OFFERING CIRCULAR Dated September 5, 2002

STATE OF ISRAEL

U.S.$2,000,000,000
Euro Medium Term Note Programme

On September 10, 1996, the State of Israel (the "Issuer" or "Israel") entered into a U.S.$750,000,000 Euro Medium Term Note Programme (the "Programme"). On September 2, 1999, the Issuer increased to U.S.$1,500,000,000 the amount of Notes which may be outstanding under the Programme. The Issuer has resolved to increase to U.S.$2,000,000,000 the amount of Notes which may be outstanding under the Programme. This Offering Circular supersedes all previous Offering Circulars. Any Notes (as defined below) issued under the Programme on or after the date of this Offering Circular are issued subject to the provisions described herein. This does not affect any Notes already issued.

Under the Programme, the Issuer may from time to time issue notes (the "Notes") denominated in any currency agreed between the Issuer and the relevant Dealer (as defined below).

The Notes may be issued on a continuing basis to one or more of the Dealers specified herein and any additional Dealer appointed under the Programme from time to time, which appointment may be for a specific issue or on an ongoing basis (each a "Dealer" and together the "Dealers"). References in this Offering Circular to the "relevant Dealer"shall, in relation to any issue of Notes, be to the Dealer or Dealers agreeing to purchase such Notes.

Applications have been made to admit Notes issued during the period of 12 months from the date of this Offering Circular to listing on the Official List of the Financial Services Authority (in its capacity as competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000, the "UK Listing Authority") and to trading on the London Stock Exchange plc (the "London Stock Exchange"). Details of the aggregate nominal amount of Notes, interest (if any) payable in respect of Notes, the issue price of Notes and any other terms and conditions not contained herein which are applicable to each Tranche (as defined herein) of Notes will be set forth in a pricing supplement (the "Pricing Supplement") which, with respect to Notes to be admitted to listing on the Official List of the UK Listing Authority will be delivered to the UK Listing Authority or before the date of issue of the Notes of such Tranche.

The Programme provides that Notes may be listed by such other listing authority or on such other stock exchange(s) as may be agreed between the Issuer and the relevant Dealer. The Issuer may also issue unlisted Notes.

Copies of each Pricing Supplement will be available from FT Business Research Centre, operated by FT Publishing at Fitzroy House, 13-17 Epworth Street, London EC2A 4DL (in the case of Notes to be admitted to listing on the Official List of the UK Listing Authority), and will be available for inspection at the specified office of the Agent (as defined herein).

The Notes of each Tranche will (unless otherwise specified in the applicable Pricing Supplement) initially be represented by a temporary global Note which will be deposited on the issue date thereof (the "Issue Date") with a common depositary on behalf of Euroclear Bank S.A./N.V., as operator of the Euroclear System ("Euroclear"), and Clearstream Banking, société anonyme, Luxembourg ("Clearstream, Luxembourg") and/or any other agreed clearance system and which will be exchanged, as specified in the applicable Pricing Supplement, for either a permanent global Note or Notes in definitive form, in each case upon certification as to non- U.S. beneficial ownership as required by U.S. Treasury regulations. A permanent global Note will be exchangeable for definitive Notes, upon request, all as further described in "Form of the Notes" below.

The Programme has been rated by Moody's Investors Service Limited ("Moodys") and by Standard & Poor's Ratings Services, a Division of the McGraw-Hill Companies, Inc. ("Standard & Poor's"). Notes issued under the Programme may be rated or unrated. Where an issue of Notes is rated, such rating will not necessarily be the same as the rating assigned to the Programme. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigned rating agency.

The Issuer may agree with any Dealer that Notes may be issued in a form not contemplated by the Terms and Conditions of the Notes herein, in which event (in the case of Notes admitted to listing on the Official List of the UK Listing Authority only) a supplementary Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Notes.

Arranger

Merrill Lynch International

Dealers

Daiwa Securities SMBC Europe Limited **Deutsche Bank**

Goldman Sachs International **Merrill Lynch International**

Morgan Stanley **UBS Warburg**

The Issuer accepts responsibility for the information contained in this Offering Circular. To the best of the knowledge and belief of the Issuer (which has taken all reasonable care to ensure that such is the case) the information contained in this Offering Circular is in accordance with the facts and does not omit anything likely to affect the import of such information.

This Offering Circular is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see "Documents Incorporated by Reference" below) (provided, however, that such incorporated documents do not form part of the equivalent offering document). This Offering Circular shall be read and construed on the basis that such documents are incorporated and form part of this Offering Circular but not part of the equivalent offering document.

The Dealers have not separately verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Dealers as to the accuracy or completeness of the information contained in this Offering Circular or any other information provided by the Issuer in connection with the Programme or any Notes.

No person is or has been authorised to give any information or to make any representation not contained in or not consistent with this Offering Circular or any other information provided by the Issuer in connection with the Programme or any Notes and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer or any of the Dealers.

Neither this Offering Circular nor any other information supplied in connection with the Programme or any Notes (i) is intended to provide the basis of any credit or other evaluation or (ii) should be considered as a recommendation or constituting an invitation or offer by the Issuer or any of the Dealers that any recipient of this Offering Circular or any other information supplied in connection with the Programme or any Notes should purchase any Notes. Each investor contemplating purchasing Notes should make its own independent investigation of the affairs, and its own appraisal of the creditworthiness, of the Issuer. Neither this Offering Circular nor any other information supplied in connection with the Programme or any Notes constitutes an offer by or on behalf of the Issuer or any of the Dealers to any person to subscribe for or to purchase any Notes.

