

The State Budget Proposal for Fiscal Year 2007

Major Provisions of the Budget

Jerusalem

October 2006

To the reader,

This booklet summarizes the major provisions of the 2007 Budget Proposal. Additional material concerning the government activities is available in more detailed booklets regarding the budget proposal.

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Part I

Budget Bill for Fiscal Year 2007

Budget Bill for Fiscal Year 2007

Budget Proposal for Fiscal Year 2007 and First Appendix (Condensed)

Forecast of State Revenues and Loans for Fiscal Year 2007

Estimated Tax Benefits in Fiscal Year 2007

Budgetary Proposal for Business Enterprises - Fiscal Year 2007

Budget Bill for Fiscal Year 2007

- Definitions**
1. In this law:

“Budget Item” – A sum of money or number of salaried positions, stated in a title and marked by a double underline;

“Range of Action” – A sum of money or number of salaried position, stated in a title and marked by a dashed line;

“Plan” – A sum of money or number of salaried position stated on a line with no marking;

“Fiscal Year 2007” – The period commencing on January 1st 2007 and ending December 31st 2007;

Any other term – As defined in the Budget Principles Law – 1985 (hereinafter: “Budget Principles Law”).
- The expenditure budget and its allocation**
2. The government is permitted to make expenditures of NIS 282,864,058 thousands during fiscal year 2007. The division of this sum into parts and any part thereof into budget items, areas of operation and plans, shall be as detailed in the first column of the first supplement titled “expenditure”.
- Revenue-dependent expenditure budget**
3. In addition to all the sums that the Government is authorized to expend pursuant to Section 2, it may expend a sum of NIS 12,561,369 thousand in fiscal year 2007, as revenue-dependent expenditures. The division of this sum into parts and any part thereof into budget items, areas of operation and plans, shall be as detailed in the second column of the first supplement titled “revenue-dependent expenditure”.
- Maximum Personnel**
4. In fiscal year 2007, the Government may fill 57,543 salaried positions. The division of this number into parts and any part thereof into budget items, areas of operation and plans, shall be as detailed in the fourth column of the first supplement titled “maximum personnel”.
- Business Enterprise Budget**
5. A. In addition to the sums the Government is authorized to expend pursuant to Sections 2 and 3, it may also expend, in fiscal year 2007, the sums appearing in the first column of the second part in the second supplement (hereinafter: “Business Enterprise Budget”). The division of these sums into budget items, areas of operation and plans, shall be as detailed in that same part.

- B. In addition to the number of jobs that the Government may fill pursuant to Section 4, it may also fill 18,417 jobs in business enterprises in fiscal year 2007. The division of this number into budget items, areas of operation and plans, shall be as detailed in the third column of the second part of the Business Enterprise Budget.
- C. The revenue forecast regarding the coverage of the Business Enterprise Budget in fiscal year 2007 shall be as detailed in the first part of the second supplement.

Validation 6. This law shall become valid and effective on January 1st 2007.

Publication 7. This law shall be published in the Official Gazette of the Israeli Government within three months of its ratification.

Budget Proposal for Fiscal Year 2007

(NIS Thousands)

Summary of the first supplement	Expenditure	Revenue- Dependent Expenditure	Spending Authorization	Maximum Personnel
Grand total	282,864,058	12,561,369	59,269,469	57,543
===== Part I: Regular budget	211,245,645	11,443,942	47,984,033	57,543
Part II: Budget for development and capital account	71,618,413	1,117,427	11,285,436	
Part I: Regular budget	211,245,645	11,443,942	47,984,033	57,543
-----	-----	-----	-----	-----
Government and Administration	28,139,077	2,113,459	2,379,995	37,991
===== 01 President of the State	24,125	618		36
02 The Knesset ¹	419,744	2,180	10,000	475
03 Government members	92,956			
04 The Prime Minister's Office	3,366,277	82,674	31,042	757
05 Ministry of Finance	1,578,034	279,060	1,150	4,902
06 Ministry of the Interior	384,556	47,359	80,166	890
07 Ministry of Homeland Security	8,071,547	497,174	2,122,889	25,680
08 Ministry of Justice	1,936,107	568,054		3,438
09 Ministry of Foreign Affairs	1,282,295	55,425		946
11 The State Comptroller ²	213,388			544
12 Pension benefits	8,460,026	435,000		
13 Miscellaneous expenses	1,253,971	95,351	73,943	
14 Financing of political parties and the Central Elections Committee	119,817			
19 Ministry of Science Culture and Sport	700,837	20,093	43,500	72
26 Ministry of the Environmental Protection	180,700	30,471	17,305	189
68 Unit in charge of Foreign Laborers	54,697			62

¹ The Knesset's annual budget proposal is submitted for approval to the Knesset's committee by the Chairman of Knesset, and is integrated into the Budget Bill.

² The State Comptroller budget is set by the Finance Committee and is integrated into the Budget Bill. It is published separately as bounded by the Basic Law: State Comptroller.

Summary of the first supplement		Expenditure	Revenue- Dependent Expenditure	Spending Authorization	Maximum Personnel
	Defense	47,891,844	2,457,539	30,948,968	1,883
	=====	=====	=====	=====	=====
15	Ministry of Defense	47,630,805	2,403,569	30,827,402	1,739
16	Civil emergency expenses	170,235		111,566	
17	Coordination of activities in the territories	90,804	53,970	10,000	144
18	Local Authorities	4,002,500			
	=====	=====			
	Social Services	83,692,713	6,023,354	2,580,780	13,198
	=====	=====	=====	=====	=====
20	Ministry of Education	25,877,676	1,517,908	1,465,566	1,598
21	Higher Education	6,050,394			
23	Ministry of Welfare	3,355,304	1,167,512	82,060	2,208
24	Ministry of Health	16,153,260	2,843,840	173,450	8,378
27	Transfers to National Insurance	23,399,999			
25	Benefits for the Nazis' Victims	1,586,242	1,812		58
29	Ministry of Construction and Housing	213,342	3,500		583
30	Ministry of Immigrant Absorption	1,375,803	35,382	595,896	351
32	Price support	4,422,855	453,400	263,808	
46	Veterans Law	1,251,196			22
56	Commission for Equal Rights	6,642			
	Economy and Administration	7,077,563	849,590	2,074,290	3,971
	=====	=====	=====	=====	=====
33	Ministry of Agriculture and Rural Development	664,299	222,107	343,354	1,179
34	Ministry of National Infrastructures	189,112	8,508	38,869	248
35	Atomic Energy Committee	147,927			
36	Ministry of Industry, Trade and Labor	1,810,053	52,946	103,918	1,580
37	Ministry of Tourism	190,644	8,681	106,625	145

Summary of the first supplement		Expenditure	Revenue- Dependent Expenditure	Spending Authorization	Maximum Personnel
38	Support for economic sectors	1,280,967	446,005	1,424,742	
39	Ministry of Communications	47,692	448		88
40	Ministry of Transportation	461,245	60,850		498
42	Grants for construction and housing	2,123,539	53,388	274,000	
43	Israel Mapping Center	69,513	24,357	500	226
28	Maintenance of inter-city roads	146,235	300		7
54	Regulatory authorities				
44	Credit subsidies	32,450			
	=====				
45	Interest and commissions payments	35,523,000			
	=====				
	Reserves	4,886,498		10,000,000	500
	=====	=====		=====	=====
47	General reserve	4,886,498		10,000,000	500
	Part II: Development and capital account budget	71,618,413	1,117,427	11,285,436	
	-----	-----	-----	-----	
	Development Budget	12,024,413	1,117,427	11,285,436	
	-----	-----	-----	-----	
	Investments in Government and Administration	507,018	120,553	3,136,067	
	=====	=====	=====	=====	
51	Government Housing	35,350	64,270	889,318	
52	Police and prisons	261,029	37,278	2,072,535	
53	Court houses	162,850	1,000	66,000	
55	Treasury	47,789	18,005	108,214	
	=====				
	Investments in Social Services	3,912,369	882,423	4,573,088	
	=====	=====	=====	=====	
60	Education	543,226		453,365	
67	Health	214,692	77,423	446,137	
70	Housing	3,154,451	805000	3673586	

Summary of the first supplement		Expenditure	Revenue- Dependent Expenditure	Spending Authorization	Maximum Personnel
	Investments in various sectors of the economy	7,605,026	114,451	3,576,281	
	=====	=====	=====	=====	
58	Urban utilities for water and sewage	30,804		563,000	
73	Water works	408,829	6,000	478,429	
76	Industrial development	93,123	40,000	113,123	
78	Tourism	149,931		80,464	
79	Transport development	4,621,658	9,000	1,030,020	
83	Miscellaneous development expenses	2,300,681	59,451	1,311,245	
84	Debt repayments — principal	59,594,000			
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Forecast of State Revenues and Loans for Fiscal Year 2007

(In NIS Thousands)

2007 Budget Proposal		
	Grand total	282,864,058
	=====	=====
Part I:	Current receipts	211,245,645
Part II:	Proceeds from bonds and capital account	71,618,413
	Part I: Current receipts	211,245,645
	-----	=====
	Taxes and compulsory fees	180,756,235
	-----	-----
	Income and property taxes	99,100,000
	-----	-----
001	Income Tax	83,950,000
002	Value added tax on non-profit organizations and financial institutions	8,100,000
003	Betterment tax	1,500,000
004	Real estate purchasing tax	3,500,000
005	Property and Sales Tax	100,000
007	Employers tax	1,950,000
	Taxes on Expenditure	81,656,235
	-----	-----
011	Customs and Import Levies	2,200,000
012	VAT, including VAT on defense imports	50,856,235
013	Purchase tax	12,100,000
015	Excise tax	700,000
018	Fuel tax	10,900,000
020	Stamp duty	

		2007 Budget Proposal
024	Vehicle levies	
025	Other license fees and levies	4,900,000
	Interest and Earnings	2,575,873
	-----	-----
034	Interest in Foreign Currency	150,000
035	Interest in NIS	2,425,873
	Royalties	629,000
	-----	-----
042	Royalties from business enterprises	
043	Royalties from natural resources	189,000
044	Royalties from government-owned companies	120,000
045	Dividends from government-owned companies	320,000
	Miscellaneous revenues	1,139,000
	-----	-----
046	Reimbursement on account of preceding years' budget	28,000
047	Revenues from various services	850,000
050	Government asset utilization fees	205,000
048	Earmarked revenues in excess of estimate	56,000
049	Profits realized by the Bank of Israel	
	Transfer from Part II	26,145,537
	-----	-----
	Part II: Proceeds from bonds and capital account	71,618,413
	=====	=====
	Repayment of Government Investments and Loans	6,015,000
	-----	-----
051	Collection of principal in NIS	5,483,000

2007 Budget Proposal

053	Collection of principal in foreign currency	
076	Revenues from sale of state-owned land	532,000
	Provisions for pension and severance pay	24,700
	-----	-----
071	Provisions by economic units	
072	Provisions by business enterprises	10,500
073	Pension allowances — companies	14,200
	Capital revenues	2,000,000
	-----	-----
075	Revenues from sale of companies and banks	2,000,000
	Domestic Loans	68,209,000
	-----	-----
081	Loans from National Insurance Institute	12,084,000
082	Revenue from emissions and deposits	56,125,000
	Loans and Grants from Overseas	21,515,250
	-----	-----
900	Independence and development bonds	4,393,000
901	Less: Distribution expenses	-220,000
	Loans and Grants from the USA:	
902	-Defense	10,432,650
904	- Civilian assistance	531,600
907	- Other loans	6,378,000
908	Bank loans	
	Transfer to Part I	-26,145,537
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Estimated Tax Benefits in Fiscal Year 2007

