesthouses	1,319	766	1,064	1,340	8.4
Restaurants and catering	539	313	435	548	14.2
Transport services	1,008	787	1,030	1,288	7
Of which: Taxi services	259	150	208	263	2
Air services	449	463	580	720	2.4
Car services <sup>d</sup>	263	153	212	268	2.3
Travel and tourist agencies	216	125	174	219	2.2
Culture and sports services	205	107	149	188	1.6
Miscellaneous: Apartment rental	764	443	616	776	2.8
b. Tourism-related goods and services <sup>e</sup>	717	416	578	729	5.5
c. Other goods and services	415	241	334	421	3.6
Total	5,427	3,353	4,593	5,778	47.8
GDP	249,017	460,723	486,022		

<sup>a</sup> Basis prices are producers' cost prices, including subsidies, such as subsidies to public transport, water and export incentives; they do not include marketing, transport or tax expenses.

<sup>b</sup> The product of incoming tourist services for all years is calculated via the input-output tables for 1995. The product for 1995 was obtained from the satellite account of tourism in Israel of the Central Bureau of Statistics, 2005.

<sup>c</sup> Some of the employed are in part-time jobs.

<sup>d</sup> Including cars, maintenance and repairs, parking etc.

<sup>e</sup> Including profit margin between wholesale and retail.

tourist services, according to National Accounts data, went down from NIS 12.8 billion in 2000 to NIS 3.8 billion in 2002. In 2004 they rose to NIS 5.5 billion. Incoming tourism to Israel is also affected by global factors: from the end of 2001 till 2003 tourism was affected by the September 11, 2001 terrorist attacks in the US, by worldwide terrorism, and by the global recession. In 2003 world tourism went down slightly, whereas in 2004 and the first half of 2005 the global economic situation improved, greatly boosting tourism. In 2004 world tourism increased by more than 10 percent, and is expected to rise by 7.7 percent in 2005.

The relative size of the incoming tourist industry in Israel is similar to the industry's size in other countries (Table 11). In 2002 exports of tourist services constituted about 1.5 percent of global GDP, and in Israel it was only 1.2 percent, rising in 2004 to 1.8 percent of GDP. The added value of tourism in 2004 accounted for a little under one percent of GDP, and in 2005 it is expected to increase to about 1.1 percent of GDP (Table 12).

The improvement in incoming tourism in 2004 and the first half of 2005 benefited mainly those industries directly involved, such as hotels and suppliers of services such as catering (restaurants), transport, car hire, air transport etc. However, an examination of the industry composition of the export of tourist services according to input-output tables reveals that those indirectly involved, such as manufacturing industry, agriculture and trade, also benefited from the rise in incoming tourism. The improvement in the tourist industry thus has an economy-wide effect. Table 12 shows the product of incoming tourism by the main industries. The main effect is on the industries characteristic of tourism.

A large proportion of those employed in tourism are employed by hotels, restaurants, taxi services and public transport—in which the monthly wage per employee is below the average wage in the economy. It was found that in 2004 almost 48,000 employees<sup>9</sup> worked to meet the demand for incoming tourist services.

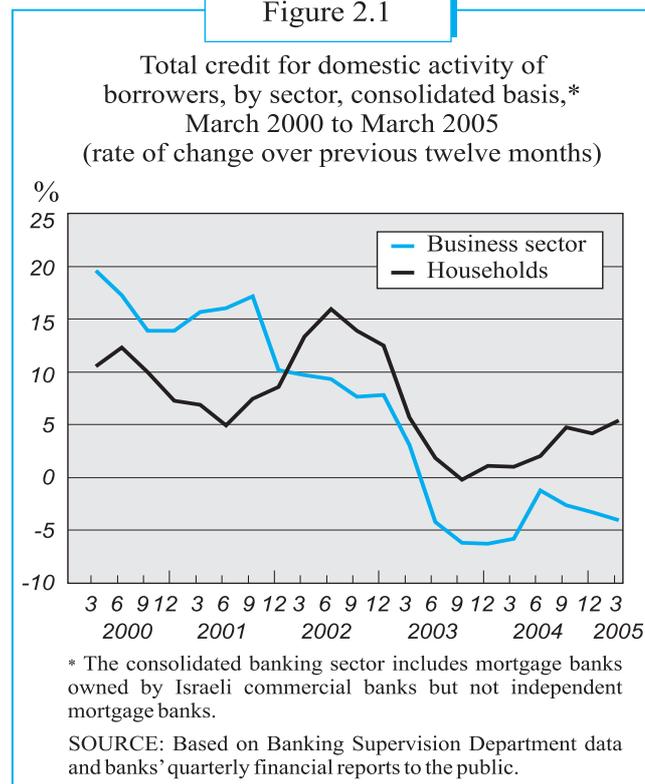
## The Development of Bank Credit, 2003 to March 2005

