

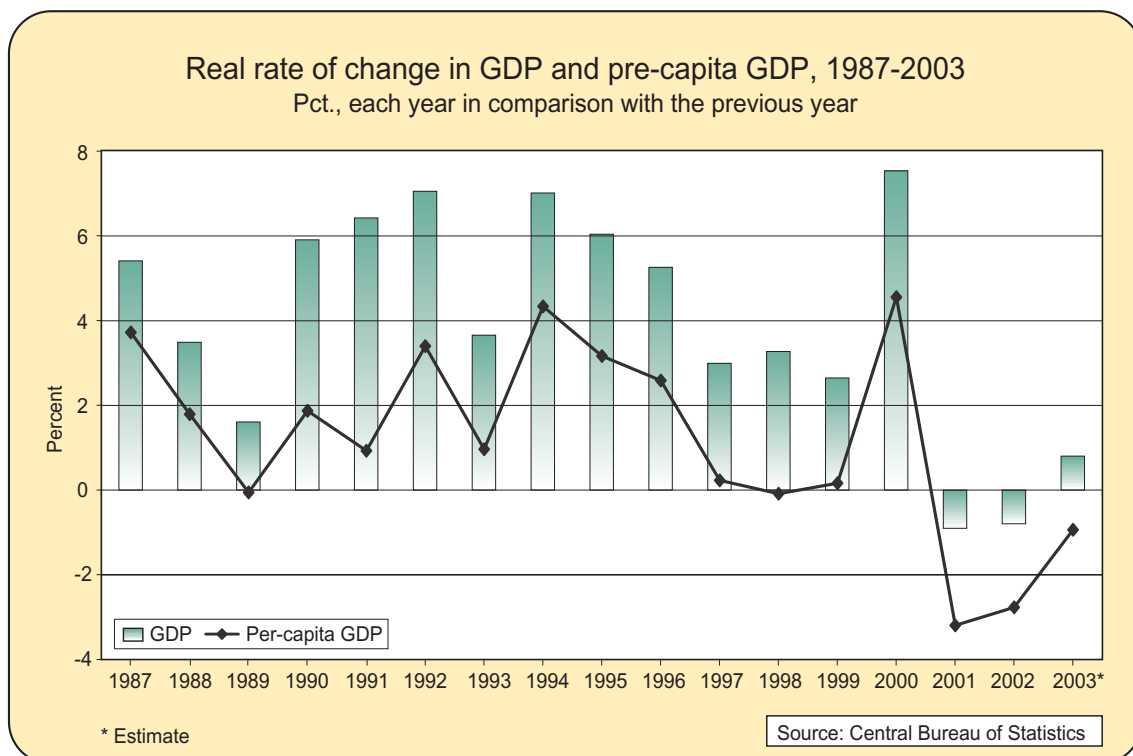
Main Economic Developments

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Growth

The National Accounting data for the first half of 2003 are indicative of a certain moderation in the declining economic activity and even of a certain stabilization of economic activity at a low level. The central powers that drove the recession in the years 2001-2002 continued to act in the first quarter of 2003, including the security situation and the global slowdown in economic growth. Beginning in March, processes were set in motion, including the ratification of the Israel Economy Recovery Plan and the end of the war in Iraq, that served to lower the economic uncertainty and improved the state of the economy. These factors resulted in a stabilization of economic activity and in an influx of capital into the country.

According to the latest estimates of the Central Bureau of Statistics, **the Gross Domestic Product (GDP)** rose by one percent in relation to the second half of 2002. This compares



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to a 0.8% decrease in GDP in 2002. This rate of growth reflects a 0.7% decrease in GDP per capita in the first half of 2003, as compared with a 2.8% in GDP per capita in 2002.

The GDP of the business sector rose by an annual rate of 0.2% in the first half of 2003, as compared with the second half of 2002, while recording a decrease of 2.6% in all of 2002. The positive trend in the business product originates from a small cluster of sectors that are primarily export-oriented.

Private consumption was down 0.4% in relation to the second half of 2002. An examination of the composition of demand in the economy reveals that this decrease reflects the impact of the decrease in the available income of individuals, as a result of the lower real wages and the increase in the unemployment rate. **Public consumption**, on the other hand, rose by an annual 5.1%, primarily on account of the growth in security expenses.

The investment in fixed assets rose in the first half of 2003 by a moderate 0.4%, following a sharp 9.0% drop in 2002.

The export of goods and services rose by an annual 8.0% in the first half of 2003, according to the estimates of the Central Bureau of Statistics, primarily as a result of growth in diamond exports and in the export of tourism services.