(In NIS Millions)

Total	31,600	
Direct taxes	27,700	
Benefits paid to factors of production	2,630	
Law for the Encouragement of Capital Investments:	2,030	
- General	70	
- Foreign investors	860	
- Alternative track	1100	
Research & development, oil exploration and films	-	
Credit for shift labor	150	
Industry Encouragement Law	-	
Capital gains tax up to (excluding stock exchange)	150	
Accelerated depreciation	300	
Benefits to the capital market	13,700	
Provident funds, net:	8000	
- Benefits upon deposit		9700
- Net of taxation upon withdrawal		-1700
Advanced Learning funds	2600	
Interest income on linked assets	3700	
Interest income on unlinked assets	800	
Capital gains on stock exchange	1600	
Tax deferral on distribution of options to employees	-	
Welfare and dispersal of the population	3090	
Income tax exemption for NPOs	-	
Exemption on Ministry of Defense allowances	400	
Exemption on National Insurance allowances	1,450	
Child allowances		850
Allowances for old age and surviving relatives		500
Other allowances		100
Credit for new immigrants	40	
Credit for medical expenses	30	
Credit for welfare recipients	30	
Credit for charitable donations	160	
Benefits for the blind and disabled	200	

Credits for inhabitants of development regions		700
Credit for employers in Eilat*		80
Household Benefits (excl. child allowance exemption)	1,910	
Credits for single-parent families		80
Half credit point for women		600
Credit for children (including single-parent families)		1,200
Credit for non-working spouse		30
Miscellaneous Income Tax Benefits	690	
Exemption on gambling revenues		220
Exemption on leasing of residential apartments		350
Veterans		40
Students		60
Foreign athletes and journalists		20
Real-Estate Tax Benefits	2680	
Real-estate purchasing tax reductions		60
Land betterment tax exemption on residential apartment		2300
Limited land betterment tax on historical properties		200
Limited land betterment tax (20%)		100
Customs and VAT Department	3800	
Customs and purchase tax	850	
New immigrants		60
Returning expatriates		10
Israeli tourists		300
Motor vehicle parts (airbags and ABS)		250
Conditional exemptions for taxi's		190
Conditional exemptions for others		40
Value added tax	2950	
Fruit and vegetables		1,750
Tourism services		700
Eilat Law		500
Levies	100	

The source: The State Revenues Administration

Budgetary Proposal for Business Enterprises - Fiscal Year 2007

(In NIS Thousands)

Summary of the second supplement		Revenues Expenditure	Authorized Spending	Maximum Personnel
	Total revenues	9,778,164		
	=====	=====		
89	Prime Minister's Office and Ministry of Finance Enterprises *	339,515		
94	Government hospitals	5,813,284		
95	Jaffa and Hadera Ports	25,365		
96	The Postal Bank			
98	Israel Land Authority (ILA)	3,600,000		
	Total expenditures	9,778,164	1,394,188	18,417
	=====	=====	=====	=====
89	Prime Minister's Office and Ministry of Finance Enterprises	339,515		103
94	Government hospitals	5,813,284		17,837
95	Jaffa and Hadera Ports	25,365		5
96	The Postal Bank			
98	Israel Land Authority (ILA)	3,600,000	1,394,188	472

Part II

General Overview

Budget Policy for 2007

Volume of the Budget

- **The government's net budget proposal for 2007 reaches a total of NIS 282.9 billion.**
- **The government's gross budget proposal reaches a total of NIS 295.4 billion**
- **The total gross expenditure, excluding payment of the principal of its debts, reaches a total of NIS 242.6 billion.**

Objectives of the 2007 financial policy and the budget

Following a long period during which economic growth rates in Israel were lower than global rates, the trend started to reverse itself and beginning in 2004, the Israeli economy began to grow at rates that were higher than the average throughout the world – 4.8% in 2004 and 5.2% in 2005.

Macroeconomic developments in 2005 were very positive. The forces that created this positive turn in the economy during the second half of 2003 and which impacted on the Israeli economy during 2004 and 2005 continued to operate during the first half of 2006 as well. During that six-month period, GDP grew at an annualized rate of 5.9%.

As a consequence of the month-long hostilities in the North, a large portion of economic activity in the North was suspended. Activity in the Northern region generally constitutes 20% of the Israeli economy. At this stage it is difficult to make an exact estimation of the economic implications of the fighting, but assuming that the situation remains quiet, it is expected that economic activity will recover. We therefore estimate that the economy lost one percent of the growth it would otherwise have experienced during 2006. Accordingly, the growth forecasted for 2006 is approximately 4.3%, and in 2007 the estimate reaches 3.8% of growth.

This forecast, which reflects a higher rate of growth than is expected in most Western countries, even after the slowdown due to the fighting in the North, is supported by – among other things – the structural reforms that have been carried out in the Israeli economy; the continuation of a policy of fiscal restraint in 2006, despite the results of the fighting; the recording of a continued surplus in the balance of payments current account ; the reduction of the public debt to GDP ratio; the continued expansion of international trade; and the absence of significant inflationary pressures. These factors allow for a low real interest rate environment that supports growth.

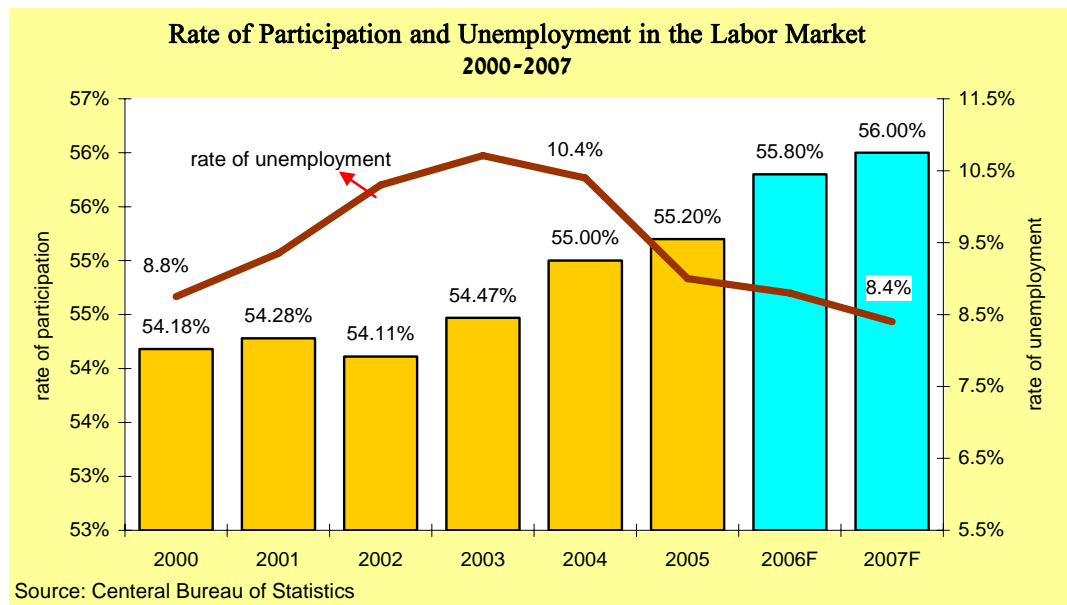
Notwithstanding the above, GDP per capita in Israel is still low in comparison to those of developed countries. It is therefore necessary to strive and work towards a

policy that will allow the economy to reach a target of 3% growth per capita over the next five years.

Employment

The rapid growth in business sector output, together with the government's decisions to impose tougher conditions for receiving unemployment benefits and supplemental income allowances and a policy of reducing the number of foreign workers, have all contributed to the increased number of employed Israelis and to a higher rate of participation in the work force – despite an 8% increase in the number of foreign workers in 2005. The unemployment rate, which had reached a peak of 10.9% during the second half of 2003, dropped to 9.0% (as an annual average) in 2005, and to 8.8% during the second quarter of 2006. The trend towards an improved rate of participation in the work force continued, with the participation rate increasing from 54.5% in 2003 to 55% in 2004, 55.2% in 2005 and 55.7% in the first half of 2006. It should be noted, for purposes of illustration only, that had there been no growth in the participation rate during the last three years, the unemployment rate in 2006 would have been less by 2%.

The number of employed in Israel grew by 3.9% in 2005. During the first half of 2006, there was an increase of 3.3% in the number of employed in comparison to the number during the corresponding period in 2005 (This was an increase of 82,000 employed persons, according to seasonally adjusted data).



Despite the positive trend in the labor market, the increase in the number of foreign workers in 2005 and in 2006 has reduced the number of jobs available for Israelis, and thus prevents additional employment opportunities for those who are not currently employed. A return to the policy of reducing the actual number of foreign workers will lead to an additional increase in employment of Israelis, higher salaries (mainly

for low-salaried workers), and an increase in the workforce participation rate. **A reduction in the number of foreign workers is a necessary condition for closing the economic gaps in Israeli society.**

The continued implementation of the steps taken through 2006 during the course of the economic plan, and additional steps set out in the 2007 budget proposal, will lead to a further increase in employment – one that will be measured in tens of thousands of employed Israelis in 2007. The workforce participation rate for Israelis is also expected to continue to increase during 2006 and 2007, as a result of this policy.

Economic Plan for 2007

The 2007 economic plan and the budget that accompanies it will support continued growth and the strengthening of disadvantaged social groups, while providing for the financing of the expenditures caused as a result of the fighting in the North. This policy is expressed in the completed financing of a significant portion of the government coalition agreement requirements - the cost of which came to NIS 3.5 billions; in a series of additional proposals for encouraging non-working population segments to become integrated into the workforce; and in financing for additional social issues, the most important of which are described below. Note that the financing of the balance of the coalition agreements amounts in 2007 (some of which are, as stated, presented below) is in addition to the NIS 1.5 billion that was budgeted in 2006 and which is consequently the basis of the 2007 budget. The financing for the balance of the agreements requirements covers the following: investment in children in distress and in at-risk youth; the increase of senior citizen pensions and supplemental income allowances for the elderly; a lower ceiling for deductible payments for elderly chronic patients; the addition of a budget for alienated ultra-orthodox youth; allotments for disadvantaged youth living in boarding schools; and other social issues.

The following are the main social issues and priorities added to the base of the 2007 budget proposal, in comparison to the 2006 budget:

- Support for local authorities (budgeting on the basis of budget balancing grants, including budget balancing grants for development) – NIS 630 million.
- Addition to the health basket (including an update based on inflation adjusted prices) – NIS 476 million.
- Raising the minimum wage – NIS 360 million.
- Increasing old-age pensions and supplemental income allowances for the elderly – NIS 200 million.
- Expanding the circle of those entitled to payments pursuant to the Nazi Persecution Victims Law – NIS 190 million.
- Strengthening the Negev – NIS 150 million.
- Struggle against violence – NIS 85 million.
- Day care centers – NIS 63 million.
- University research and integrated technologies – NIS 60 million.
- Expanding grants for integrating special needs children into the regular educational system – NIS 40 million.

- Strengthening of welfare services (not including natural growth in welfare allowances) – NIS 32 million.
- Expansion of the school nutrition program pursuant to the Meal A Day Per Student Law – NIS 30 million.