### 1. The development of bank credit

Bank credit increased slowly from mid-2002 due *inter alia* to the tightening of monetary policy by the Bank of Israel, and decreased between 2003 and the first quarter of 2005 despite the upturn in economic activity and the gradual reduction of the interest rate by the Bank of Israel. An analysis of the characteristics of the firms which raised capital in the domestic capital market through corporate bonds during this

<sup>9</sup> Some in part-time employment.

Figure 2.1



period and of the commercial banks' balance sheets reveals that in addition to the impact of demand-side factors, supply-side factors also played a major role in the development of bank credit. This contribution seems to have been greater than initially thought from a first glance of the data.

The data show that the decrease in bank credit reflects a contraction of credit to the business sector, since bank credit to households began to expand at the beginning of 2003 due to the growth in housing loans.

The contraction of bank credit during the period surveyed cannot be attributed to a higher risk premium arising from a higher probability of borrowers' default because of the slowdown in economic activity, since the economy started emerging from the recession during this period. The decrease in bank credit to the business sector as a result of risk factors may still reflect the continued slowdown in the construction and in the real estate sectors, whose relative weight in total bank credit is particularly high (15–20 percent). However, credit to the business sector exclusive of these sectors continued to contract, implying that its decrease and that of bank credit as a whole during the last two years cannot be attributed to the current level of economic activity. The data on bank credit presented here are net of loan-loss provisions arising from borrowers' domestic activity. The rise in loan-loss provisions could be also regarded as the source of the decline in bank credit during the two last years. This claim is not however borne out by the data which indicate that

bank credit expanded in 2002 in spite of the fact that loan-loss provisions reached their peak during that year—NIS 7 billion—and contracted in 2003 and 2004 when these provisions declined.

Data of the Banking Supervision Department at the Bank of Israel also indicate that the observed decrease in bank credit cannot be attributed to prudential restrictions on bank lending, which could have pushed borrowers to raise capital through corporate bonds in the domestic capital market. It seems therefore that the observed decline in bank credit on the one hand and the issuing of corporate bonds by the business sector on the other should be attributed to one or both of two economic possibilities: The first, on the demand side, is that borrowers moved away from banks as evidenced by the unprecedented wave of corporate bond issues during the period reviewed, taking advantage of, among other factors, the gradual exit of the government from the domestic capital market because of its diminishing finance requirements for its decreasing budget deficit. The second possibility is that the supply of bank credit contracted for reasons other than the extent of economic activity, limiting borrowers' access to bank credit because of its higher cost, and pushing them towards raising the required funds through corporate bonds in the domestic capital market.

## **2. The contraction of bank credit: a fall in demand or a supply contraction?**

An analysis of the data relevant to the wave of corporate bond issues in the domestic capital market during the two last years and of the commercial banks' balance sheets shows that the duration (average term to maturity) of the banks' liabilities, which constitute the main source of credit financing, was on average considerably lower than that of the financing requirements of the issuing companies. It also transpires from the data that issues representing a considerable proportion of the funds raised by corporate bonds were used at least partially for restructuring the issuing firms' liabilities. The consolidated balance sheet data of the banking sector indicate a fall in the share of bank credit on the asset side of the balance sheet and a rise in banks' holdings of government bonds, while data on the evolution of interest rates show an increase in the spread between the interest rate on short-term unindexed local-currency bank credit and the Bank of Israel interest rate. The claim that will be presented below is that these findings are consistent with a contraction in the supply of bank credit.