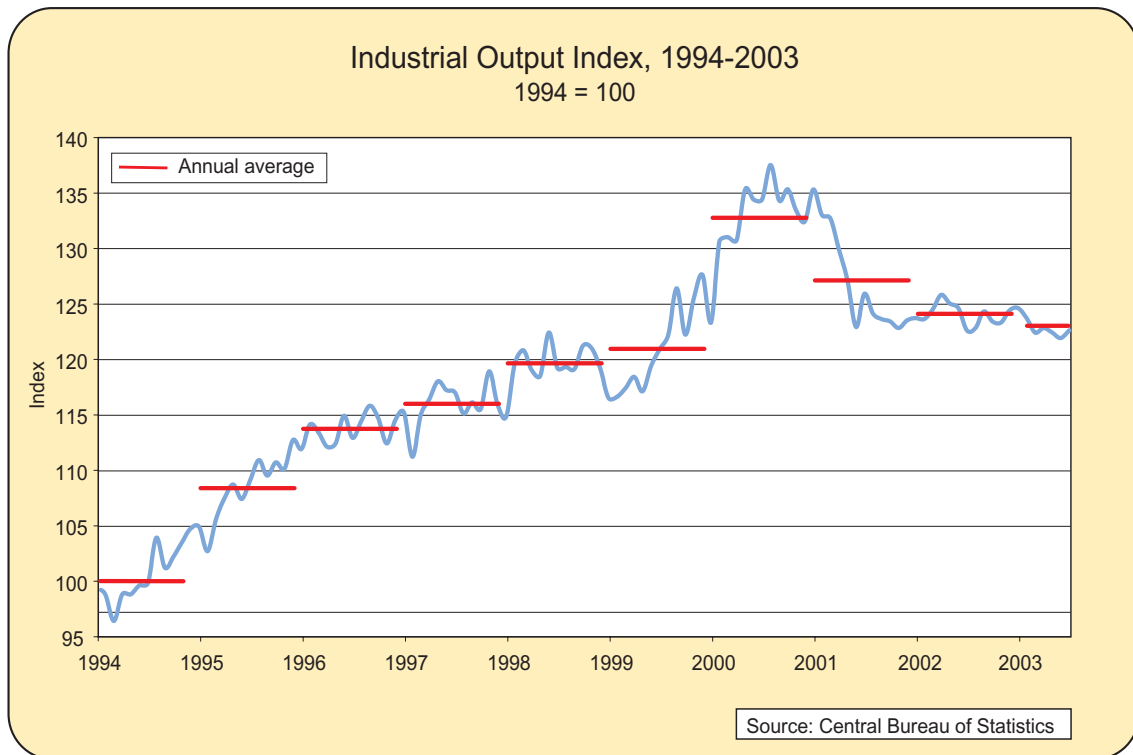
Economic Sectors

According to Bank of Israel data, the Combined State of the Economy Index fell by 3.3% in the first half of 2003, as compared with the first half of 2002, following a 3.3% drop in all of 2002. The decrease in the Combined Index reflects primarily the decrease in the number of jobs, coupled with the decrease in the turnover of the commerce and services sector.

Industry

Industrial production (net of diamonds) stabilized at a low level in the first half of 2003, following a 2.4% decrease in 2002 and a 4.1% in 2001. Looking at a division according to technological intensiveness, an increase was recorded in the production index of high technology, as compared with a decrease in the traditional and mixed industrial sectors.

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Exports were 5.1% higher in the first half of the year, in relation to the first half last year. The export of goods and services were up by 8% in annual terms in the first half of 2003, following a 2.3% rise in the previous six-month period. A slight increase in the export of goods was recorded in the first two months of the year. This trend was reversed in March to a decrease, reflecting primarily the developments in industrial exports.

Industrial exports developed in the first half of 2003 in a manner that reflects the intensity of the impact of the slowdown in global trade on the exports of the advanced sectors, whereas the more traditional sectors were more affected by the real-term exchange rate that rose during 2002. Furthermore, the damage to the exports of the hi-tech industries is more severe than the apparent damage derived from the global trade figures, since the decrease in global demand for the products in which the Israeli industry specializes, was greater than the general decrease in global trade. An increase of 4.2% was recorded in industrial exports in the first half of 2003, in relation to the first half of 2002, whereas the industrial export figures for hi-tech products indicate a decrease of 3.2%

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Construction

Since 1996, the construction sector in Israel has constantly been adjusting its level of activity to the level of demand. This process began with the decrease in the number of new immigrants arriving in Israel, in the wake of the massive immigration during the early nineties. The operations in the sector expanded in 2000, although the security events in September 2000 led to a sharp reduction in activity — that is still continuing. This served to lower the demand for housing and along with the economic recession, led to uncertainty regarding the expected economic developments and the shifting of demand from buying apartments to renting them. On the supply side, the decrease is reflected by a lower number of employees in the sector, a lower volume of housing starts and by the volume of marketing of land. The lower activity in the sector has also served to lower apartment prices, in real terms.

Housing Supply

Marketing of Land — In the first half of 2003 the Israel Land Authority (ILA) and the Ministry of Construction and Housing marketed land for the construction of 8,920 residential units. These volumes are 5% lower than the corresponding period last year.

Housing Starts — Construction on 14,736 residential units began in the first half of 2003 (private and public construction). The number of housing starts in 2002 reached 32,175 residential units. During the past decade, the average number of annual housing starts was equal to 45,000 residential units per annum.

Employees in the Construction Sector — Since the construction sector is labor-intensive, changes in the number of employees come as a direct result of the volume of operations in the sector. A constant decrease of 27% was recorded in the number of employees in the sector since 1997. In the second quarter of 2003, the total number of employees in the construction sector amounted to 188 thousand. A significant increase in the number of Israeli employees in the sector was recorded since 2002, primarily at the expense of foreign laborers.