In addition to these subjects, NIS 800 million was budgeted for the strengthening of the North and Haifa, as described below

Establishing Growth

The economic plan for the continued establishment of growth in 2007 continues the economic policy steps taken from mid 2003 until now. The country needs to follow a consistent and long-term economic policy, in order to preserve the accomplishments of the past years. Only such a policy will establish a basis for the Israeli economy as a free and dynamic one, with an efficient public service and a competitive private sector – an economy that provides jobs for the country's citizens and makes services and products accessible to Israeli citizens at low prices.

With consistent growth of more than four percent each year through the end of the decade, Israel can continue to bring its income per capita statistics in line with those of the OECD developed countries, reduce the economic gaps in its society and initiate a most significant social improvement - the transition from unemployment to work.

The Budget Framework

The budget framework and structure are aimed at achieving fiscal policy goals in line with the prevalent trends in developed countries, in the following areas:

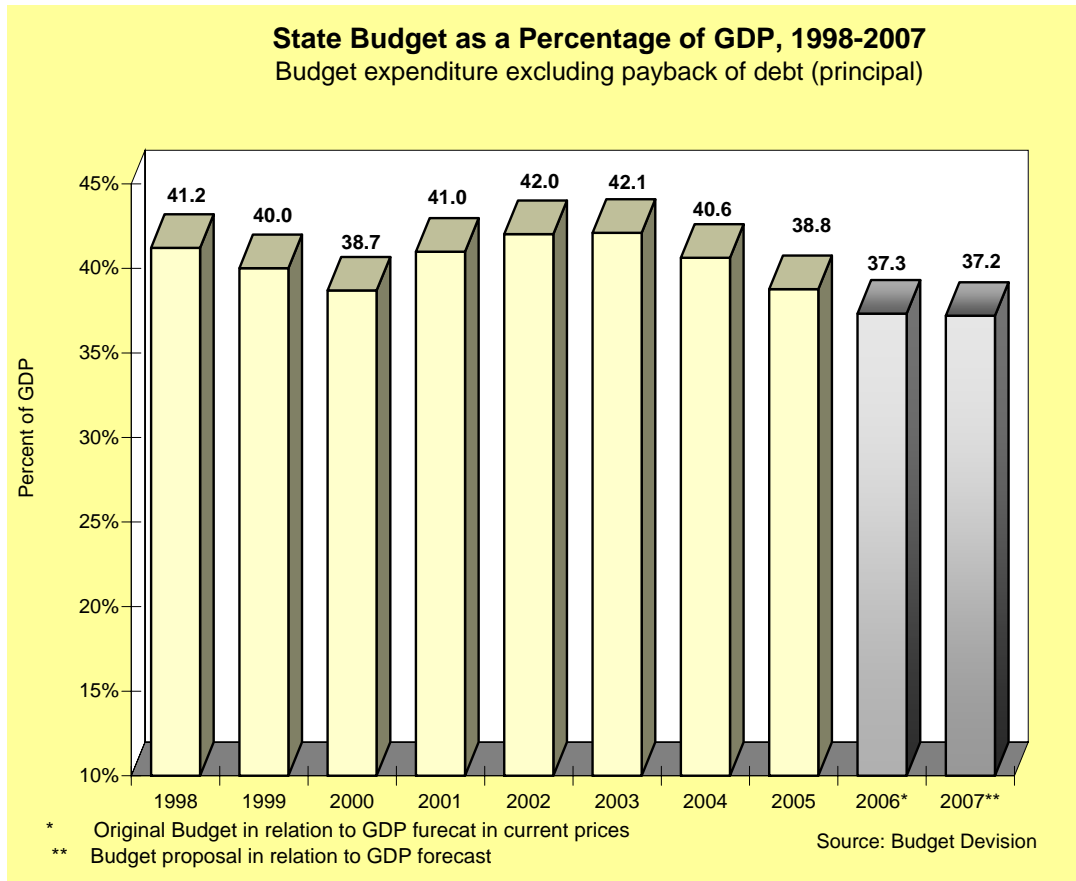
Gradual reduction of the total government expenditure to GDP ratio*

An inefficient, bloated public sector damages the economy's growth potential by depriving the productive business sector of resources. Moreover, it is the economic activity of the business sector that finances most of the public sector's expenditures. Due to the unique historical development of the Israeli economy, the public sector's share of the GDP is still high in comparison to that of most Western countries.

Beginning in 2001 and continuing through 2003, there were signs of a trend towards an increase in government expenditure as a percentage of GDP. In order to reverse this trend, the government decided, during discussions of the 2004 economic policy, to amend the Deficit Reduction Law to require that government expenditure not increase by more than one percent each year for the years 2005-2010. The government's foundation policy of May 2006 provided that the Deficit Reduction

* During 2006, the Central Bureau of Statistics initiated a technical change in the manner of measuring Israel's GDP for the purpose of international comparison. The GDP amount increased as a result of this measurement. The statistics in this pamphlet, including the government budget as a percentage of GDP, the deficit rate and the public debt are all presented in relation to the new measurement method.

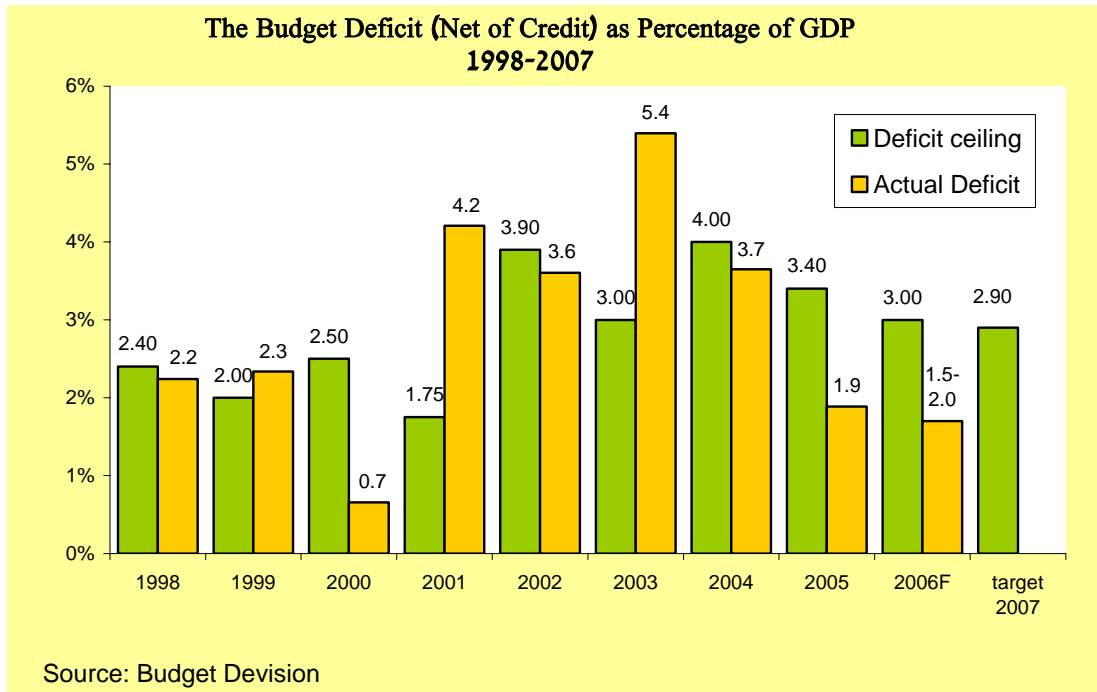
Law was to be amended so that government expenditure, less one-time expenditures, would increase by 1.7% in comparison to the budget of the previous year. This policy, which provides for an additional 0.7% growth above what had been determined in the 2004 economic policy discussions, as described above, will allow for the continued reduction of government expenditure in proportion to GDP while making resources available for the business sector. Beginning in 2004, the above-described trend towards an increase in the ratio between public expenditure and GDP began to reverse itself and the ratio gradually dropped. Notwithstanding the said trend towards improvement, the level of public sector expenditure in Israel – even if defense spending is excluded – is high in comparison that of developed countries. This means that Israel has significant potential for growth that is being restrained by the heavy weight of public expenditure. The full realization of this potential is dependent on the continuation of the economic policy: a reduction each year in the ratio of public expenditure to GDP, along with a reduced tax burden for citizens and companies.



A 2.9% deficit ceiling for 2007

A low government deficit sends a message of stability to the business sector and facilitates the financing of its investments. In most developed countries, government deficits have been reduced significantly in recent years and some of them are even

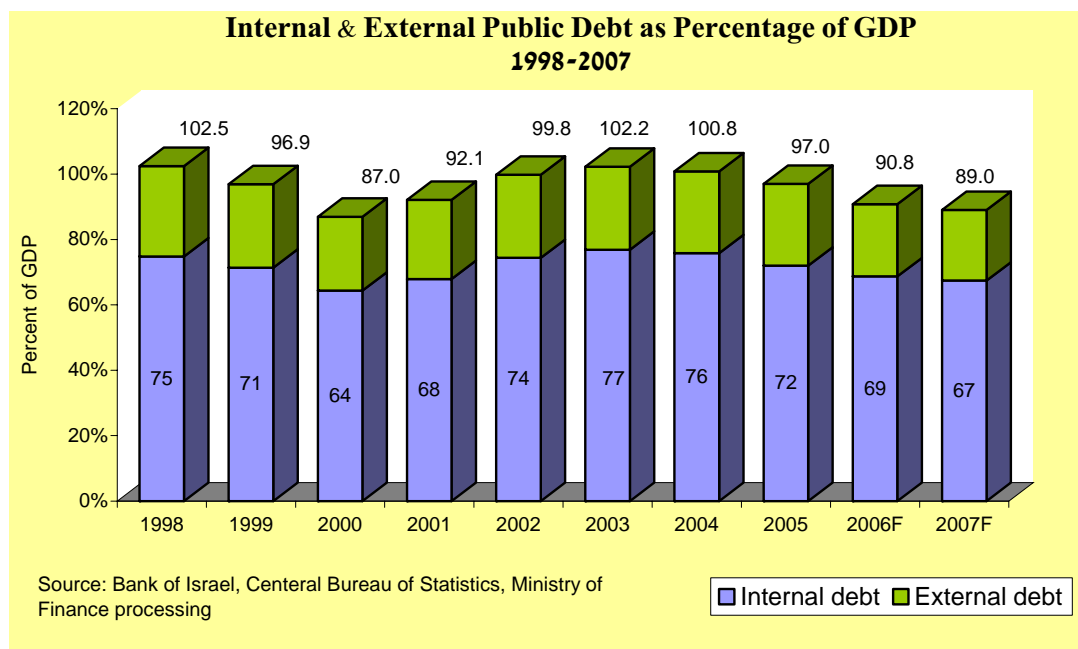
enjoying budget surpluses. In 2007, Israeli's total government deficit (excluding the extension of credit) is expected to be 2.9% of GDP, which is itself forecasted to reach NIS 645 billion during that year.



Reduction of public debt as a percentage of GDP

After a significant reduction in the ratio of the public debt to GDP from approximately 102.5% in 1998 to approximately 87% in 2000, the ratio rose in the years 2001–2003 and reached 102.2% in 2003. The increase in the public debt to GDP ratio was a direct result of the growth in the deficit and of the slow-down in economic activity. In 2004 and 2005, the public debt came to 100.8% and 97%, respectively, of GDP. Public debt is expected to continue to drop to approximately 90.8% of GDP in 2006 and to approximately 89% in 2007.