### *Corporate bond issues: some stylized facts*

(1) The data on (straight) bond issues between 2003 and the first quarter of 2005 indicate that the overwhelming majority of these issues were made by a small number of large firms with a relatively high credit-rating. According to the data,

42 companies (excluding bank-owned financial companies) raised a total of NIS 23.9 billion by issuing corporate bonds. 49 percent of the funds were raised by only four companies (The Israel Electric Corporation, IDB, Bezeq and Partner). Eight companies with an AAA-AA rating raised 57 percent of the total funds while 47 percent of the funds were raised by firms that had raised capital previously by issuing corporate bonds.<sup>10</sup>

The issues by firms with a relatively high credit-rating, which could have obtained bank credit at competitive terms due to their access to alternative sources of finance can provide but limited support to the hypothesis of a borrowers' flight by these firms from bank credit at the present time since they had already raised capital from non-banking sources in the past. The reason for a substantial portion of the unprecedented wave of corporate (straight) bond issues and their timing must consequently lie in factors other than competition to bank credit from the domestic capital market resulting from the gradual exit of the government from it due to the diminishing financing requirements for its budget deficit and the decreasing government debt. It should be noted in this respect that the real par value of the net domestic public debt (excluding local authorities) increased by 9.4 and 1.5 percent in 2003 and 2004 respectively, years during which the wave of corporate bond issues gathered momentum.

(2) Particularly notable in the data is the larger proportion of issues of bonds with a long duration by highly rated firms than the proportion of such issues by non-rated and construction and real estate companies. Except for the bond issues of the latter firms the duration of most of the issues was much longer than the duration of bank credit and of its sources of finance. Issues of bonds with a duration of over 4 years by highly rated companies reached 60 percent of the total funds raised through corporate bonds, while the duration of total bank credit and bank deposits between 2001 and 2004 ranged between 1.6 and 1.5 years and between 0.9 and 1.2 years respectively. In other words, large highly rated firms were also those whose issues were characterized by relatively long durations. The combination of high credit ratings and long durations for the issued corporate bonds may reflect, in addition to the expansion of demand for credit as a result

<sup>10</sup> Thirteen companies with rating of between AA and A+ raised 33 percent of the total issue proceeds, nine companies with a rating of A to A- raised 3.3 percent, and 36 percent of the issuing companies were not rated and raised only 7.3 percent of the total issue proceeds. Financial companies' issues, which totaled NIS 5.2 billion during the period reviewed, were nearly all issues made by subsidiary companies of the commercial banks for the purpose of depositing the proceeds of the issues at the parent companies. These issues therefore do not constitute a substitute for raising capital by the business-sector via the commercial banks.

of the upturn in economic activity, the banks' difficulties in extending the duration of bank credit in line with the financing requirements of the bond-issuing firms, in view of the relatively short duration of bank deposits used to finance bank credit. The disparity between the duration of bank deposits and the financing requirements of the bond issuing firms would have exposed the lending banks to interest-rate risks had they extended the duration of bank credit without taking the cost of that risk into consideration. The pricing of this risk which is equivalent to a contraction of the supply of long-term bank credit may have rendered the raising of long-term funds through the issue of corporate bonds more attractive for highly rated firms than raising them through bank credit. Firms with high credit ratings and low default probabilities are expected to pay a lower risk premium for extending the term of their liabilities than high risk firms, a fact which makes long-term credit attractive for these firms under the presently prevailing low interest rates. However, raising long-term credit in the domestic capital market does not necessarily involve the payment by borrowers of an interest rate premium in view of the existence of institutional investors with long-term investment horizons. Such a premium would have been paid, however, to compensate the banks for their exposure to interest-rate risks as a result of the disparity between the duration of bank deposits and that of the finance requirements of the bond issuing forms.

(3) The data on bond issues also indicate that the percentage of the proceeds from the issue of corporate bonds used in part to reduce corporate debt (other than rolling over of bond debt) is considerable. For highly rated firms it exceeds fifty percent of the funds raised through corporate bonds during the surveyed period and rises as the credit rating of the issuing firms declines. This percentage is higher among non-rated and construction and real estate firms than among other companies.

In order to determine this percentage, the ratio of the change (during the quarter of the corporate bond flotations) in the issuing firms' overall liabilities to the funds raised by the bonds issue was calculated. A ratio smaller than unity implies that the proceeds from a particular bond issue were used to reduce other corporate debt during the same quarter (Table

13).<sup>11</sup> The data also reveal that in the case of highly rated firms a smaller number of issues was used for that purpose compared to non-rated firms. The phenomenon of credit substitution described here, which it may be assumed also included bank credit, and which mainly characterized non-rated, construction and real estate firms may reflect a contraction in the supply of bank credit to these firms as a result of a higher idiosyncratic credit-risk assessment of non-rated firms and a higher sector-specific risk of the real estate and construction firms due to the prolonged slowdown in economic activity in those sectors. The fact that highly rated firms also used the funds raised through corporate bonds for credit substitution, even though to a lesser extent, may reflect a general increase in the cost of bank credit supply apparently following a credit-risk reassessment by commercial banks which may have created a disparity between their credit-risk appraisals and those of the credit rating agencies. This interpretation of facts is also consistent with the observation that the fall in bank credit was not limited to the construction and real estate sectors.