The delivery of this Offering Circular does not at any time imply that the information contained herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same. The Dealers expressly do not undertake to review the financial condition or affairs of the Issuer during the life of the Programme.

The distribution of this Offering Circular and the offer or sale of Notes may be restricted by law in certain jurisdictions. The Issuer and the Dealers do not represent that this document may be lawfully distributed, or that any Notes may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer or the Dealers (save for the approval of this document by the UK Listing Authority) which would permit a public offering of any Notes or distribution of this document in any jurisdiction where action for that purpose is required. Accordingly, no Notes may be offered or sold, directly or indirectly, and neither this Offering Circular nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations, and the Dealers have represented that all offers and sales by them will be made on the same terms. Persons into whose possession this Offering Circular or any Notes come must inform themselves about, and observe, any such restrictions. In particular, there are restrictions on the distribution of this Offering Circular and the offer or sale of Notes in the United States, the United Kingdom, The Netherlands, Japan and Germany (see "Subscription and Sale" below).

The Notes have not been and will not be registered under the United States Securities Act 1933, as amended, (the "Securities Act") and are subject to U.S. tax law requirements. Subject to certain exceptions,

Notes may not be offered, sold or delivered within the United States or to U.S. persons (see "Subscription and Sale" below).

All references in this document to "U.S. dollars", "U.S.$" and "$" refer to the currency of the United States of America, those to "New Israeli Shekels" and, those to "NIS" refer to the currency of the State of Israel, those to "Sterling" and "£" refer to the currency of the United Kingdom and those to "euro" refer to the single currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty establishing the European Community, as amended.

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In connection with the issue and distribution of any Tranche of Notes, the Dealer (if any) disclosed as the stabilising manager in the applicable Pricing Supplement may over-allot or effect transactions with a view to supporting the market price of the Notes of the Series (as defined below) of which such Tranche forms a part thereof at a level higher than that which might otherwise prevail for a limited period. However, there may be no obligation on the stabilising manager or any agent of his to do this. Such stabilising, if commenced, may be discontinued at any time and must be brought to an end after a limited period. Such stabilising shall be in compliance with all relevant laws and regulations.

DOCUMENTS INCORPORATED BY REFERENCE

All supplements to this Offering Circular circulated by the Issuer from time to time in accordance with the provisions of the Programme Agreement described below shall be deemed to be incorporated in, and to form part of, this Offering Circular save that any statement contained herein or in a document which is deemed to be incorporated by reference herein shall be deemed to be modified or superseded for the purpose of this Offering Circular to the extent that a statement contained in any such subsequent document which is deemed to be incorporated by reference herein modifies or supersedes such earlier statement (whether expressly, by implication or otherwise).

Any reference in this Offering Circular to equivalent offering document means this Offering Circular excluding all information incorporated by reference. The Issuer has confirmed that any information incorporated by reference, including any such information to which readers of this Offering Circular are expressly referred, has not been and does not need to be included in the equivalent offering document to satisfy the requirements of the Financial Services and Markets Act 2000 or the Listing Rules. The Issuer believes that none of the information incorporated herein by reference conflicts in any material respect with the information included in the equivalent offering document.

The Issuer will provide, without charge, to each person to whom a copy of this Offering Circular has been delivered, upon the written request of such person, a copy of any or all of the documents deemed to be incorporated herein by reference unless such documents have been modified or superseded as specified above. Requests for such documents should be directed to the Ministry of Finance of Israel at its office set out at the end of this Offering Circular. In addition, such documents will be available from the principal office in England of Merrill Lynch International in its capacity as authorised adviser (the "Authorised Adviser") for the Notes admitted to listing on the Official List of the UK Listing Authority.

If the terms of the Programme are modified or amended in a manner which would make this Offering Circular, as supplemented, inaccurate or misleading, a new Offering Circular will be prepared to the extent required by law.

GENERAL DESCRIPTION OF THE PROGRAMME

Under the Programme, the Issuer may from time to time issue Notes denominated in any currency and having a minimum maturity of one month, subject as set out herein. A summary of the terms and conditions of the Programme and the Notes appears below. The applicable terms of any Notes will be agreed between the Issuer and the relevant Dealer prior to the issue of such Notes and will be set out in the Terms and Conditions of the Notes endorsed on, or incorporated by reference into, the Notes, as modified and supplemented by the applicable Pricing Supplement attached to, or endorsed on, such Notes, as more fully described under "Form of the Notes" below.