The size of the public debt to GDP ratio is much higher in Israel in comparison to the OECD countries. As a comparative example, the public debt to GDP ratio established in the Maastricht Treaty is 60% of GDP. The continuation of measures that will reduce Israel's public debt as a percentage of its GDP is necessary in order to facilitate the business sector's ability to expand its activity and in order to reduce the interest payments included in the State budget. Moreover, the reduction of public debt will, in the future, allow the government to allocate many more resources to the areas making up the set of priorities that it establishes, as the percentage of the budget taken up by repayment of principal and interest will be lowered.



Composition of the Budget

As part of the discussions regarding the 2007 state budget, the government decided to carry out adjustments to the budget in the amount of approximately NIS 3.8 billion, in order to limit budget growth to 1.7% – an amount equal to NIS 3.9 billion. The said adjustments will allow the government to work towards accomplishing the objectives described above, while continuing the implementation of tax reform, the infrastructures program and the social reinforcement programs in areas on which the government had determined to focus its efforts. The budgetary adjustments are necessary in order to continue to encourage growth in the economy and to allow the government to focus on the issues making up the set of priorities that had been outlined by the government. The 2007 budget proposal includes proposals for making the public sector more efficient and for reducing expenditures as a result of efficiency measures and structural changes in a number of areas. The budget proposal includes, as stated, the continued implementation of the tax reforms, continued investments in infrastructures, the strengthening of the North and the various social reinforcement measures described above. In addition to the increased expenditure of approximately NIS 4 billion, which constitutes an increase of 1.7% in comparison to the 2006 budget, it was decided that the budgetary expenditure in 2007 would be increased by an additional NIS 3.5 billion (an increase of an additional 1.6%) in order to finance one time expenses arising from the fighting in the North.

Financing of one time expenses arising from the fighting in the North

The State's budget framework for 2007 will grow by an additional 1.6%, as stated – an amount which is equal to NIS 3.5 billion, in order to finance unexpected expenses arising from the fighting in the North. These expenses include reserve duty costs, the restocking of the army's munitions inventory, maintenance of equipment used during

the fighting and various logistical costs. Out of the said amount, approximately NIS 2.7 billion will be allocated for the financing of the 2007 portion for the fighting's direct costs, in addition to the NIS 1 billion that was allocated by Government Resolution 375 of August 13, 2006. An additional NIS 800 million of the 2007 special supplement will be allocated for the financing of the plan to strengthen the North and Haifa, as part of a total program of approximately NIS 4.5 billion. In order to finance the said expenditures, it was decided to increase the State budget in a one time fashion and to add additional amounts over the years 2007 and 2008, such that after the expenses of the fighting are financed, the State budget will return to the path of only a 1.7% increase from year to year, in relation to the 2007 budget less the security expenses resulting from the fighting and from the strengthening program for the North.

This budget increase will allow the government to finance the one time expenses and at the same time to outline a large part of the areas chosen by the government as making up its order of priorities for 2007. Nevertheless, and in order to continue the responsible fiscal policies that encourage growth and broadcast dependability to the world markets and to the Israeli economy, the proposed budget includes a series of measures the objective of which is comply with the expenditure ceiling, except for the one-time expenses of NIS 3.5 billions arising from the fighting in the North.

The plan to strengthen the North and Haifa

As stated above, in addition to the funds to be allocated by the government ministries and through contributions, NIS 800 million has been allocated for the strengthening of the North and Haifa, in accordance with the government's resolution.

Due to the fighting in the North during July and August of 2006, the Israeli government adopted a resolution regarding the formulation of a comprehensive plan to strengthen the North and Haifa. On September 14, 2006, the "Cabinet for Strengthening the North" approved a comprehensive proposal establishing the manner in which assistance will be provided and the budget will be allocated. The program, which has a total budget of NIS 2.76 billion and includes existing budgets and additional amounts from the State budget, along with an additional 300 million dollars that will be received as aid from Jews abroad, will be used to improve the standard of living of the area's residents. The program is based on four measurable objectives – improvement of the educational accomplishments of students in the North; increasing the number of employed in the region, improved balance of migration in and out of the region and the empowerment of the area's special needs population groups.

The Disengagement Plan

Expenditure for financing of the disengagement plan as of the end of 2006 was measured at approximately NIS 5.9 billion (by the end of 2006, approximately NIS 4.4 billion had been expended). The plan's cost, including the construction of temporary and permanent residential areas, is estimated at approximately NIS 9 billions.

As the processing of resettling and the payment of compensation progresses, it is estimated that the total expenditure in 2007 will come to approximately NIS 1.1

billion. In order to finance the disengagement plan activities, it has been proposed to increase the State budget in 2007 as well, by an additional one half of one percent.

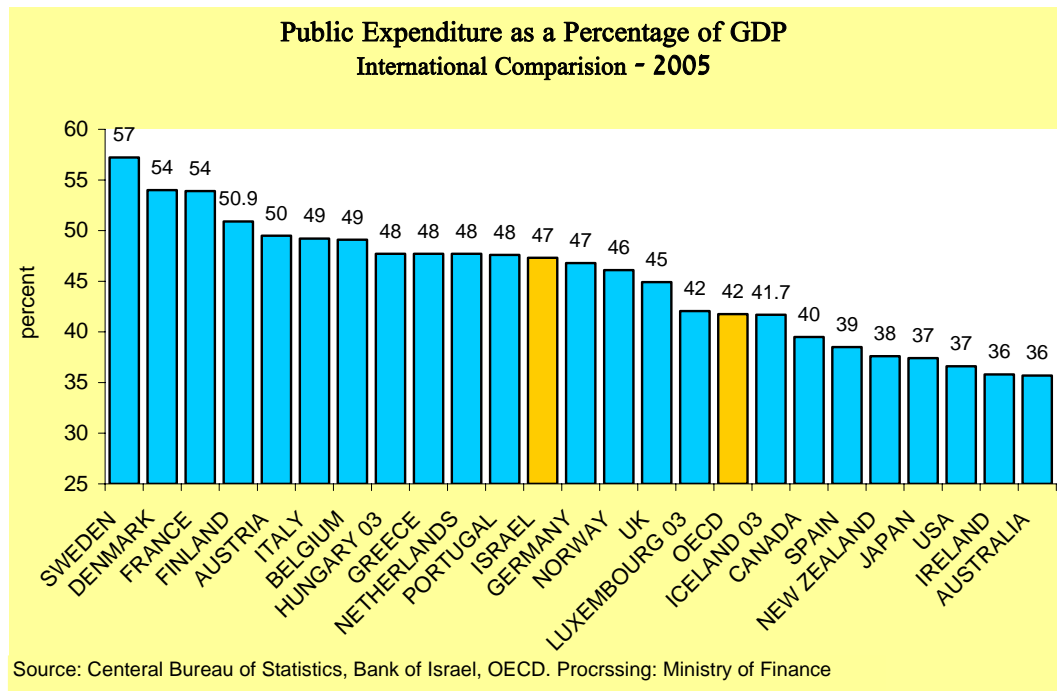
Structural Changes in the Economy

In order to improve the standard of living of all of the State's citizens, the government has resolved to carry out structural changes in a number of critical areas, while emphasizing the completion of structural reforms that have already begun to be implemented.

Reducing the Size of the Public Sector

Israel's public expenditure as a percentage of its GDP is still high in comparison to the average percentage in OECD countries. Although the economic plan has succeeded until now in reducing the public expenditure as a percentage of the GDP, the need to close the gap between Israel and these other countries by the end of the decade remains important. This is a critical objective, the realization of which will improve the State of Israel's economic strength immeasurably, and in order to obtain it, the government must limit the growth in its expenditure. If growth of government expenditure is limited to 1.7%, with GDP growing by approximately 4% of the year, public expenditure will decrease as a percentage of GDP.

Complying with the target expenditure level is the key to the success of the economic plan. Israel's economy will be rated in international markets based on this issue. Violation of this framework in order to finance government expenditures will lead to a painful and immediate result in the financial markets and will immediately change the direction in which investments flow.



Improving the Competitive Capability of the Business Sector

Several reforms proposed in the 2006 budget are aimed at lowering costs and improving the competitive capability of the business sector.

Continued implementation of reforms is the key means of increasing freedom and activity in the economy. In 2007, this entails a series of reforms that aim to make government services more efficient, increase competition in the business and infrastructure sectors, lower prices of products and services, increase the transparency of business operations, encourage efforts to seek work, and increase investments in the economy.

The central reforms in 2007

- **Continuation of the foreign workers reform**

Continuation of the policy of reducing the number of foreign workers by raising the cost for employers. Increased enforcement of the laws concerning illegal foreign workers and their employers.

- **Integrating mothers into the workforce – increasing the number of available day care centers**

Changing the criteria for operating day care centers – transition to the “voucher” system. Increased enforcement and supervision of the quality of day care centers.

- **Approval of the budget no later than December 31**

Approval of the budget after the start of the fiscal year has a negative impact on the proper administration of government ministries. In order to allow the ministries to implement the original budget program, it is proposed that the budget be approved no later than December 31.

- **Completing of the reform of the electricity industry – promotion of a competitive market structure**

Division of the Israel Electric Corporation into three separate segments – production, transmission and distribution.

Division of the production segment into competing companies.

Division of the distribution segment into a number of companies

Establishment of separate service companies (planning, construction and execution, information technology, logistics.)

At the second stage – share offerings of additional manufacturing, distribution and services companies.

- **Streamlining and developing the water supply system**

Implementation of the reform in the urban water supply systems – the incorporation of the water and sewage system companies.

Expansion of the investments in drainage infrastructure and the development of the water supply.

- **Economical arrangement of the water supply system**

Establishment of flexible production charges in order to enable efficient management of the various water sources. Reaching a long-term arrangement with the agricultural sector regarding the price of water used in agriculture.

- **Structural changes in the Israel Airport Authority**

The establishment of an inter-ministerial team for examining and formulating a new structure for the Israel Airports Authority, which will support the transformation of its main activity into independent business units.

- **Completing the privatization of the Oil Refineries Ltd.**

Share offering of the Haifa oil refinery over the course of 2007.

- **Privatization of the Postal Company**

Advancing the process of selling the State's holdings in the Postal Company, pursuant to the outline established by the government on September 12, 2006 (Government Resolution Number 438).

- **Increasing control and transparency in the defense budget**

The division of the defense budget into classified and unclassified areas of activity along with the general publication of the segments that are unclassified, in order to strengthen civilian control over and transparency of the defense budget.

- **Aviation agreement with the European Union**

Responding to the European Union's proposal to advance a global aviation agreement.

Appointment of an inter-ministerial team to accompany the contacts with the European Union.

- **Reform of the judgments collections system**

Measures to increase efficiency in the judgment collections system; i.e., expansion of the databases available to the court registrars and the opening of a fast track for those winning court cases in which the

amount is less than NIS 50,000. In such cases, the judgment collections office rather than the successful litigant will initiate the collections activity. In addition, the magistrate's courts and the judgment collections offices are undergoing an administrative separation, in order to have funds allocated specifically to the judgment collections offices.