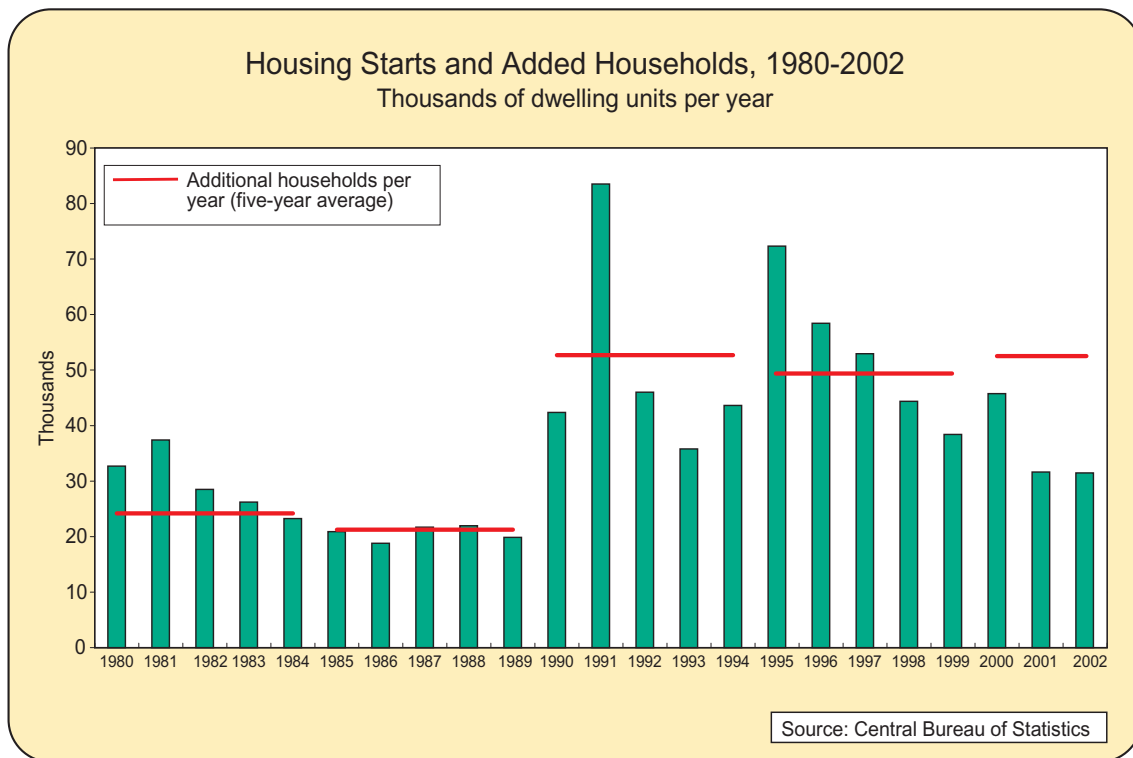
Demand for Housing

Number of Transactions (New and Second-Hand Apartments) — According to Betterment Tax and Property Tax figures, some 47,000 transactions were carried out in the

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first half of 2003, representing a 16% decrease in relation to the corresponding period last year. An average number of 2,310 new apartments were sold every month during this period, down approximately 24% from the corresponding period last year.

The average number of months that an apartment is available in the market prior to its sale serves as an effective parameter to examine the state of the housing market: An increase in this number over time indicates surplus supply in the housing market, while a decrease is indicative of surplus demand. During the period between January-May of 2003, the average time span for the sale of an apartment was approximately 14.6 months.



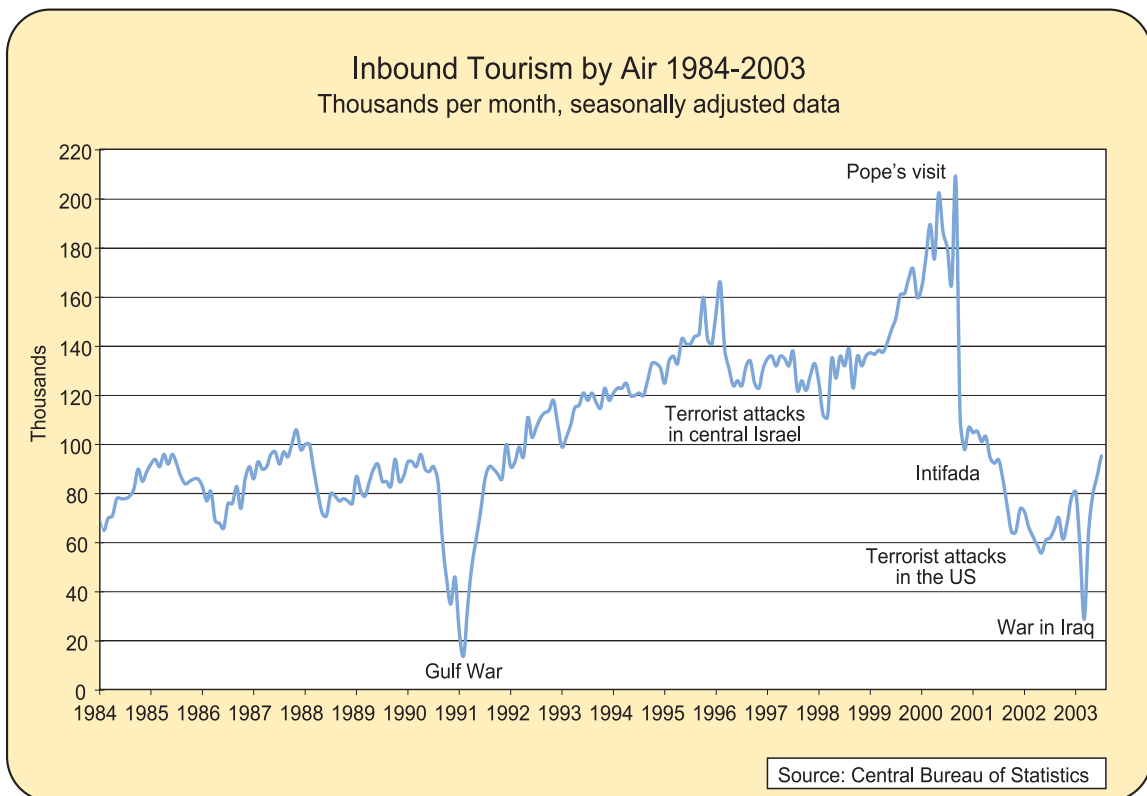
Tourism

The recession in the tourism sector reached bottom in the first quarter of 2003, primarily due to the deteriorating security situation and the war in Iraq. With the end of the war in Iraq and the improvement in the security situation in Israel, a positive turnaround is evident in terms of the arrival of tourists to Israel.

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An increase of 16% was recorded in incoming tourism to Israel in the first eight months of the year, as compared with the corresponding period last year. Tourist bednights represented 21% of total hotel bednights, up from 18% in the corresponding period last year. We note that during the months January-August 2000, the number of tourist bednights was three times greater than the number of bednights this year. A considerable part of the impact of the decrease in incoming tourism since the end of September 2000, was somewhat moderated as a result of considerable growth in the volume of internal tourism. Actually, one of the significances of the sharp drop in the volume of incoming tourism over the last several years is that the tourism sector has nearly ceased to be an export sector and currently relies primarily on domestic demand.