This Offering Circular and any supplement will only be valid for the admission of Notes to listing on the Official List of the UK Listing Authority and to trading on the London Stock Exchange during the period of 12 months from the date of this Offering Circular in an aggregate nominal amount which, when added to the aggregate nominal amount then outstanding of all Notes previously or simultaneously issued under the Programme, does not exceed U.S.$2,000,000,000 or its equivalent in other currencies. For the purpose of calculating the U.S. dollar equivalent of the aggregate nominal amount of Notes issued under the Programme from time to time:—

(a) the U.S. dollar equivalent of Notes denominated in another Specified Currency (as defined under "Form of the Notes" herein) shall be determined, at the discretion of the Issuer, either as of the date on which agreement is reached for the issue of Notes or on the preceding day on which commercial banks and foreign exchange markets are open for business in London, in each case on the basis of the spot rate for the sale of the U.S. dollar against the purchase of such Specified Currency in the London foreign exchange market quoted by any leading international bank selected by the Issuer on the relevant day of calculation;

(b) the U.S. dollar equivalent of Dual Currency Notes, Indexed Notes and Partly Paid Notes (each as defined under "Form of the Notes" herein) shall be calculated in the manner specified in (a) above by reference to the original nominal amount on issue of such Notes (in the case of Partly Paid Notes regardless of the subscription price paid); and

(c) the U.S. dollar equivalent of Zero Coupon Notes (as defined under "Form of the Notes" herein) and other Notes issued at a discount or premium shall be calculated in the manner specified in (a) above by reference to the net proceeds received by the Issuer for the relevant issue.

SUMMARY OF THE PROGRAMME AND TERMS AND CONDITIONS OF THE NOTES

The following summary does not purport to be complete and is taken from, and is qualified in its entirety by, the remainder of this document and, in relation to the terms and conditions of any particular Tranche of Notes, the applicable Pricing Supplement. Words and expressions defined in "Form of the Notes" and "Terms and Conditions of the Notes" below shall have the same meanings in this summary.

Issuer:	State of Israel
Description:	Euro Medium Term Note Programme
Arranger:	Merrill Lynch International
Dealers:	Daiwa Securities SMBC Europe Limited Deutsche Bank AG London Goldman Sachs International Merrill Lynch International Morgan Stanley & Co. International Limited UBS AG, acting through its business group UBS Warburg
Issuing and Principal Paying Agent:	Citibank, N.A.
Size:	Up to U.S.$2,000,000,000 (or its equivalent in other currencies calculated as described herein) outstanding at any time. The Issuer may increase the amount of the Programme in accordance with the terms of the Programme Agreement.
Distribution:	Subject to applicable selling restrictions, Notes may be distributed by way of private or public placement and in each case on a syndicated or non-syndicated basis.
Currencies:	Subject to any applicable legal or regulatory restrictions, such currencies as may be agreed between the Issuer and the relevant Dealer. Each issue of Notes denominated in a currency in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time (see "Subscription and Sale" herein). Issues of Notes denominated in Swiss Francs or carrying a Swiss Franc related element with a maturity of more than one year (other than certain issues of Notes privately placed with a single investor with no publicity) will be effected in compliance with the relevant regulations of the Swiss National Bank based on article 7 of the Federal Law on Banks and Savings Banks of November 8, 1934 (as amended) and article 15 of the Federal Law on Stock Exchanges and Securities Trading of March 24, 1995 in connection with article 2 of the Ordinance of the Federal Banking Commission on Stock Exchanges and Securities Trading of December 2, 1996. Under the said regulations, the relevant Dealer or, in the case of a syndicated issue, the Lead Manager must be a bank domiciled in Switzerland (which includes branches or subsidiaries of a foreign bank located in Switzerland) (the "Swiss Dealer") or a securities dealer duly licensed by the Swiss Federal Banking Commission pursuant to the Federal Law on Stock Exchanges and Securities Trading of March 24, 1995. The Swiss Dealer must report certain details of the relevant transaction to the Swiss National Bank no later than the relevant Issue Date.
Redenomination:	The applicable Pricing Supplement may specify that certain Notes may be redenominated in euro. If so, the wording of the redenomination clause will be set out in full in the applicable Pricing Supplement.

Maturities: Such maturities as may be agreed between the Issuer and the relevant Dealer and as indicated in the applicable Pricing Supplement, subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Specified Currency.

Issue Price: Notes may be issued on a fully-paid or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par.

Form of Notes: Each Tranche of Notes will initially be represented by a temporary global Note or (if so specified in the applicable Pricing Supplement that such Pricing Supplement is in respect of Notes to which U.S. Treasury Regulation §.1.163.5(c)(2)(i)(C) (the "C Rules") applies) a permanent global Note. Such global Note will be deposited on the relevant Issue Date with a common depositary for Euroclear and Clearstream, Luxembourg and/or any other agreed clearance system. Interests in each temporary global Note will be exchanged for either interests in a permanent global Note or definitive Notes (as indicated in the applicable Pricing Supplement) in either case not earlier than the later of (i) 40 days after the Issue Date and (ii) 40 days after completion of distribution of the relevant Tranche upon certification of non-U.S. beneficial ownership as required by U.S. Treasury regulations. Each permanent global Note will be exchangeable, if so specified in the applicable Pricing Supplement in whole but not in part for definitive Notes upon not less than 60 days' written request to the Agent as described in "Form of the Notes" below. Any interest in a global Note will be transferable only in accordance with the rules and procedures for the time being of Euroclear, Clearstream, Luxembourg and/or any other agreed clearance system as appropriate.

Fixed Rate Notes: Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer (as indicated in the applicable Pricing Supplement) and on redemption and will be calculated on the basis of such Fixed Day Count Fraction as may be agreed between the Issuer and the relevant Dealer(s) and as indicated in the applicable Pricing Supplement.