Along with the measures that are aimed at encouraging growth, utmost importance is attached to measures that will promote employment among population groups who are of working age but are not participating in the workforce. These measures must focus on three central aspects: creating motivation to go to work, improving the ability to join the workforce and creating employment opportunities.

As part of the policy of moving these population groups towards the labor market and encouraging the transition from welfare to work, and pursuant to the reform of the payments of supplemental income allowances and children's allowances, the proposed 2007 budget includes a number of measures aimed at increasing the motivation to go to work and raising the workforce participation rate.

An integration of the proposed policy measures will be an effective tool to be used in strengthening of society's weakest population segments, increasing employment for Israelis and ending the continued expansion of economic inequality in Israeli society.

Budget Proposal Analysis

The 2007 proposed budgetary expenditure, as defined for the purpose of calculating compliance with the expenditure ceiling, is 1.7% higher, in real terms, than that of the original 2006 budget. Due to the fighting in the North during the summer of 2006, the government decided to increase budgetary expenditure on a one-time basis by an additional 1.6%. Tax revenues for 2006 are expected to drop by about 0.7% in real terms (less the increase in the consumer price index), as compared to the anticipated revenues for 2006. This anticipated drop is the result of several one-time large volume revenues having been received in 2006, which will not be repeated in 2007.

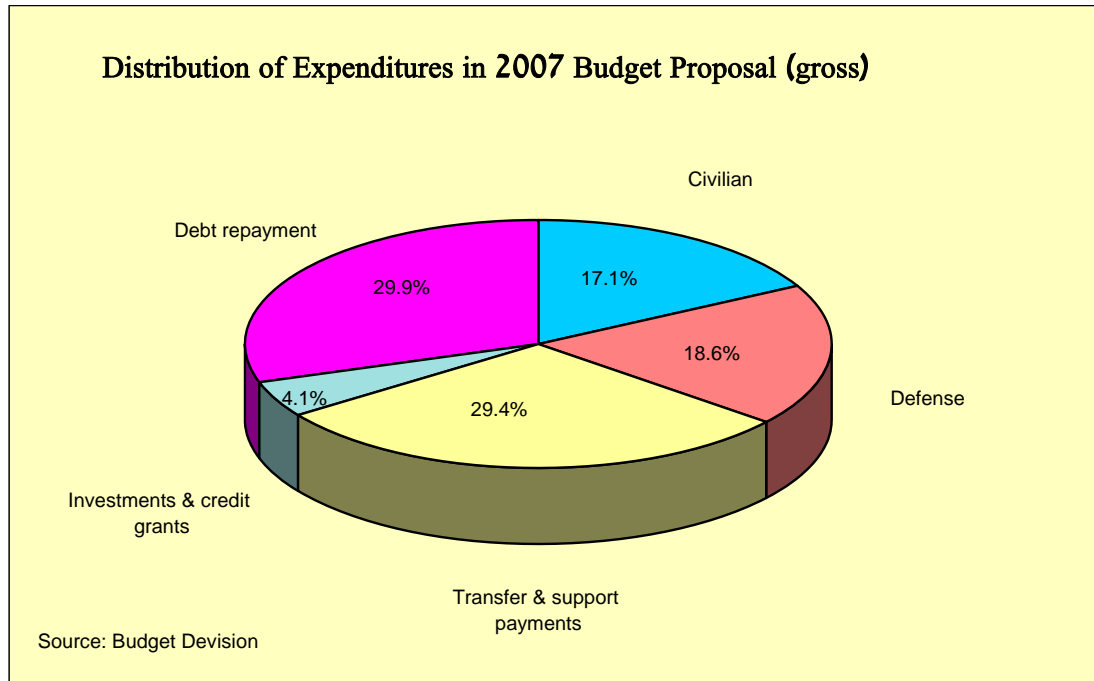
Expenditures

The following are the principal real-term changes – with regard to budgetary expenditures – in the 2007 budget proposal, in comparison to the original budget for 2006:

- **Budgetary expenditure, as defined in the Expenditure Target Law, will increase by 1.7% in 2007.**
- **In order to finance the costs of the fighting in the North and the plan to strengthen the North and Haifa, budgetary expenditure will increase by an additional 1.6%.**
- **Civilian consumption will increase by approximately 2.3%**, as a consequence of changes necessitated by legislation and various government resolutions.
- **Defense sector consumption will increase by approximately 7.9%.** Most of the increase is the result of a one-time addition for the financing of the unexpected expenses due to the fighting in the North, including: reserve duty costs, restocking of munitions inventory, maintenance of equipment used during the fighting and various logistical expenses.
- **Transfer and support payments will increase by approximately 4.5%**, in accordance with the government resolutions adopted in the context of the deliberations regarding the 2007 budget.
- **Interest payments will decrease by approximately 1.3%**, as a result of a reduction of the interest payments on domestic and foreign loans.
- **Principal repayments, excluding principal repayments for the National**

Insurance Institute, will drop by approximately 0.6%, due to the structure of the debt clearing schedules.

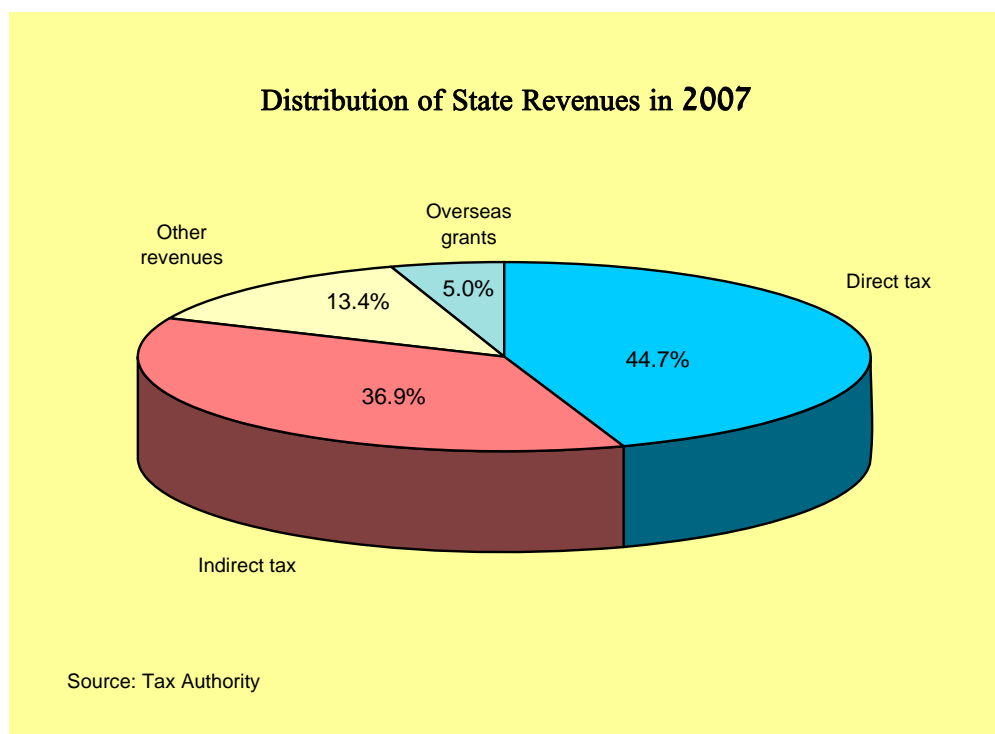
- **Credit extension will decrease by approximately 17.7%** pursuant to the forecast for credit expenditures in 2007.



The State revenues

An estimate of the 2007 tax revenues, as compared with those expected in 2006, points to a decline, in real terms, of about 0.7%. This reduction is expected despite the GDP growth forecast for 2007, mostly due to the one-time revenues received in 2006, in the amount of approximately NIS 6 billion. These one-time receipts were the result of the sale of Iscar to a foreign investor, the sale of the mutual fund management companies and the notional sale of securities.

A detailed description of the estimated state revenues from taxes appears in this booklet's Hebrew version, in the chapter "Forecast of State Revenues from Taxes in 2007."



The State Budget Deficit

Excluding credit, the total deficit in the 2007 budget will be approximately NIS 18.7 billion, comprising 2.9% of the forecast GDP, which is estimated at approximately NIS 645 billion in 2007.

Excluding credit, the domestic deficit in the 2007 budget year will be approximately NIS 14.3 billion, comprising 2.2% of the GDP.

Excluding credit, the external deficit in the 2007 budget year will be approximately NIS 4.4 billion, comprising 0.7% of the GDP.

The overall deficit (including net credit) in 2007 will be approximately NIS 15.8 billion.

Financing the Overall Deficit for 2007

(In NIS Billions)

Sources of finance for the deficit*	Sum
Revenues from the sale of companies and banks, net	4.5
External loans (net)	0.1
Loans from the public (net)	11.2
Total	15.8

* There may be a certain substitution between the various components of the deficit financing.

The Budget Deficit and its Financing

(In NIS Thousands)

	The budget proposal for 2007	Original Law For 2006	2005 budget performance
1. Total expenditures and granting of credit	242,562,427	231,777,040	221,669,688
=====	=====	=====	=====
Of which: Domestic	223,855,425	212,005,739	213,283,106
- Consumption and investment	111,025,306	103,881,431	105,413,565
Of which: Domestic	101,521,344	93,481,212	103,569,509
- Transfer and support payments	81,880,058	77,316,420	72,262,781
- Interest payments and credit subsidies	35,555,450	35,531,450	33,193,167
Of which: Domestic	28,424,450	28,171,450	26,650,641
- Issue of credit	2,596,083	3,111,281	3,016,674
- Other expenditure	11,505,530	11,936,458	7,783,501
2. Total revenues and grants	226,749,427	217,205,759	213,436,503
=====	=====	=====	=====
Of which: Domestic	212,475,863	203,369,189	196,296,255
Tax revenues	180,756,235	169,200,000	163,123,228
- Other income	35,028,942	36,413,759	38,832,995
Of which: Credit repayment	5,483,000	5,740,000	5,772,142
- Grants from overseas	10,964,250	11,592,000	11,480,280
3. Surplus (+) [Deficit (-)]	-15,813,000	-14,571,281	-8,233,185
=====	=====	=====	=====
Surplus (+) [Deficit (-)], excl. net credit	-18,699,917	-17,200,000	-10,988,653
Of which: Domestic	-14,266,479	-11,225,269	-19,603,233
Of which: External	-4,433,438	-5,974,731	8,614,580
4. Financing¹			
=====			
4.1 Overseas loans (net)	125,000	2,622,000	6,117,925
-----	-----	-----	-----
Loans assumed	10,551,000	15,950,000	16,215,889
Debt repayment	10,426,000	13,328,000	10,097,964
4.3 Domestic loans (net)	11,188,000	9,949,281	-2,136,824
-----	-----	-----	-----
Loans assumed	53,625,000	49,051,281	35,999,214
Principal Repayment	42,437,000	39,102,000	38,136,038
Net capital gains	4,500,000	2,000,000	8,572,595
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Privatization	4,500,000	2,000,000	8,572,595

¹ There may be a certain substitution between the various components of the deficit financing.