Despite the growth in the number of tourists arriving to Israel, stability was recorded in the number of hotel bednights in Israel. During the first eight months of the year, the number of hotel bednights amounted to 10 million — similarly to the corresponding period last year — yet was 30% lower than the number of bednights during the corresponding period in 2000. The stability in the number of bednights is the result of a 17.2% increase in tourist bednights, that was offset by a moderate decrease in bednights by Israelis.

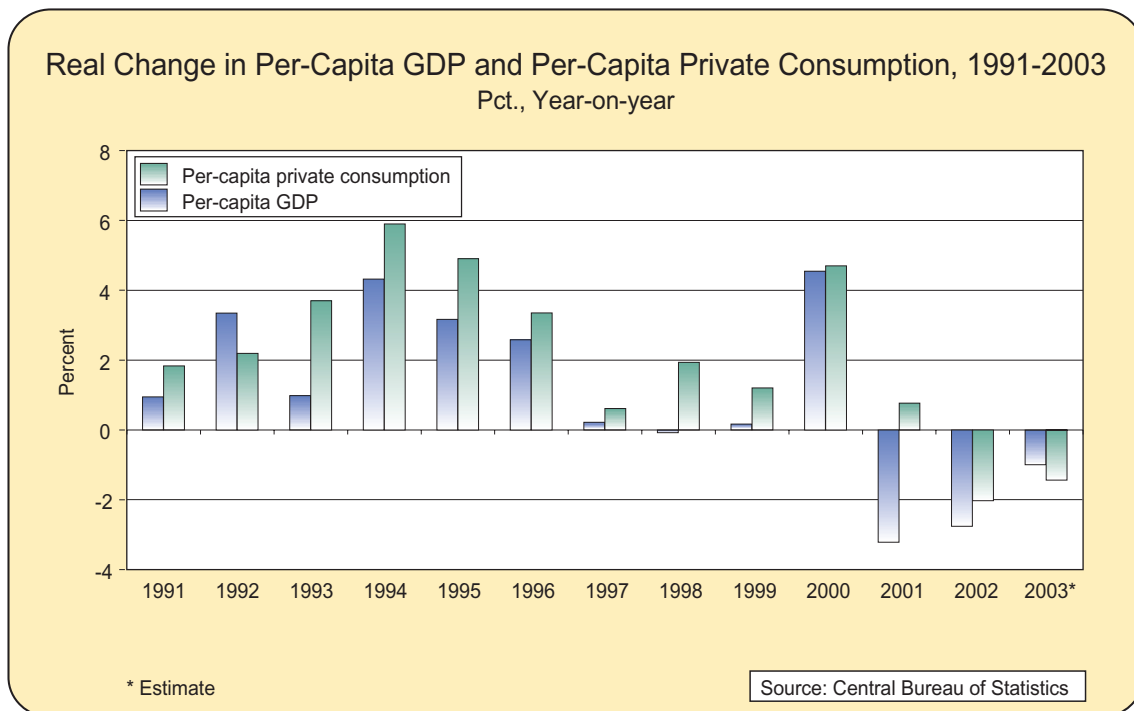


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Private Consumption

The expenditure on private consumption fell by 0.4% in the first half of 2003, following a decrease of 1% in the second half of 2002. We note that due to the optimism that followed the end of the war in Iraq, impressive growth was recorded in private consumption in the second quarter of 2003, as compared with consumption in the first quarter. The expenditure on private consumption per capita fell by an annual rate of 2.1% in the first half of 2003, following a 2.8% decrease in the second half of 2002. The reduction of consumption per capita reflects a sharp 9.2% decrease in the expenditure of households on durable goods. A 1.2% decrease was recorded in the expenditure on current consumption.

The reduction of private consumption reflects the impact of the declining available income of individuals as a result of the continued decrease in real wages in the economy.