#### *The banks' balance sheets*

The above developments were accompanied by two parallel processes in 2003 and 2004: the gradual reduction of the auctions of the commercial bank deposits at the Bank of Israel and a gradual increase of the stock of Treasury bills reflecting the removal of all quantitative restrictions regarding their issue by the Bank of Israel. As a result of these

<sup>11</sup> From among the issuing companies, companies were identified that had issued bonds due for maturity by the end of the quarter in which the issue was floated. For these companies, the said ratio was calculated exclusive of the effect of the bond maturity. We thereby obtained an estimate of the extent to which the proceeds of the issue were used to reduce the firms' other liabilities, including bank credit and excluding the upcoming maturity of old bonds that was known in advance. This indirect way of estimating the extent of the use of the proceeds from corporate bond issues to reduce corporate debt, other than rolling over of bond debt was adopted because with the existing data base bank credit cannot be distinguished from other types of business-sector liabilities. Given the relatively small number of issues, it is not possible to conduct statistical tests for determining the significance of the calculations.

**Table 13. Proportion of Bond Issues Used to Partially Repay Debt in Total Bond Issues with the Same Rating (by value, percent)**

Industry rating	AAA-AA	-AA	-A-A	Unrated
Total	54	66	73	76
Excluding real estate	50	64*	74	74
Real estate	84	75	73	85

\* Excluding "Partner," which introduced a structural change in its debt composition.

two processes, the commercial banks' deposits at the Bank of Israel fell by NIS 32 billion between 2003 and 2004, and were almost eliminated. This development was accompanied by a commensurate rise in the stock of Treasury bills issued by the Bank of Israel in the context of liquidity-absorbing repo transactions with commercial banks. The bulk of the Treasury bills which initially reached the commercial banks through the repo arrangement was eventually absorbed by the public and only NIS 4 billion was taken up by the banks. Bank credit of the consolidated banking sector for domestic activity fell gradually from NIS 527 billion at the end of 2002 to NIS 500 billion at the end of 2004 and the bank holdings of government bonds increased by NIS 15 billion, with unindexed bonds accounting for most of this amount. Part of the change in bond holdings reflects the higher prices of these securities due to the fall in their yields. It should be noted however that given market prices, the composition of an asset portfolio reflects its holder's preferences so that the change in the banks' asset composition could reflect their doubts as to the profitability of bank credit expansion apparently because of risk considerations.

The entry of low-risk borrowers to the domestic capital market because of the disparity between the short duration of the banks' sources of credit finance and the issuing firms' financing requirements described earlier, alongside the partial use of the funds raised through corporate bonds to reduce other corporate debt and most probably bank credit and the change in the composition of bank assets are consistent with a policy of credit-supply contraction by the banking sector.

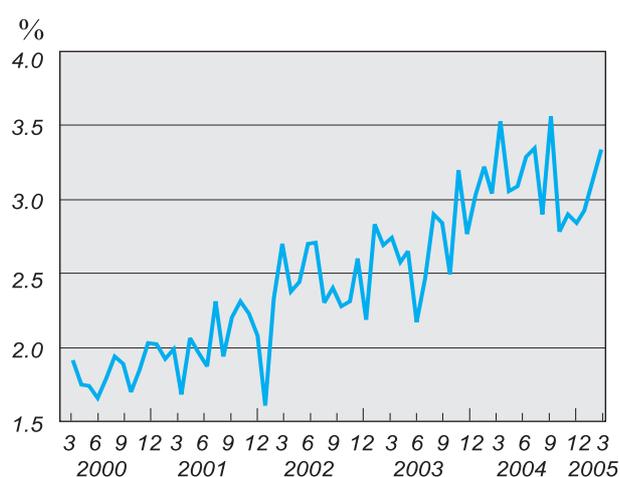
Such a policy could reflect the banks' effort to enhance their risk-adjusted capital adequacy against the background of a possible reassessment of credit risks. The conduct of such a policy during 2002 and 2003 is documented in the corresponding Annual Reviews of Israel's Banking System by the Supervisor of Banks.<sup>12</sup> This interpretation is also consistent with interest-rate data which show the widening of the spread between the marginal interest rate on short-term unindexed domestic currency denominated bank credit and that of the Bank of Israel during the same period and its stabilization thereafter at a high level (Figure 2.2). The hypothesis that the observed contraction of bank credit was the result of the borrowers' flight from commercial banks to alternative sources of finance would have been consistent with the wave of corporate bond issues only had it been accompanied by a narrowing of the above interest-rate spread, which did not materialize.