Gross Expenditure by Economic Classification

(Excluding the Bank of Israel)

(In NIS Thousands)

	The budget proposal for 2007	Original Law For 2006	2005 budget performance
Net Expenditure	282,864,058	271,437,014	258,342,170
=====	=====	=====	=====
Revenue-Dependent Expenditure	12,561,369	12,770,026	12,439,375
Total Gross Budget (1+2+3)	295,425,427	284,207,040	270,781,545
=====	=====	=====	=====
1. Total Expenditures and Credit Granted	242,562,427	231,777,040	222,547,543
1.1 Civilian consumption	50,265,408	48,466,221	44,750,293
-----	-----	-----	-----
- Domestic payroll	31,569,313	29,682,212	28,312,001
- Domestic procurement	16,905,653	16,918,560	14,594,273
- Payroll and procurement overseas	1,790,442	1,865,449	1,844,019
1.2 Defense consumption	50,953,221	46,565,686	51,632,278
-----	-----	-----	-----
- Payroll	19,086,477	17,456,761	19,156,757
- Transfer payments	2,072,040	2,011,082	2,206,928
- Procurement	18,737,046	15,272,737	17,320,458
- Construction	1,020,000	1,020,000	1,119,331
- Overseas procurement	9,722,649	10,482,694	11,503,533
-Emergency expenditures and coordination of operations in the territories	315,009	322,412	325,271
-----	-----	-----	-----
- To local authorities	12,252,759	11,664,640	10,248,316
- To religious councils	202,938	184,867	161,862
- To individuals and institutions	40,931,091	37,900,321	38,698,155
- Subsidies for basic commodity prices	3,043,255	3,418,386	3,486,276
- Transfers to National Insurance Institute	23,377,975	22,137,124	21,142,234
1.4 Investments and the issuance of credit	14,481,233	13,979,896	11,963,753

	The budget proposal for 2007	Original Law For 2006	2005 budget performance
-----	-----	-----	-----
- Direct investment	11,885,150	10,868,615	8,947,079
Of which: Housing	1,852,143	1,984,091	1,910,314
- Credit issuance	2,596,083	3,111,281	3,016,674
Of which: Housing	2,169,461	2,265,787	1,843,346
1.5 Interest payment	35,555,450	35,531,450	33,193,167
-----	-----	-----	-----
- Domestic interest payments	28,392,000	28,136,000	26,635,952
- Credit subsidies	32,450	35,450	14,689
- Overseas interest payments	7,131,000	7,360,000	6,542,526
1.6 Miscellaneous expenses	6,731,000	6,655,000	7,271,209
-----	-----	-----	-----
- Repayment of principal to National Insurance	6,731,000	6,655,000	6,392,817
- Miscellaneous			878,392
1.7 Reserves	4,768,097	5,273,449	1,474,062
-----	-----	-----	-----
2. Debt Repayment (principal)	52,863,000	52,430,000	48,234,002
-----	-----	-----	-----
- Domestic repayment to public	42,437,000	39,102,000	38,136,038
- Debt repayment overseas	10,426,000	13,328,000	10,097,964

Revenues and Loans (Excluding Bank of Israel)
(In NIS Thousands)

	The Budget Proposal for 2007	Original Law for 2006	2005 budget performance
Grand total	282,864,058	271,437,014	257,459,227
=====	=====	=====	=====
Part I: Current receipts	211,245,645	200,071,644	192,091,142
Part II: Proceeds from bonds and capital account	71,618,413	71,365,370	65,368,085
Part I: Current receipts	211,245,645	200,071,644	192,091,142
Taxes and compulsory payments	180,756,235	169,200,000	163,123,228
-----	-----	-----	-----
Income and Property taxes	99,100,000	88,600,000	87,468,970
Taxes on Expenditure	81,656,235	80,600,000	75,654,258
Interest, royalties and miscellaneous revenues	4,343,873	4,936,185	7,216,902
-----	-----	-----	-----
Transfer from Part II	26,145,537	25,935,459	21,751,012
-----	-----	-----	-----
Part II: Proceeds from bonds and capital account	71,618,413	71,365,370	65,368,085
=====	=====	=====	=====
Collection of principal	5,483,000	5,740,000	5,772,142
-----	-----	-----	-----
Miscellaneous	556,700	556,548	999,488
-----	-----	-----	-----
Privatization	4,500,000	2,000,000	8,572,595
-----	-----	-----	-----
Domestic Loans	65,709,000	61,462,281	44,078,703
-----	-----	-----	-----
Loans from National Insurance Institute	12,084,000	12,411,000	12,400,000
Domestic loans, net of National Insurance	53,625,000	49,051,281	31,678,703

	The Budget Proposal for 2007	Original Law for 2006	2005 budget performance
Loans and Grants from Overseas	21,515,250	27,542,000	27,696,169
-----	-----	-----	-----
Defense aid from USA	10,432,650	10,488,000	8,799,435
Civilian aid	531,600	1,104,000	2,680,845
Israel Independent & Development Bond (net)	4,173,000	4,350,814	4,111,288
Other loans	6,378,000	11,599,186	12,104,601
Transfer to Part I	-26,145,537	-25,935,459	-21,751,012
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Main Economic Developments

Growth

The GDP grew by 5.9% in the first half of 2006, in annual terms, while the per-capita GDP rose by 4.1%. The rapid growth in the first half of 2006 is a continuation of the high growth rates of 5.1% in the preceding half and 6.1% in the first half of 2005.

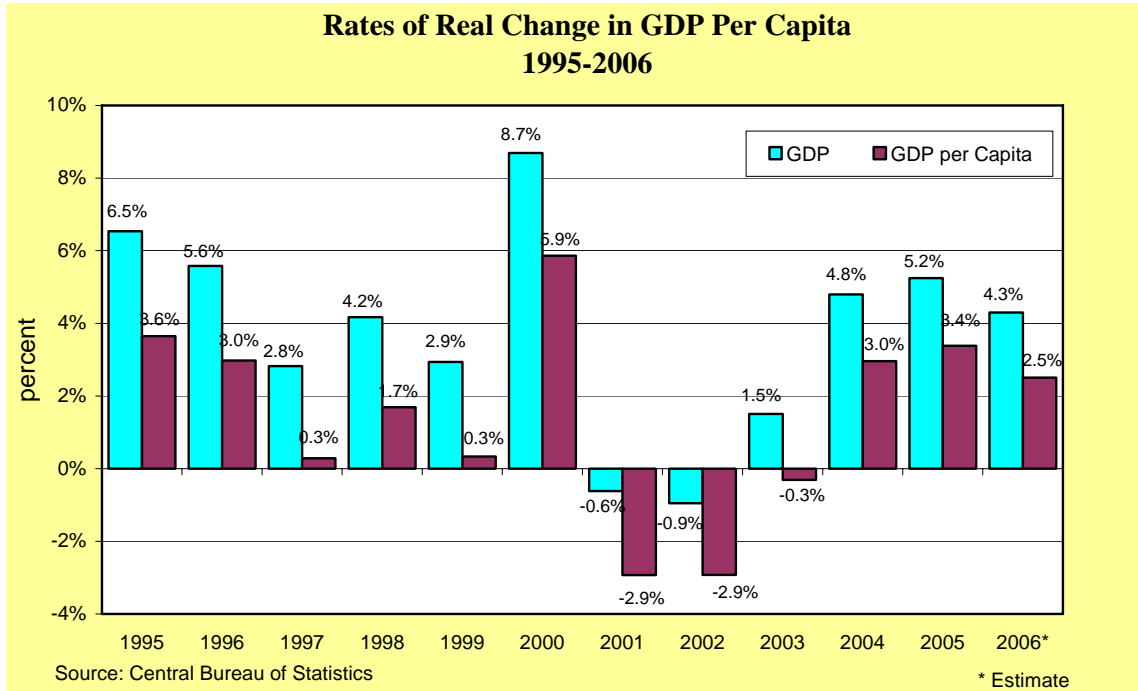
An examination of the economic developments in each quarter shows that the GDP increased by 6.2% in the second quarter of 2006, following a 5.9% increase in the first quarter and a 5.6% increase in the last quarter of 2005. The composition of the increase in GDP in the second quarter of 2006 reflects an increase in all categories of utilization of resources (excluding with regard to investments in fixed assets) – exports of commodities and services (up 25.8%), investments in fixed assets (down 9.3%), spending on private consumption (up 3.7%), and spending on public consumption other than on defense imports (up 8.2%).

The consistent budgetary policy applied over the last four years has helped to halt the economic slowdown and has led to high growth rates in 2005 and in the first half of 2006, while the level of economic activity and the flow of capital into Israel have been stabilized. The tight fiscal policy increased the government's credibility; together with the continued receipt of loan guarantees from the United States, this policy has led to a decrease in Israel's risk premium in the financial markets.

The business sector's output rose by 7.4% in the first half of 2006, in annual terms, following a 6.6% increase in the preceding half and a 7.6% increase in the first half of 2005. The development of the business product in the first half of 2006 reflects growth in the industrial sector and in most business services sectors.

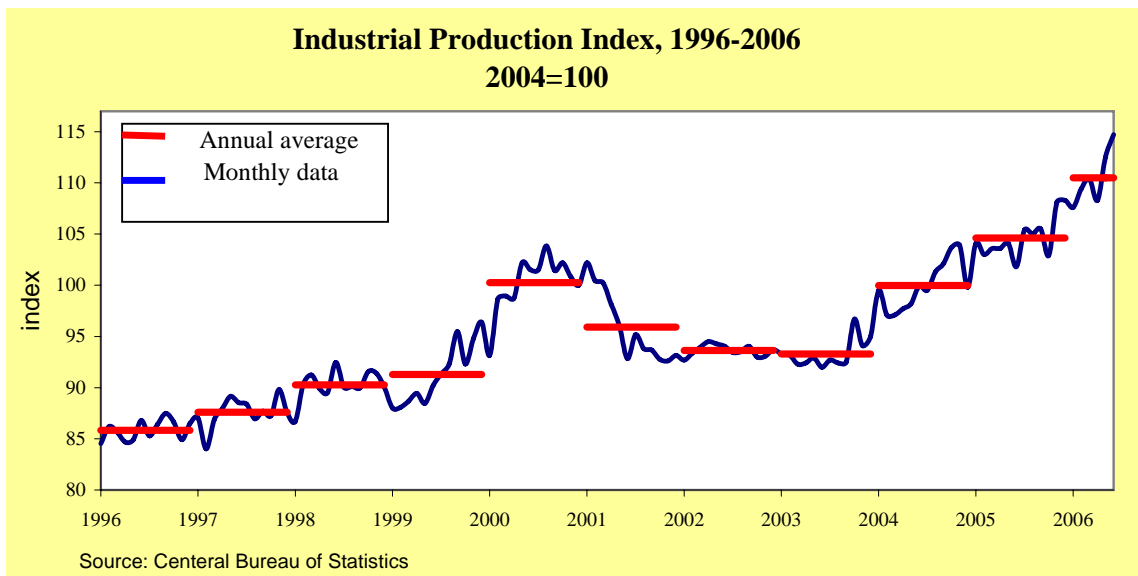
Private consumption increased at an annualized rate of 5.4% in the first half of 2006, following a 3.3% increase in the preceding half and a 3.7% increase in the first half of 2005. This increase was influenced by the considerable growth in the number of employed Israelis. Public consumption (excluding defense imports) increased by 3.4%, in annual terms, in the first half of 2006, following a 2.5% increase in the preceding half.

Investments in fixed assets increased by 4.1% in the first half of 2006, following a 9.2% increase in the preceding half and a 3% increase in the first half of 2005.



Industry

The industrial production index (excluding diamonds) rose at an annualized rate of 10.5% in the first quarter of 2006, and by 10.3% in the second quarter.