Floating Rate Notes: Floating Rate Notes (as defined in the applicable Pricing Supplement) will bear interest at a rate determined either:

(i) on the same basis as the floating rate under a notional interest-rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the 2000 ISDA Definitions, as published by the International Swaps and Derivatives Association, Inc., and as amended and updated as at the Issue Date of the first Tranche of the Notes of the relevant Series; or

(ii) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or

(iii) on such other basis as may be agreed between the Issuer and the relevant Dealer,

as indicated in the applicable Pricing Supplement.

The Margin (if any) relating to such Floating Rate Notes will be agreed between the Issuer and the relevant Dealer for each Series of Floating Rate Notes.

Indexed Notes:	Payments of principal in respect of Indexed Redemption Amount Notes or of interest in respect of Indexed Interest Notes will be calculated by reference to such index and/or formula as the Issuer and the relevant Dealer may agree (as indicated in the applicable Pricing Supplement).
Other provisions in relation to Floating Rate Notes and Indexed Interest Notes:	Floating Rate Notes and Indexed Interest Notes may also have a maximum interest rate, a minimum interest rate or both. Interest on Floating Rate Notes and Indexed Interest Notes in respect of each Interest Period, as selected prior to issue by the Issuer and the relevant Dealer, will be payable on such Interest Payment Dates specified in, or determined pursuant to, the applicable Pricing Supplement and will be calculated on the basis of such Day Count Fraction as may be agreed between the relevant Issuer and the relevant Dealer(s) (as indicated in the applicable Pricing Supplement).
Dual Currency Notes:	Payments (whether in respect of principal or interest and whether at maturity or otherwise) in respect of Dual Currency Notes will be made in such currencies, and based on such rates of exchange, as the Issuer and the relevant Dealer may agree (as indicated in the applicable Pricing Supplement).
Zero Coupon Notes:	Zero Coupon Notes will be offered and sold at a discount to their nominal amount and will not bear interest other than in the case of late payment.
Redemption:	The Pricing Supplement relating to each Tranche of Notes will indicate either that the Notes of such Tranche cannot be redeemed prior to their stated maturity (other than in specified instalments (see below), if applicable, or following an Event of Default) or that such Notes will be redeemable prior to their stated maturity at the option of the Issuer and/or the Noteholders upon giving not less than 30 nor more than 60 days' irrevocable notice (or such other notice period (if any) as is indicated in the applicable Pricing Supplement) to the Noteholders or the Issuer, as the case may be, on a date or dates specified prior to such stated maturity and at a price or prices and on such terms as are indicated in the applicable Pricing Supplement. Any Notes in respect of which the issue proceeds are received by the Issuer in the United Kingdom and which have a maturity of less than one year must (a) have a minimum denomination of £100,000 (or its equivalent in other currencies) and be issued only to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses; or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses or (b) be issued in other circumstances which do not constitute a contravention of section 19 of the Financial Services and Markets Act 2000 by the Issuer. The Pricing Supplement relating to any particular Notes may provide that such Notes may be repaid in two or more instalments of such amounts and on such dates as are indicated in the applicable Pricing Supplement.
Denomination of Notes:	Notes will be issued in such denominations as may be agreed between the Issuer and the relevant Dealer and as indicated in the applicable Pricing Supplement save that the minimum denomination of each Note will be such as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the relevant Specified Currency.

	Any Notes in respect of which the issue proceeds are received by the Issuer in the United Kingdom and which have a maturity of less than one year must (a) have a minimum denomination of £100,000 (or its equivalent in other currencies) and be issued only to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses; or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses or (b) be issued in other circumstances which do not constitute a contravention of section 19 of the Financial Services and Markets Act 2000 by the Issuer.
Taxation:	All payments in respect of the Notes will be made without deduction for or on account of withholding taxes imposed within the State of Israel, as more fully described in Condition 6.
Status of the Notes:	The Notes will constitute direct, general and unconditional obligations of the Issuer and will rank *pari passu* without any preference among themselves. The payment obligations of Israel under the Notes will rank at least equally with all other payment obligations of the Issuer relating to unsecured, unsubordinated External Indebtedness (as more fully described in Condition 2).
Cross Default:	None.
Negative Pledge:	None.
Rating:	The Programme has been rated by Moody's and by Standard & Poor's. Notes issued under the Programme may be rated or unrated. Where any issue of Notes is rated, such rating will not necessarily be the same as the rating assigned to the Programme. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.
Listing:	Application has been made to admit the Notes to listing on the Official List of the UK Listing Authority and to trading on the London Stock Exchange. The Notes may also be listed on such other or further listing authority or stock exchange(s) as may be agreed between the Issuer and the relevant Dealer in relation to each Series. Unlisted Notes may also be issued. The Pricing Supplement relating to each Tranche of Notes will state whether or not and, if so, on which listing authority or stock exchange(s) the Notes are to be listed.
Governing Law:	The Notes will be governed by, and construed in accordance with, English law.
Selling Restrictions:	There are selling restrictions in relation to the United States, the United Kingdom, The Netherlands, Japan and Germany and such other restrictions as may be required in connection with the offering and sale of a particular Tranche of Notes. See "Subscription and Sale" below.