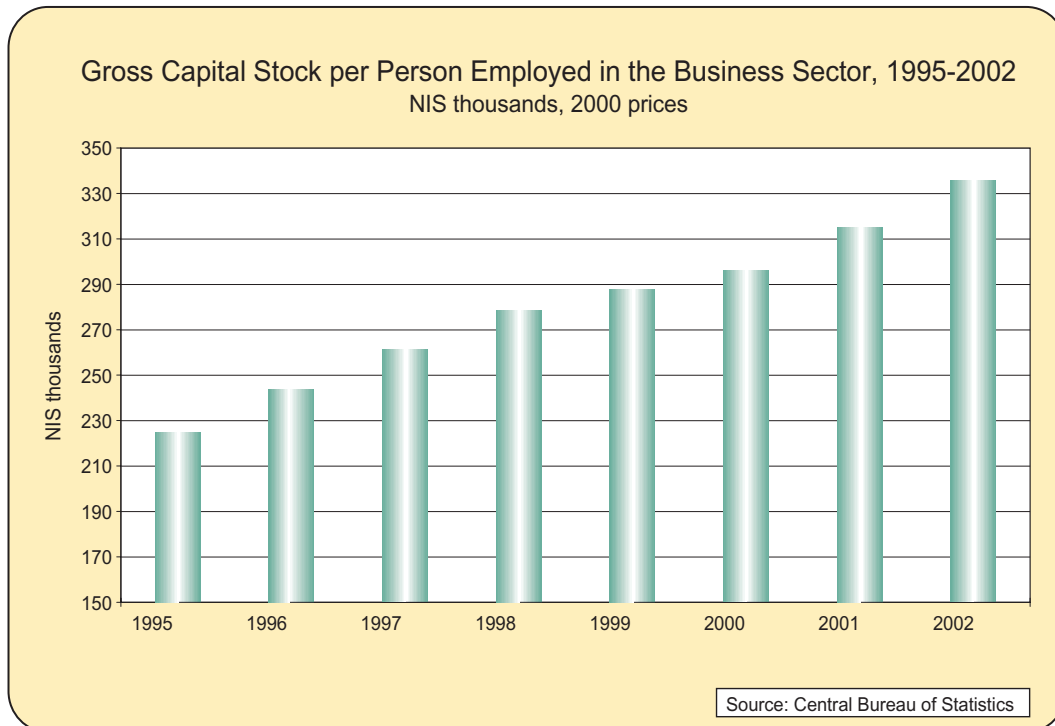


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Investment

The stabilization of economic activity is also reflected in investments. The investment in fixed assets rose by 0.4% in the first half of 2003, following a 6.0% decrease in the previous six-month period. By comparison with the corresponding six-month period last year, this represents a decrease of 2.9%. We note that investment data were influenced by large fluctuations in investments in ships and airplanes. The investment in fixed assets, net of ships and airplanes, rose by 3.8% in the first half of the year, following a decrease of 5.1% in the second half of 2002. The investment in economic sectors remained unchanged in the first half of 2003, while the investment in residential construction rose 0.5%, following a decrease of 10.0%-11.0% in the two preceding six-month periods.

In parallel to investments, data regarding the import of goods is also indicative of stabilization and even improvement in the state of the economy. The import of investment assets (net of ships and airplanes) rose by 9.2% in the first six months of the year. The import of raw materials (except for diamonds and energy materials) was up 8.7%. We emphasize that the import of raw materials and investment products may serve as an index for business sector expectations regarding anticipated trends in economic activity, including an expected recovery in industrial production.

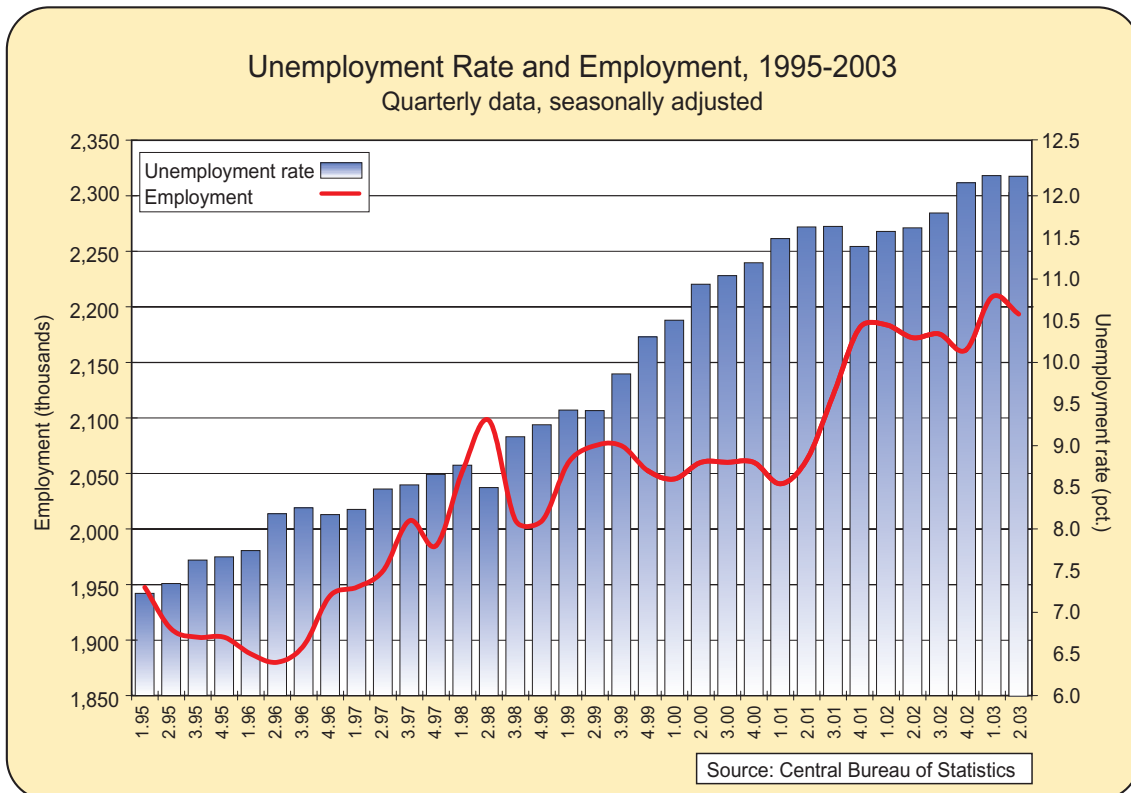


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Employment

Contrary to most economic indicators, the developments in the labor market in the first half of 2003 are indicative of a renewed deterioration, following six months of initial signs of improvement. The rate of participation in the civilian labor force was equal to 54.2% in the second quarter of 2003, similar to the rate in the last quarter of 2002, and as compared with significant growth — reaching a rate of 54.6% — in the first quarter of 2003. The rise in the participation rate in the first quarter of the year resulted in a sharp rise in unemployment, reaching 10.8%, with only a slight decrease in the second quarter — to a level of 10.6% — still higher than the unemployment rate of 10.3% that was recorded in 2002.

The number of jobs in the economy grew by 48 thousand jobs since the beginning of the year. The business services sector recorded growth of 18 thousand jobs, mostly in guarding and security.