Exports of goods and services increased at an annualized rate of 25.8% during the second quarter of 2006, in contrast to an increase of 1.5% during the first quarter.

During the first half of 2006, exports increased at an annualized rate of 6.4%, following increases of 2.3% and 3% during the two previous halves. The increase in exports during the first half of 2006 mainly reflects an increase in industrial exports excluding diamonds of 13.9% and an annualized increase of 55.4% in tourism exports.

Residential Construction

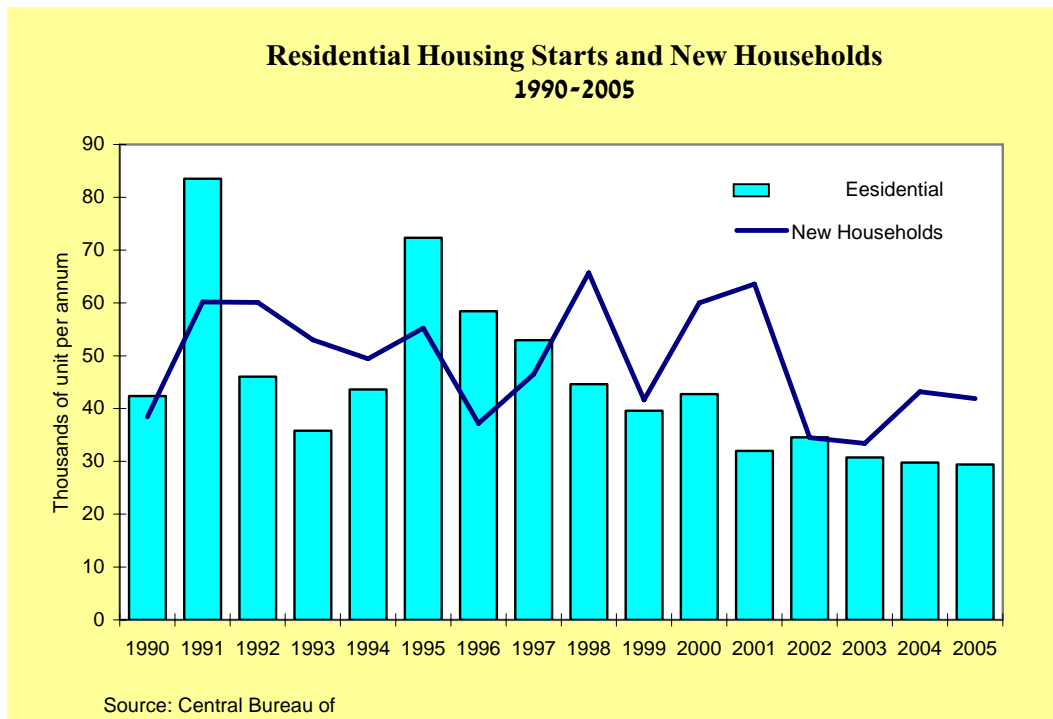
Since 1996, the construction industry in Israel has been adjusting its level of activity to the level of demand. This process began with the decline in the number of immigrants arriving in Israel after the immigration wave of the early 1990s. Activity in the industry expanded in 1999-2000, but the security events of September 2000 caused a contraction that persisted continuously until the first half of 2006.

Despite the recent improvements with regard to the factors that affect demand for housing - such as the increase in average wages, the declining interest rates on mortgages, and stability in housing prices - demand for housing has remained low. The growth process is expected to trickle down to wider population segments, leading to increased demand for housing in 2007.

Housing Supply

Marketing of land – During the first seven months of 2006, the Israel Lands Administration and the Ministry of Construction and Housing have marketed land for 9,363 residential units. This figure represents a volume of approximately 1,700 more residential units than were sold in the corresponding period last year.

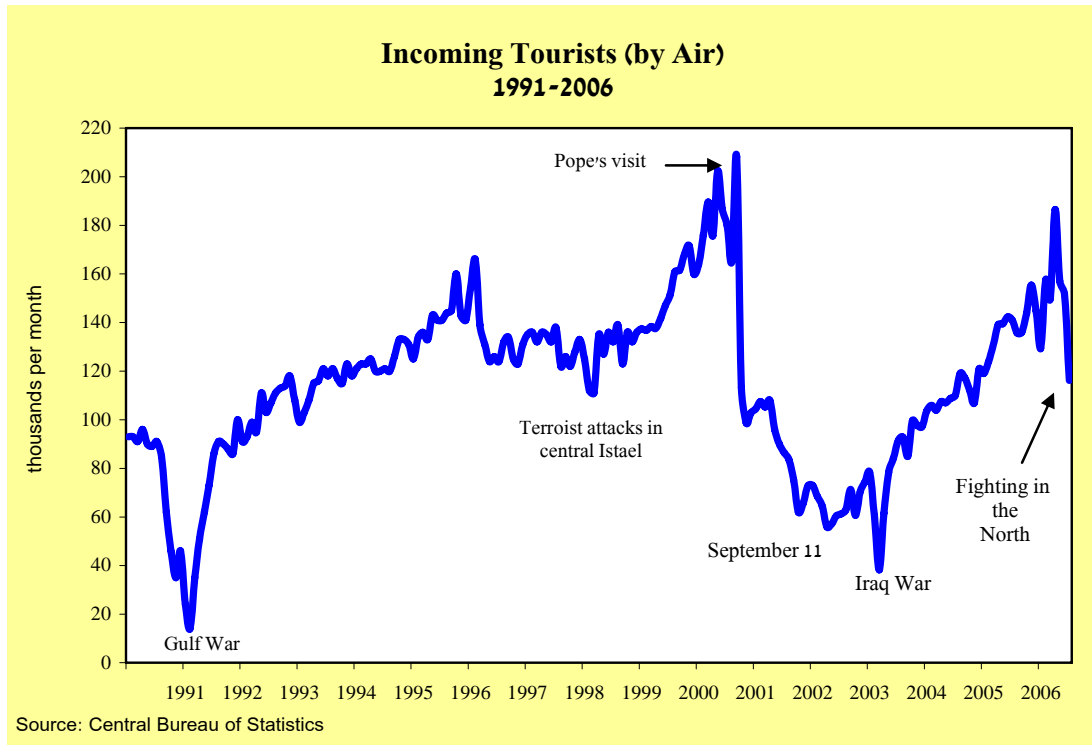
Housing starts – The number of housing starts totaled 29,400 residential units in 2005, representing a drop of 370 units as compared to 2004. During the first five months of 2006, housing starts totaled 12,459 units.



Tourism

After almost three years of new lows in the number of tourists entering Israel, incoming tourism began to recover somewhat in 2003. The reversal of the trend continued in 2004, a year in which 1.4 million tourists entered Israel. The trend continued during 2005 as well, and during the first half of 2006, when 1.06 million tourists entered – a figure representing a 22% increase in terms of arrivals by air, as compared to the corresponding period in 2005. Nevertheless, the number of tourists is expected to drop during the second half of 2006 and during 2007, as a result of the fighting in the North.

However, in domestic tourism, the peak level of 12 million overnight stays by Israelis attained in 2002 was maintained during 2003-2005. The same stability continued in the first half of 2006 – 6.2 million tourists, similar to the number in the corresponding period during the preceding two years.

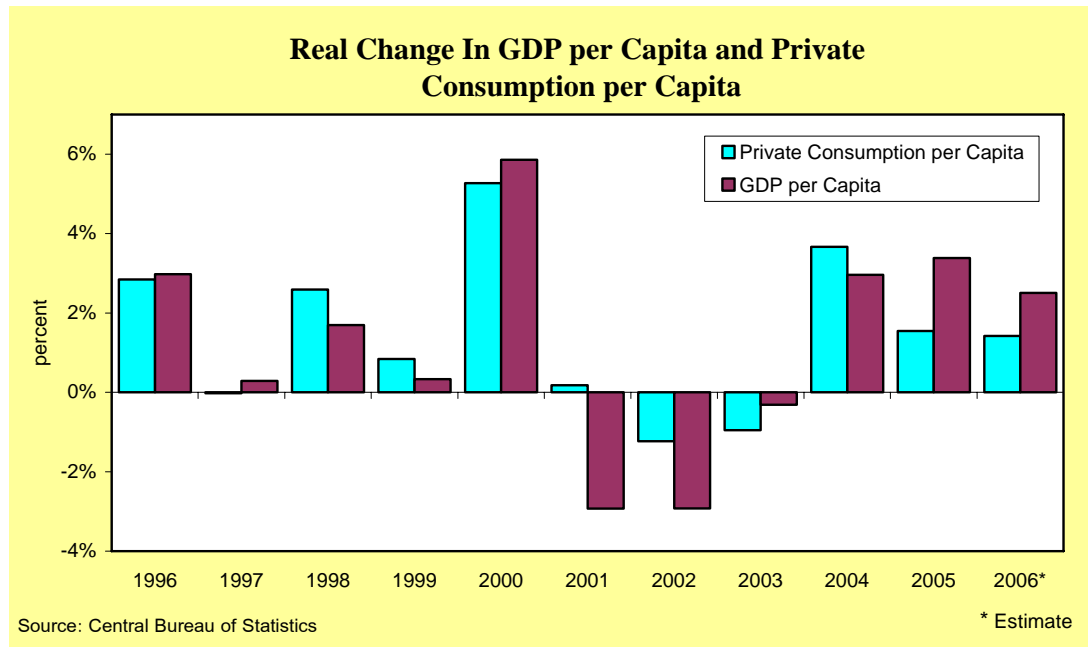


Private Consumption

Per-capita spending on private consumption rose by 3.6% in the first half of 2006, following increases of 2.0% and 1.5%, respectively, in the first and second halves of 2005.

The increase in per-capita consumption in the first half of 2006 reflects a 4.7% increase in per-capita spending by households, excluding spending on durable goods, along with a 6.7% decrease in per-capita spending on durable goods.

The increase in private consumption spending reflects the effect of the increase in individuals' disposable income as a result of tax reductions and of a sizable increase in the number of employed Israelis – approximately 75,000 – during the first half of the year.



Investments

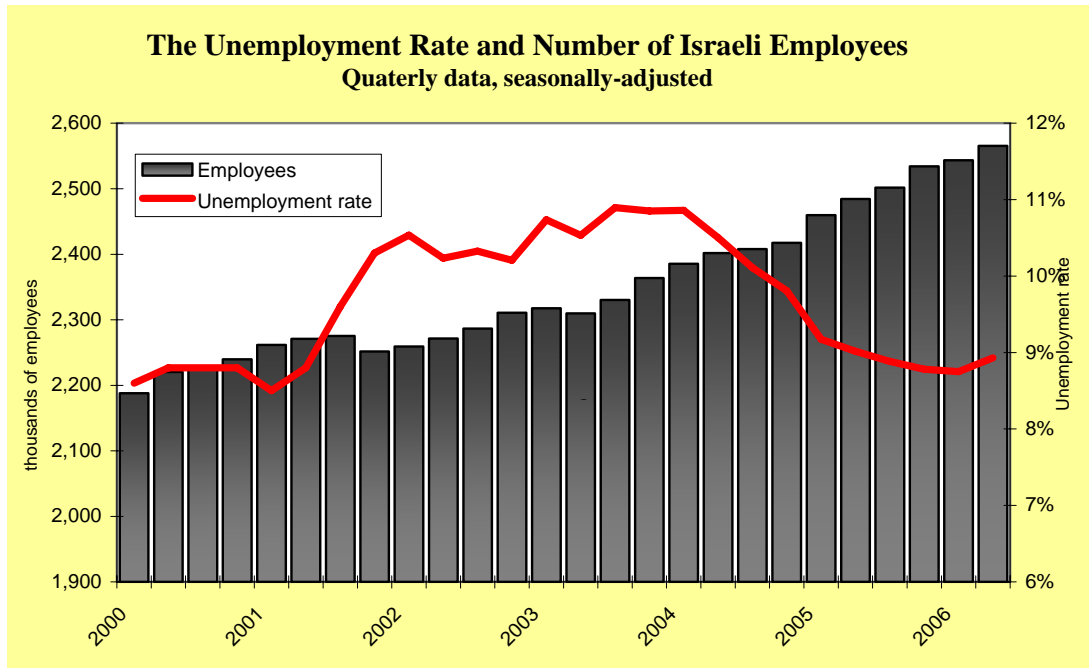
Investments in fixed assets increased by 4.1% in the first half of 2006, following increases of 8.2% during the preceding half and 3.0% in the first half of 2005.