FORM OF THE NOTES

Each Tranche of Notes will be initially represented by a temporary global Note or, if so specified in the applicable Pricing Supplement, by a permanent global Note without receipts, interest coupons or talons, which will be delivered to a common depositary for Euroclear and Clearstream, Luxembourg. Whilst any Note is represented by a temporary global Note, payments of principal and interest (if any) due prior to the Exchange Date (as defined below) will be made against presentation of the temporary global Note only to the extent that certification (in a form to be provided), as required by U.S. Treasury regulations, has been received by Euroclear and/or Clearstream, Luxembourg and Euroclear and/or Clearstream, Luxembourg, as applicable, has given a like certification (based on the certifications it has received) to the Agent. Any reference in this section "Form of the Notes" to Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearance system approved by the Issuer and the Agent.

On and after the date (the "Exchange Date") which is the later of (i) 40 days after the temporary global Note is issued and (ii) 40 days after completion of the distribution of the relevant Tranche, as certified by the relevant Dealer (in the case of a non-syndicated issue) or the relevant lead manager (in the case of syndicated issue) (the "Distribution Compliance Period"), interests in such temporary global Note will be exchangeable (provided, in the case of a Partly Paid Note (as defined below) that all instalments of the purchase moneys due before the Exchange Date have been paid) (free of charge) upon a request as described therein either for interests in a permanent global Note without receipts, interest coupons or talons or for definitive Notes with, where applicable, receipts, interest coupons and talons attached (as indicated in the applicable Pricing Supplement and subject, in the case of definitive Notes, to such notice period as is specified in the applicable Pricing Supplement) in each case against certification of beneficial ownership as described in the second sentence of the immediately preceding paragraph unless such certification has already been given. The holder of a temporary global Note will not be entitled to collect any payment of interest or principal due on or after the Exchange Date unless, upon due certification, exchange of the temporary global Note is improperly withheld or refused. Pursuant to the Agency Agreement (as defined under "Terms and Conditions of the Notes" below) the Agent shall arrange that, where a further Tranche of Notes is issued, the Notes of such Tranche shall be assigned a common code and ISIN by Euroclear and Clearstream, Luxembourg which are different from the common code and ISIN assigned to Notes of any other Tranche of the same Series until at least the expiry of the Distribution Compliance Period applicable to the Notes of such Tranche.

Payments of principal and interest (if any) on a permanent global Note will be made through Euroclear and/or Clearstream, Luxembourg against presentation or surrender (as the case may be) of the permanent global Note without any requirement for certification. If so specified in the applicable Pricing Supplement, a permanent global Note will be exchangeable (free of charge), in whole but not in part for definitive Notes with, where applicable, receipts, interest coupons and talons attached upon not less than 60 days' written notice to the Agent as described therein. Global Notes and definitive Notes will be issued pursuant to the Agency Agreement.

The following legend will appear on all global Notes and definitive Notes which have an original maturity of more than 365 days and on all receipts, interest coupons and talons relating to such Notes:

> "Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in Sections 165(j) and 1287(a) of the Internal Revenue Code."

The sections referred to provide that holders who are United States persons (as defined in the United States Revenue Code of 1986, as amended), with certain exceptions, will not be entitled to deduct any loss on Notes, receipts or interest coupons and will not be entitled to capital gains treatment of any gain on any sale, disposition, redemption or payment of principal in respect of Notes, receipts or interest coupons.

A Note may be accelerated by the holder thereof in certain circumstances described in "Terms and Conditions of the Notes – Events of Default". In such circumstances, where any Note is still represented by a global Note and a holder of such Note so represented and credited to his securities account with Euroclear or Clearstream, Luxembourg gives notice that it wishes to accelerate such Note, unless within a period of 15 days from the giving of such notice payment has been made in full of the amount due in accordance with the terms of such global Note, such global Note will become void. At the same time, holders of interests in such global Note credited to their accounts with Euroclear or Clearstream, Luxembourg will become entitled to proceed directly against the Issuer on the basis of statements of account provided by Euroclear and Clearstream, Luxembourg, on and subject to the terms of a deed of covenant (the "Deed of Covenant") dated September 5, 2002, executed by the Issuer.

FORM OF PRICING SUPPLEMENT

Pricing Supplement dated [ ]

STATE OF ISRAEL

Issue of [Aggregate Nominal Amount of Tranche] [Title of Notes]
under the U.S.$2,000,000,000
Euro Medium Term Note Programme

This document constitutes the Pricing Supplement relating to the issue of Notes described herein. Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated September 5, 2002. This Pricing Supplement must be read in conjunction with such Offering Circular as so supplemented.

Include whichever of the following apply or specify as "Not Applicable" (N/A). Note that the numbering should remain as set out below, even if "Not Applicable" is indicated for individual paragraphs or sub-paragraphs. Italics denote directions for completing the Pricing Supplement.