Moreover the volume of business-sector bond issues in Israel during the period surveyed was only 4.5 percent of the total stock of domestic bank credit. This percentage seems rather small to change the risk composition of bank borrowers as a result of the alleged flight of high quality borrowers to the capital market and a parallel increase in the relative weight of low quality bank borrowers.<sup>13</sup> Such a change in the risk profile of bank borrowers would have been consistent with a higher marginal interest rate on short-term bank credit and could have explained the widening of the aforementioned interest-rate spread.

To conclude, the contraction of bank credit during the period surveyed reflects mainly a decrease in credit to the business sector. The data also show that this development resulted from a combination of demand and supply factors. The contractionary effect of the supply factors on the development of bank credit seems to have been stronger than what is suggested by a first glance at the data. Were it not for these supply factors, which mitigated the decline in the interest rate on bank credit relative to the Bank of Israel interest rate, the latter might have been expansionary to a degree inconsistent with price stability. This development emphasizes the fact that the impact of monetary policy relies mainly on its effect on market interest rates which do not depend only on the central bank's interest rate but also on financial intermediaries' assessment of credit risks.

Figure 2.2

The spread between interest on local-currency unindexed bank credit flows up to 3 months and effective interest on banks' deposits in the Bank of Israel, January 2000 to March 2005



SOURCE: Based on Banking Supervision Department data.

<sup>12</sup> See the item on capital adequacy in Chapter 5 of Israel's Banking System, Annual Survey 2002 and 2003. According to these surveys, the commercial banks took measures to improve their capital adequacy during those years, following the accrual of non-performing loans resulting from the delayed impact of the recession on the borrowers' repayment ability.

<sup>13</sup> The amounts raised through other instruments in the capital market are also important in this respect. During the most recent wave of issues, the volume of corporate bond issues was exceptionally higher than in the past.

### Events from January–June 2005

Month	Date	Event	Details
January 2005	1	As the current stage of the “Rabinovitch reform” begins, tax brackets are widened at all wage levels and the maximum marginal tax rate on labor is lowered to 49% as against 60% two years ago.	For example, an individual earning NIS 20,000 per month will pay a 39% marginal rate as against 50%; at NIS 12,000 37% as against 45%; and at NIS 4,000—under the tax threshold as against 20%.
	1	Tax discrimination between foreign and domestic securities abolished.	As part of the tax reform, it was decided that tax rates on capital gains on foreign securities would be brought into line with those on Israeli securities. This reform does not affect insurance companies, which are currently exempt from tax on profits from foreign securities, or companies, which pay tax at the same rate on profits from Israeli and foreign securities.
	11	S&P upgrades Israel’s credit rating from “Negative” to “Stable.”	
	16	The Government approves implementation of the Dovrat Committee Report on education-system reform.	
	17	Prof. Stanley Fischer appointed eighth governor of the Bank of Israel	
	20	Child allowances for children born before 31 March 2003 cut, with effect from the January 2005 allowance.	
	21	Details of the sale of Israel Discount Bank, Ltd., are finalized.	The Bronfman-Schron group will acquire a controlling interest in IDB by purchasing 26% of share equity for NIS 1.3 billion, with an option for another 25% at the same price.
	24	The Bank of Israel lowers the key rate by 0.2 percentage point, setting it at 3.5% for January.	The NIS–\$ interest-rate differential narrows to 1.25 percentage points.
February	1	The government signs contracts with the companies that were successful bidders in the tender to erect employment centers	The centers, expected to start operating in July 2005, will help recipients of income support benefits to join the labor force (the Wisconsin program).
	1	The arrangement with the EU regarding marking of goods produced in Judea, Samaria and the Gaza strip comes into effect.	
	13	The Minister of Finance and the Minister of Defense decide on a process to privatize Israel Military Industries (Ta’as).	It was decided that part of the activities would be sold to Rafael (the Armaments Development Authority); Ta’as will be privatized by selling the State’s shares; the country’s vital interests in Ta’as will be protected.
	14	The international rating agency Fitch raises its forecast of Israel’s long-term local-currency credit rating from “negative” to “stable.”	
	16	The Knesset passes the Disengagement Program Implementation Law.	This law deals with, among other things, payment of compensation to settlers, and the temporary change in the government’s deficit target.