Investments in all sectors of the economy increased by 5.8% in the first half of 2006, following an 11.2% increase in the preceding half. Investments in residences dropped by 1.5% in the first half of the year, following relative stability during the preceding year.

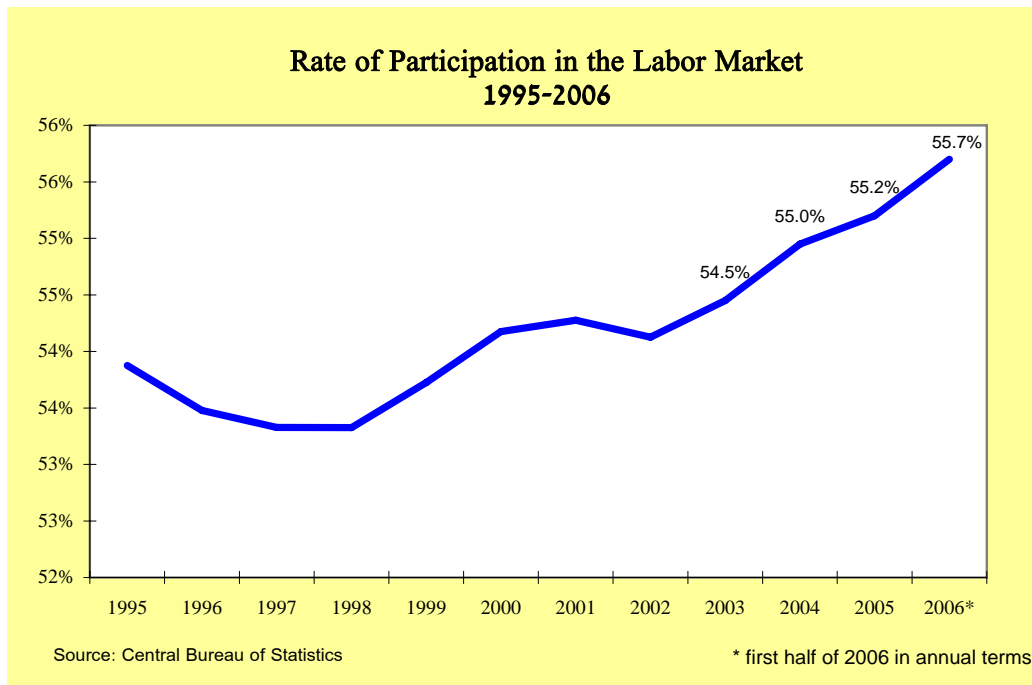
Employment

Employment figures for 2005 and 2006 indicate a continuation of the positive trend in the labor market, with Israelis returning to the workforce and the creation of new jobs. The number of employed Israelis rose by 3.3% in the second quarter of 2006, in contrast to the corresponding quarter last year.

The unemployment rate fell from 9.2% in the first quarter of 2004 to 8.9% in the second quarter of 2006, reflecting stability in the number of unemployed persons, despite the considerable increase of approximately 110,000 in those participating in the workforce.



The workforce participation rate increased to 55.7% during the first half of 2006, versus 54.1% in 2002.

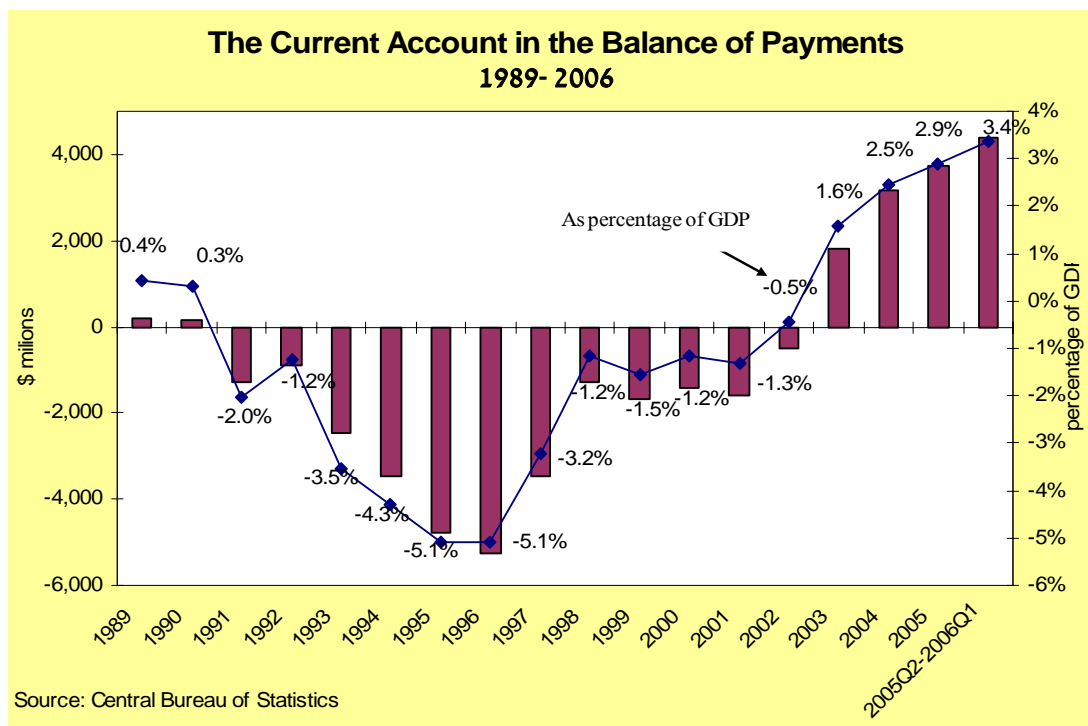


Notwithstanding the increase in the workforce participation rate, it should be noted that the participation rate in Israel remains significantly low in comparison to rates in Western Europe and the United States, particularly among men. The low participation

rate reflects low workforce participation in the Ultra-Orthodox population and in minority sectors, among other factors.

Balance of Payments and Foreign Trade

The surplus in the balance of payments¹ current account stood at approximately \$3.6 billion in the first half of 2006, following a surplus of \$2.4 billion in the preceding half, and of \$1.6 billion during the first half of 2005. The surplus indicates a high level of external stability, both by international comparison and relative to the deficit rate in the mid-1990s, which had reached approximately 5% of the GDP.

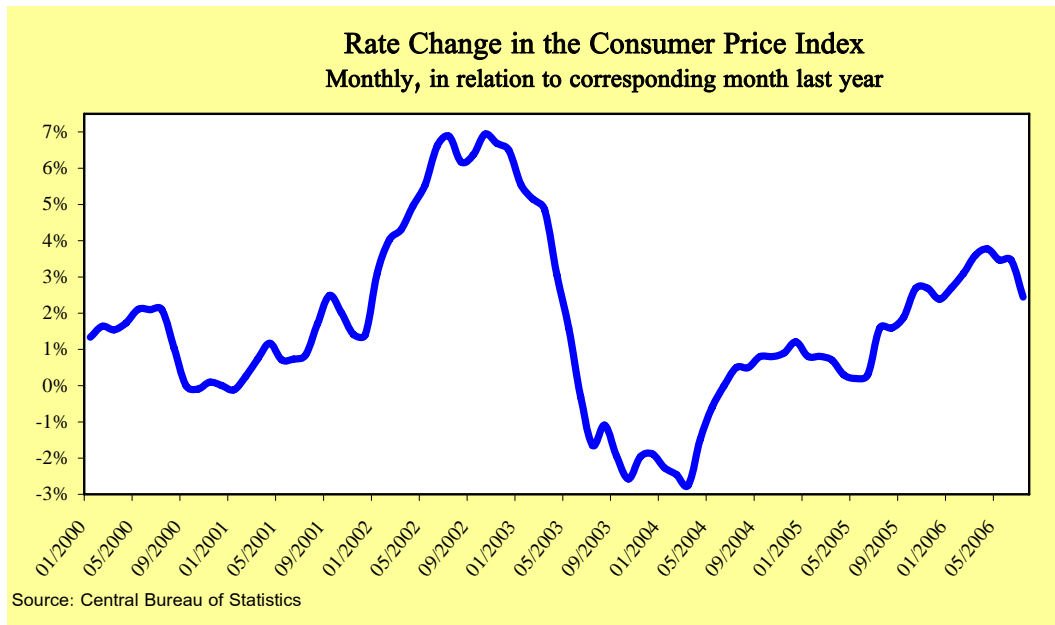


Inflation and Monetary Policy

During the past year (July 2005 through July of 2006), the consumer price index rose by 2.4%. A significant part of the rise in prices flowed from increased fuel prices, which impact directly as well as indirectly on the prices of products for which fuel is raw material. Price changes were also influenced by increases in the prices of fruits and vegetables, in contrast to a decrease in the prices of furniture and home equipment and of clothing and footwear.

¹ The current account includes Israel's foreign trade in goods, imports and exports of services, and receipts and payments to and from parties abroad, which result from revenues from factors of production and from ongoing transfers.

The shekel's exchange rate remained remarkably stable in contrast to the significant devaluations of exchange rates in developed economies during the first half of the year. The shekel's stability was supported by a surplus in the current account and a responsible fiscal policy. This exchange rate stability contributed, in turn, to price stability and allowed the Bank of Israel to refrain from raising real interest rates and thus to support continued growth in the economy.



Exchange Rate

The shekel's exchange rate against the dollar remained nearly flat during the first five months of 2006. The shekel-dollar exchange rate rose by approximately 2.5% during the third quarter and returned to a level similar to that of the first half of 2005. The upward trend continued during September, when the shekel was strengthened by 0.6% compared to its average exchange rate during August.

Budget Deficit

The government's overall deficit (excluding credit) totaled 3.7% of GDP in 2004, in comparison to a 4% deficit target.

In 2005, the government's overall deficit (excluding credit) totaled 1.9% of the GDP, while the deficit target was 3.4% (including the costs of the disengagement.)

In order to meet the deficit target during 2004 and 2005, the government adopted a responsible fiscal policy, as expressed in the continued implementation of the multi-year program which began with the approval of the recovery program for Israel's economy.

In 2006, the total deficit (excluding credit) is expected to move between 1.5% and 2% of GDP. The target ceiling is 3 percent of GDP.