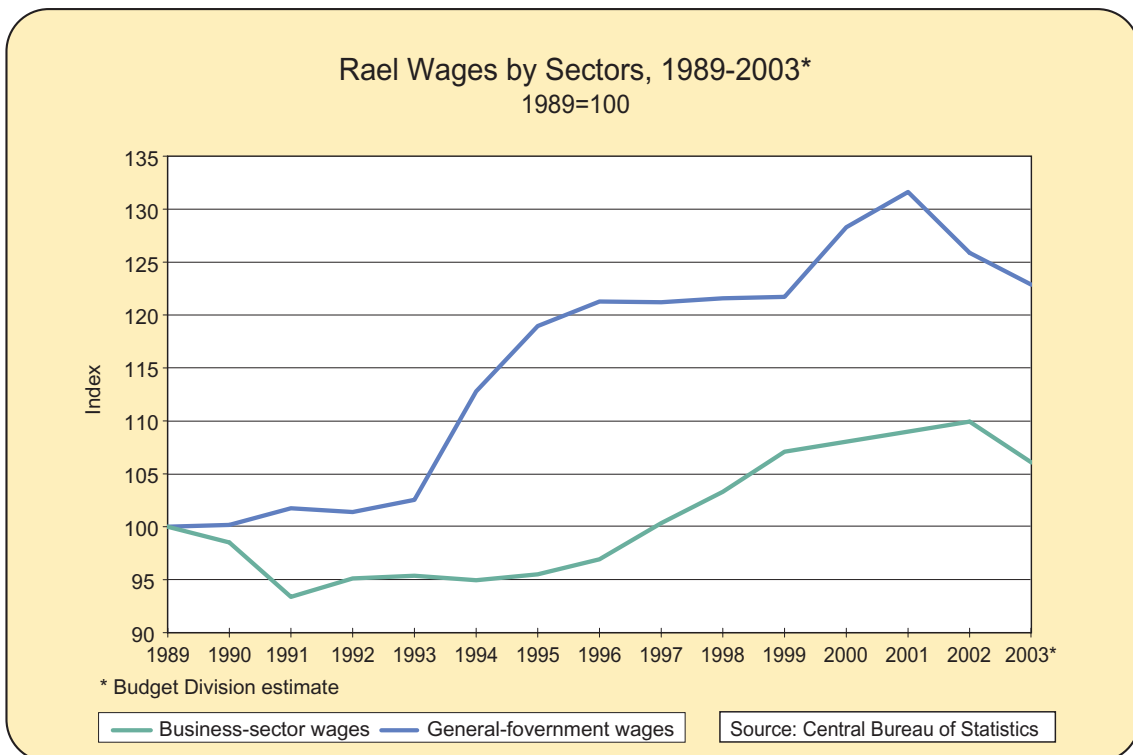


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Wages

The real wages in the business sector continued to fall in the first seven months of 2003, in most economic sectors, recording a decrease of 1.9% in relation to January-July last year. The real wages in the business sector fell by a sharp 6.7% in 2002. The lowering of wages took place primarily in the banking, construction, insurance and financial institution sectors — where the employment actually grew during the same period. The sharp drop in wages in 2002, that continued in 2003 as well, comes as a result of adjustments made by the business sector in order to contend with the economic recession.

The real wages in the public sector also fell by 4.3% between January-July of 2003, in relation to the corresponding period last year. This decrease took place despite the cost-of-living supplement that was paid in January 2003 and is explained primarily by the implementation of the wage reduction agreement signed by the New General Labor Union (Histadrut) and the Ministry of Finance, following the Israel Economy Recovery Plan, as well as by non-recurring payments in early 2002 and wage deductions following the strikes in the public sector during April and May 2003.



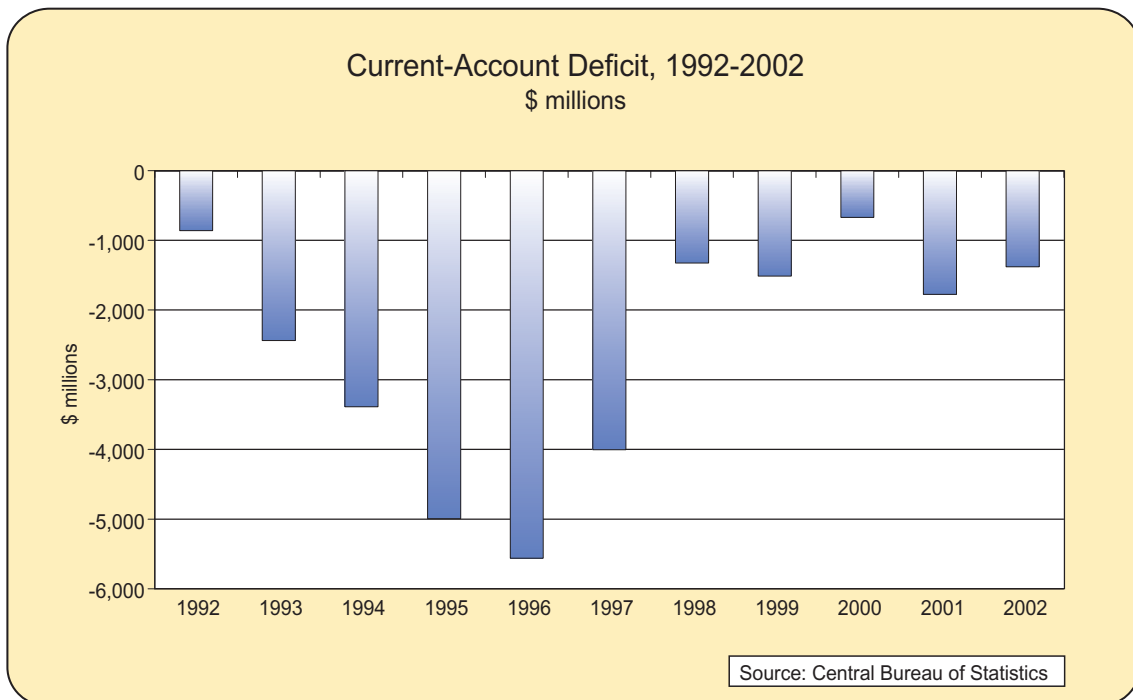
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Balance of Payments and Foreign Trade

The surplus in the current account of the balance of payments in the first quarter of 2003, representing a surplus in current transfers and in the services account, amounted to \$0.6 billion, as compared with a deficit of \$0.2 million in the corresponding period in 2002.