Month	Date	Event	Details
	24	The agreement between the Ministry of Finance and the Histadrut (General Federation of Labour) relating to the privatization of the ports is signed, and its implementation starts.	The agreement includes <i>inter alia</i> the establishment of a separate company in each port, guarantees of the workers' rights, and the future privatization of the port companies.
<b>March</b>	1	The State sells 6.5% of the shares of Bank Leumi to Deutsche Bank for NIS 1.162 billion	
	28	The Minister of Industry, Trade and Labor adopts the recommendations of the committee formed to investigate the shortage of labor in the construction and infrastructure industry.	The committee recommended ways to encourage the participation of Israelis in the industry, including government subsidies, contractors' obligation to pay a fair wage, and the provision of professional training on building sites.
	29	The Knesset passes the budget and the Arrangements Law for 2005.	
	30	The Ministry of Finance announces that it will operate an experimental program in Beit She'an to increase the aid to working mothers by participating in the cost of day care centers. In Arad an experimental program will operate to recognize child-care expenses for tax purposes.	The programs will operate in the next school year; their purpose is to encourage women to join the labor force.
	30	The Knesset Finance Committee approved the reform in the Research and Development Law that will enable know-how supported by the Chief Scientist to be transferred abroad.	The amendment permits know-how developed with aid from the Office of the Chief Scientist in the Ministry of Industry, Trade and Labor to be transferred abroad. A payment for such transfer will be made to the Office of the Chief Scientist, which will be reinvested in Research and Development.
<b>May</b>	2	Prof. Stanley Fischer, eighth governor of the Bank of Israel, takes office.	
	16	The Prime Minister approves the main proposals of the Gadish Committee for the reform of the Israel Lands Administration.	<p>The main proposals are:</p> <ul style="list-style-type: none"> <li>• Transfer of urban land rights to the private owners of the apartments and houses.</li> <li>• Speeding up the settlement and registration of land rights.</li> <li>• Adopting a uniform land policy towards land in Israel.</li> <li>• Increasing the transparency and reducing the complexity of land policy.</li> </ul> <p>The decision to transfer rights to apartment and house owners requires government and Israel Land Council approval to become effective.</p>

Month	Date	Event	Details
	17	Start of the implementation of the system of licensing in the employment of foreign workers in the construction industry.	38 corporations received licenses to operate as manpower agencies for the employment of 400 foreign workers (for each cooperation).
	23	The Vice Premier, the Minister of Finance, and the Minister of Housing and Construction agree on a housing assistance campaign in the Negev and the Galilee.	Assistance will be given to those entitled to purchase apartments in townships in the Negev and the Galilee included in the National priority Areas A and B. The campaign will start on 1 June 2005 and continue till 31 October 2005. Assistance will be in the form of grants to families purchasing apartments in high-occupancy buildings. In Area A, NIS 25,000, and in Area B, NIS 20,000.
	24	A framework agreement signed to promote joint R&D projects between Israeli and Chinese companies.	The agreement signed in Beijing by the Chief Scientist of the Ministry of Industry, Trade and Labor states that Israeli and Chinese companies will establish joint R&D projects at Quinghua University's six science and technology parks, which cooperate with the Chinese Government and with the support of China's Ministry of Science and Technology. Such projects will be supported by both sides.
<b>June</b>	9	The NIS/currency-basket exchange –rate band was abolished.	The Governor of the Bank of Israel, the Minister of Finance and the Prime Minister decided on the abolition of the band. Since 1997 the Bank of Israel has not needed to intervene to protect the band, whose limits have not been effective for years.
	22	The Ministerial Committee for Disengagement authorized the granting of bridging loans for businesses that transfer their activity from the area being evacuated.	The "Sela" Administration (the Administration for aid to the Gaza evacuees) will grant bridging loans via the Investment Center of the Ministry of Industry, Trade and Labor for the transfer of activity of businesses being evacuated and relocated in Israel.
	26	An agreement between the State and the fuel companies was signed regarding the privatization of the Pi Gelilot company.	According to the agreement, the activity of the company at three locations—Jerusalem, Ashdod and Beersheba—will be sold by tender such that offers may be made for the purchase of all three sites together, or each one separately. The highest return offered will determine how the sale will be made, i.e., each site separately or all three together.
	29	The Minister of Finance instructed the Accountant General to prepare a tender for the sale of the controlling interest in Bank Leumi.	