1.	Issuer		State of Israel
2.	(i)	Series Number:	[ ]
	[(ii)	Tranche Number: (If fungible with an existing Series, details of that Series, including the date on which the Notes become fungible)	(*If fungible with an existing series, details of that series, including the date on which the Notes become fungible*)]
3.	Specified Currency or Currencies:		[ ]
4.	Aggregate Nominal Amount:		
	(i)	Series:	[ ]
	(ii)	Tranche:	[ ]
5.	(i)	Issue Price:	[ ] per cent. of the Aggregate Nominal Amount [plus accrued interest from [*insert date*] (*in the case of fungible issues only, if applicable*)]
	[(ii)	Net proceeds:	[ ] (*Required only for listed issues*)]
6.	Specified Denomination(s):		[ ] [ ]
7.	(i)	Issue Date:	[ ]
	(ii)	Interest Commencement Date (if different from the Issue Date):	[ ]
8.	Maturity Date:		[*specify date or (for Floating Rate Notes) Interest Payment Date falling in the relevant month and year*] *[If the Notes have a maturity of less than one year from the Issue Date and either (a) the issue proceeds are received by the Issuer in the United Kingdom or*

(b) the activity of issuing the Notes is carried on from an establishment maintained by the Issuer in the United Kingdom, (i) the Notes must have a minimum redemption value of £100,000 (or its equivalent in other currencies) and be sold only to "professional investors" or (ii) another applicable exemption from section 19 of the FSMA must be available.]

9.	Interest Basis:	[[ ] per cent. Fixed Rate] [[Specify reference rate] +/- [ ] per cent. Floating Rate] [Zero Coupon] [Indexed Interest] [Other (*specify*)] (further particulars specified below)
10.	Redemption/Payment Basis:	[Redemption at par] [Indexed Redemption Amount] [Dual Currency] [Partly Paid] [Instalment] [Other (*specify*)]
11.	Change of Interest or Redemption/ Payment Basis:	[*Specify details of any provision for convertibility of Notes into another interest or redemption/payment basis*]
12.	Put/Call Options:	[Investor Put] [Issuer Call] [(further particulars specified below)]
13.	Listing:	[Applications have been made for the Notes to be admitted to listing on the Official List of the UK Listing Authority and to trading on the London Stock Exchange/other (*specify*)/None]
14.	Method of distribution:	[Syndicated/Non-syndicated]

PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE

15.	**Fixed Rate Note Provisions**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Rate[(s)] of Interest:	[ ] per cent. per annum [payable [annually/semi-annually/quarterly/monthly] in arrear]
	(ii)	Interest Payment Dates(s):	[ ] in each year
	(iii)	Fixed Coupon Amount[(s)]:	[ ] per [ ] in Nominal Amount

	(iv)	Broken Amount(s):	[*Insert particulars of any initial or final broken interest amounts which do not correspond with the Fixed Coupon Amount(s)*]
	(v)	Fixed Day Count Fraction:	[30/360 or Actual/Actual (ISMA) *or specify other*]
	(vi)	Other terms relating to the method of calculating interest for Fixed Rate Notes:	[Not Applicable/*give details*]
16.	**Floating Rate Note Provisions**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Specified Period(s)/Specified Interest Payment Dates:	[ ]
	(ii)	Business Day Convention:	[Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/ other (*give details*)]
	(iii)	Additional Business Centre(s):	[ ]
	(iv)	Manner in which the Rate(s) of Interest is/are to be determined:	[Screen Rate Determination/ISDA Determination/ other (*give details*)]
	(v)	Party responsible for calculating the Rate(s) of Interest and Interest Amount(s) (if not the Agent):	[ ]
	(vi)	Screen Rate Determination:	
		— Reference Rate:	[ ]
		— Interest Determination Date(s):	(Second London business day prior to the start of each Interest Period if LIBOR (other than Sterling or euro LIBOR), first day of each Interest Period if Sterling LIBOR and second day on which the TARGET System is open day prior to the start of each Interest Period if EURIBOR or euro LIBOR)
		— Relevant Screen Page:	[ ]
	(vii)	ISDA Determination:	(*In the case of EURIBOR if not Telerate 248, ensure it is a page which shows a composite rate*)
		— Floating Rate Option:	[ ]
		— Designated Maturity:	[ ]
		— Reset Date:	[ ]
	(viii)	Margin(s):	[+/-] [ ] per cent. per annum
	(ix)	Minimum Interest Rate:	[ ] per cent. per annum

	(x)	Maximum Interest Rate:	[ ] per cent. per annum
	(xi)	Day Count Fraction:	[ ]
	(xii)	Fall back provisions, rounding provisions, denominator and any other terms relating to the method of calculating interest on Floating Rate Notes, if different from those set out in the Conditions:	[ ]
17.	**Zero Coupon Note Provisions**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Accrual Yield:	[ ] per cent. per annum
	(ii)	Reference Price:	[ ]
	(iii)	Any other formula/basis of determining Amortised Face Amount:	[ ]
	(iv)	Day Count Fraction in relation to Early Redemption Amounts and late payments:	[Condition 5(d)(iii) and 5(i) apply/*specify other*]
18.	**Indexed Interest Note Provisions**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Index/Formula:	[*give or annex details*]
	(ii)	Calculation Agent responsible for calculating the interest due:	[ ]
	(iii)	Provisions for determining Coupon where calculation by reference to Index and/or Formula is impossible or impracticable:	[ ]
	(iv)	Specified Period(s)/Specified Interest Payment Dates:	[ ]
	(v)	Business Day Convention:	[Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/ other (*give details*)]
	(vi)	Additional Business Centre(s):	[ ]
	(vii)	Minimum Rate of Interest:	[ ] per cent. per annum
	(viii)	Maximum Rate of Interest:	[ ] per cent. per annum
	(ix)	Day Count Fraction:	[ ]