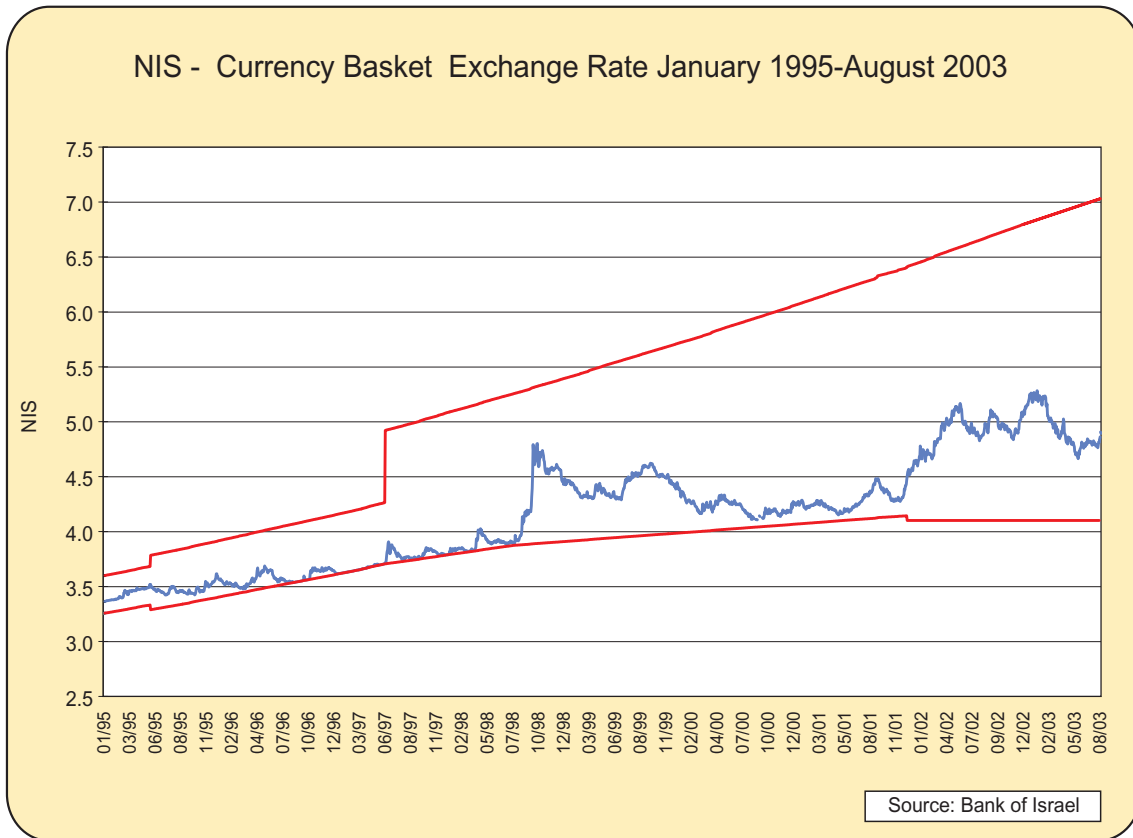
The current account of the balance of payments improved significantly in the years 1996-1998 as a result of the acceleration of exports on the part of hi-tech sectors, Israel's improved trading conditions and the recession that served to curtail imports. This trend reversed itself in 1999, primarily as a result of significant growth in the importing of goods and services, as a result of rapid growth in the import of investment products.

We note that the development in foreign trade in the first quarter was accompanied by improved trading conditions, since export prices rose more rapidly than import prices.



The Exchange Rate

Having started in the middle of 2002, the revaluation of the shekel against the dollar continued in 2003, following the raising of interest rates by the Bank of Israel. The revaluation peaked in July 2003, when the exchange rate of the US dollar was 11.5% higher than in June 2002. The moderate lowering of interest rates throughout 2003 did not curb this revaluation in the exchange rate, that also occurred following the granting of US bank guarantees and the improvement in the security situation — including the rapid completion of the war in Iraq.