19.	**Dual Currency Note Provisions**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Rate of Exchange/method of calculating Rate of Exchange:	[*give details*]
	(ii)	Calculation Agent, if any, responsible for calculating the principal and/or interest due:	[ ]
	(iii)	Provisions applicable where calculation by reference to Rate of Exchange impossible or impracticable:	[ ]
	(iv)	Person at whose option Specified Currency(ies) is/are payable:	[ ]

PROVISIONS RELATING TO REDEMPTION

20.	**Issuer Call**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Optional Redemption Date(s):	[ ]
	(ii)	Optional Redemption Amount(s) and method, if any, of calculation of such amount(s):	[ ]
	(iii)	If redeemable in part:	
		(a) Minimum Redemption Amount:	[ ]
		(b) Higher Redemption Amount:	[ ]
	(iv)	Notice period (if other than as set out in Condition 5(b)):	[ ]
21.	**Investor Put**		[Applicable/Not Applicable] (*If not applicable, delete the remaining sub-paragraphs of this paragraph*)
	(i)	Optional Redemption Date(s):	[ ]
	(ii)	Optional Redemption Amount(s) and method, if any, of calculation of such amount(s):	[ ]
	(iii)	Notice period (if other than as set out in Condition (5(c)):	[ ]
22.	**Final Redemption Amount**		[Par/other (*specify*) see Appendix]

23.	**Early Redemption Amount**	
	Early Redemption Amount(s) payable on redemption for taxation reasons or on event of default and/or the method of calculating the same (if required or if different from that set out in the Conditions):	[ ]

GENERAL PROVISIONS APPLICABLE TO THE NOTES

24.	Form of Notes:	**Bearer Notes:** [Temporary Global Note exchangeable for a Permanent Global Note which is exchangeable for Definitive Notes on 60 days' notice given at any time]. [Temporary Global Note exchangeable for Definitive Notes upon certification as to non-U.S. beneficial ownership on or after the Exchange Date.] [Permanent Global Note exchangeable for Definitive Notes on 60 days' notice at any time].
25.	Additional Financial Centre(s) or other special provisions relating to Payment Dates:	[Not Applicable/*give details. Note that this item relates to the place of payment, and not interest period end dates to which items 16(iii)and 18(vi) relate*)
26.	Talons for future Coupons or Receipts to be attached to Definitive Notes (and dates on which such Talons mature):	[Yes/No. *If yes, give details*]
27.	Details relating to Partly Paid Notes: amount of each payment comprising the Issue Price and date on which each payment is to be made and consequences (if any) of failure to pay, including any right of the Issuer to forfeit the Notes and interest due on late payment:	[Not Applicable/*give details*]
28.	Details relating to Instalment Notes: amount of each instalment, date on which each payment is to be made:	[Not Applicable/*give details*]
29.	Redenomination, renominalisation and reconventioning provisions:	[Not Applicable/The provisions annexed to this Pricing Supplement apply]
30.	Other terms or special conditions:	[Not Applicable/*give details*]

DISTRIBUTION

31.	(i)	If syndicated, names of Managers:	[Not Applicable/*give names*]
	(ii)	Stabilising Manager (if any):	[Not Applicable/*give names*]

32.	If non-syndicated, name of Dealer:	[Not Applicable/*give names*]
33.	Whether TEFRA C or TEFRA D rules applicable or TEFRA rules not applicable:	[TEFRA C/TEFRA D/TEFRA not applicable]
34.	Additional selling restrictions:	[Not Applicable/*give details*]

OPERATIONAL INFORMATION

35.	ISIN Code:	[ ]
36.	Common Code:	[ ]
37.	Any clearing system(s) other than Euroclear and Clearstream, Luxembourg and the relevant identification number(s):	[Not Applicable/*give name(s) and number(s)*]
38.	Delivery:	Delivery [against/free of] payment
39.	Additional Paying Agent(s) (if any):	[ ]

[LISTING APPLICATION

This Pricing Supplement comprises the details required to list the issue of Notes described herein pursuant to the listing of the U.S.$2,000,000,000 Euro Medium Term Note Programme of the State of Israel.]

RESPONSIBILITY

The Issuer accepts responsibility for the information contained in this Pricing Supplement.

Signed on behalf of the Issuer:

By: ....
Duly authorised

TERMS AND CONDITIONS OF THE NOTES

The following are the Terms and Conditions of the Notes which will be incorporated by reference into each global Note and each definitive Note, in the latter case only if permitted by the relevant listing authority or stock exchange (if any) and agreed by the Issuer and the relevant Dealer at the time of issue but, if not so permitted and agreed, such definitive Note will have endorsed thereon or attached thereto such Terms and Conditions. The applicable Pricing Supplement in relation to any Tranche of Notes may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Notes. The applicable Pricing Supplement (or the relevant provisions thereof) will be endorsed upon, or attached to, each temporary global Note, permanent global Note and definitive Note. Reference should be made to "Form of the Notes" above for a description of the content of Pricing Supplements which will specify which of such terms are to apply in relation to the relevant Notes.

This Note is one of a Series (as defined below) of Notes issued by the State of Israel (the "Issuer") pursuant to the Agency Agreement (as defined below).

References herein to the "Notes" shall be references to the Notes of this Series and shall mean:—

(i) in relation to any Notes represented by a global Note, units of the lowest Specified Denomination in the Specified Currency;

(ii) definitive Notes issued in exchange for a global Note; and

(iii) any global Note.