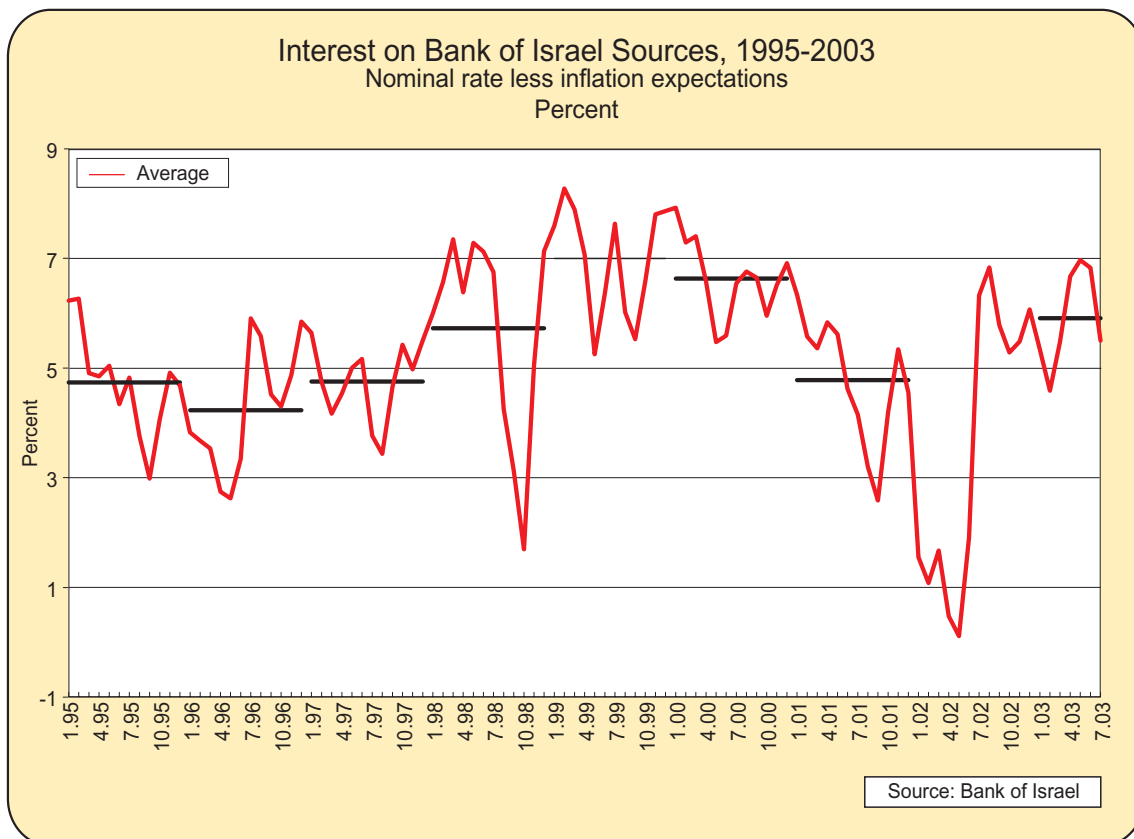


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Monetary Policy

The Bank of Israel continued to implement a relatively contractionary monetary policy in 2003. In the second quarter, following the approval of the economic plan and the granting of the US guarantees, the Bank of Israel began moderately lowering the interest rate. The cumulative decrease in the Bank of Israel's interest rate amounts to 3.0 percentage points since December 2002. This contractionary monetary policy contributed to the low inflation rate and also to the revaluation of the exchange rate. The countries of the world continued to exercise an expansionary monetary policy in 2003. The Federal Reserve interest rate in the United States decreased in 2003, reaching only 1.0% in October. The interest rate margin between the Bank of Israel interest rate and the Fed interest rate was equal to 6.1 percentage points in October.

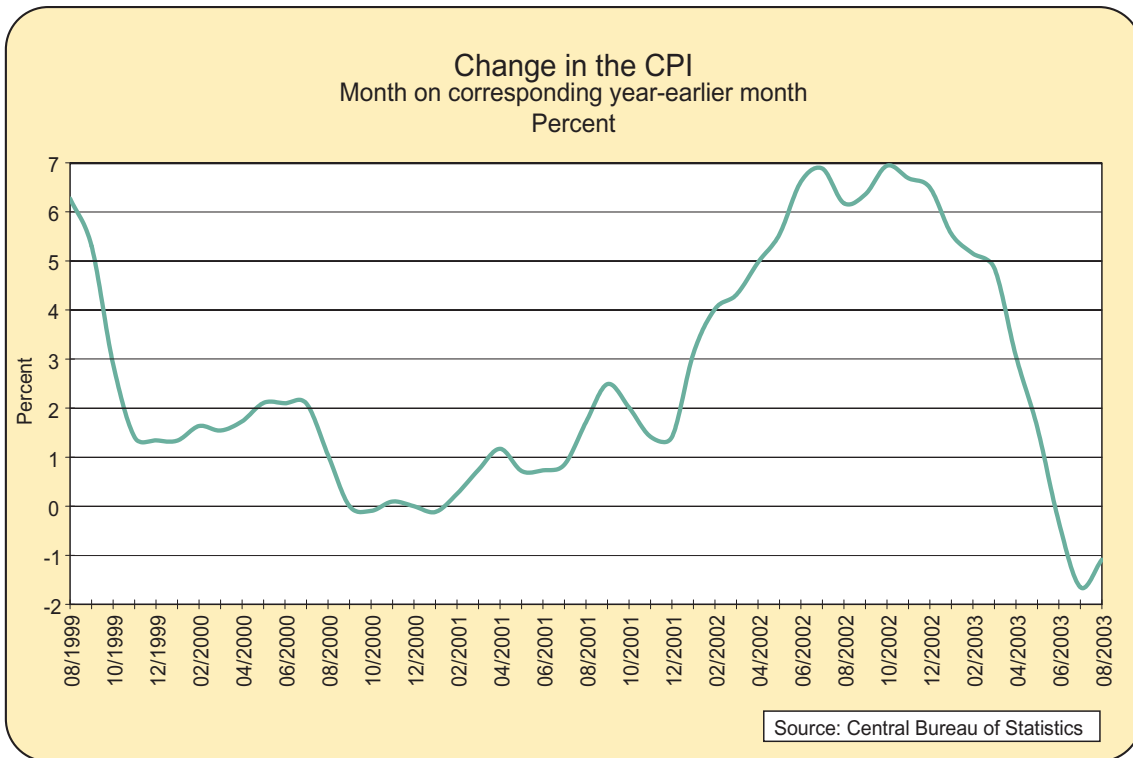
No change was recorded in the circulation medium (M1) between January-July and by comparison with July 2002, a decrease of 2.0% was even recorded in the circulation medium.



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Inflation

The Consumer Price Index (CPI) fell by 1.0% during the first eight months of 2003, as compared with a 6.6% increase in January-August last year. This decrease in the CPI originates primarily from the revaluation of the shekel exchange rate this year, coupled with the recessionary real-term activity environment. The contractionary monetary policy is expected to result in an inflation rate in 2003 that will be lower than the 1.0%-3.0% objective set by the government.



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The Budget Deficit

The government's total budget deficit (net of credit) amounted to 3.86% in 2002, consisting of a deficit of 3.59% in domestic activity and a deficit of 0.27% in overseas activity. The economic recession severely and consistently damaged state revenues from taxes, as the collection of taxes began to decrease in 2001 and continued in 2002 and 2003 as well. In order to meet the 2002 deficit objective, the government initiated responsible fiscal policy. This was expressed in the implementation of the emergency economic plan for the years 2002-2003, from April 2002, as well as in the Israel Economy Recovery Plan of April 2003, at which time the government decided to cut the budget by a total of NIS 9 billion, in order to reduce the government deficit and halt the economic deterioration. A deviation from the deficit objective is expected in 2003, as the deficit will lie in the range between 5% and 6% of GDP, with most of the deviation originating from the decrease in state revenues from taxes.