The Notes, the Receipts (as defined below) and the Coupons (as defined below) are issued with the benefit of an Amendment and Restatement Agreement (Agency Agreement) dated September 5, 2002 (the "Agency Agreement", which expression shall include such agreement as further amended, supplemented or restated as at the Issue Date of the first Tranche of the Notes) and made among the Issuer, Citibank, N.A., London office as issuing and principal paying agent and agent bank (the "Agent", which expression shall include any successor agent specified in the applicable Pricing Supplement) and the other paying agents named therein (together with the Agent, the "Paying Agents", which expression shall include any additional or successor paying agents).

Interest bearing definitive Notes (unless otherwise indicated in the applicable Pricing Supplement) have interest coupons ("Coupons") and, if indicated in the applicable Pricing Supplement, talons for further Coupons ("Talons") attached on issue. Any reference herein to Coupons or coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons or talons. Definitive Notes repayable in instalments have receipts ("Receipts") for the payment of the instalments of principal (other than the final instalment) attached on issue.

The Pricing Supplement for this Note (or the relevant provisions thereof) is attached to or endorsed on this Note and supplements these Terms and Conditions and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with these Terms and Conditions, replace or modify these Terms and Conditions for the purposes of this Note. References herein to the "applicable Pricing Supplement" are to the Pricing Supplement (or the relevant provisions thereof) attached to or endorsed on this Note.

Any reference herein to "Noteholders" shall mean the holders of the Notes, and shall, in relation to any Notes represented by a global Note, be construed as provided below. Any reference herein to "Receiptholders" shall mean the holders of the Receipts and any reference herein to "Couponholders"shall mean the holders of the Coupons, and shall, unless the context otherwise requires, include the holders of the Talons.

As used herein, "Tranche" means Notes which are identical in all respects (including as to listing) and "Series" means a Tranche of Notes together with any further Tranche or Tranches of Notes which are (i) expressed to be consolidated and form a single series and (ii) identical in all respects (including as to listing) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices.

The Noteholders, the Receiptholders and the Couponholders are entitled to the benefit of the Deed of Covenant (the "Deed of Covenant") dated September 5, 2002, and made by the Issuer. The original of the Deed of Covenant is held by a common depositary on behalf of Euroclear (as defined below) and Clearstream, Luxembourg (as defined below).

Copies of the Agency Agreement, the applicable Pricing Supplement and the Deed of Covenant are available for inspection during normal business hours at the specified office of each of the Paying Agents save that, if this Note is an unlisted Note of any Series, the applicable Pricing Supplement will only be available for inspection by a Noteholder holding one or more unlisted Notes of that Series and such Noteholder must produce evidence satisfactory to the relevant Paying Agent as to its holding of such Notes and identity. The Noteholders, the Receiptholders and the Couponholders are deemed to have notice of, and are entitled to the benefit of, all the provisions of the Agency Agreement and the applicable Pricing Supplement which are applicable to them.

Words and expressions defined in the Agency Agreement or used in the applicable Pricing Supplement shall have the same meanings where used in these Terms and Conditions unless the context otherwise requires or unless otherwise stated and provided that, in the event of inconsistency between the Agency Agreement and the applicable Pricing Supplement, the applicable Pricing Supplement will prevail.

1. Form, Denomination and Title

The Notes are in bearer form and, in the case of definitive Notes, serially numbered, in the Specified Currency and the Specified Denomination(s). Notes of one Specified Denomination may not be exchanged for Notes of another Specified Denomination.

This Note is a Fixed Rate Note, a Floating Rate Note, a Zero Coupon Note, an Indexed Interest Note, an Indexed Redemption Amount Note, a Dual Currency Note, a Partly Paid Note or an Instalment Note or any combination of the foregoing, depending upon the Interest Basis or, as the case may be Redemption/Payment Basis specified in the applicable Pricing Supplement.

Definitive Notes are issued with Coupons attached, unless they are Zero Coupon Notes in which case references to Coupons and Couponholders in these Terms and Conditions are not applicable.

Subject as set out below, title to the Notes, Receipts and Coupons will pass by delivery. The Issuer and any Paying Agent may deem and treat the bearer of any Note, Receipt or Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any global Note, without prejudice to the provisions set out in the next succeeding paragraph.

For so long as any of the Notes is represented by a global Note held on behalf of Euroclear Bank S.A./N.V., as operator of the Euroclear System ("Euroclear") and/or Clearstream Banking, société anonyme, Luxembourg ("Clearstream, Luxembourg"), each person (other than Euroclear or Clearstream, Luxembourg) who is for the time being shown in the records of Euroclear or of Clearstream, Luxembourg as the holder of a particular nominal amount of such Notes (in which regard any certificate or other document issued by Euroclear or Clearstream, Luxembourg, as to the nominal amount of such Notes standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer and the Paying Agents as the holder of such nominal amount of such Notes for all purposes other than with respect to the payment of principal or interest on the Notes, for which purpose the bearer of the relevant global Note shall be treated by the Issuer and the Paying Agents as the holder of such Notes in accordance with and subject to the terms of the relevant global Note and the expressions "Noteholder" and "holder of Notes" and related expressions shall be construed accordingly. Notes which are represented by a global Note will be transferable only in accordance with the rules and procedures for the time being of Euroclear or of Clearstream, Luxembourg, as the case may be.

References to Euroclear and/or Clearstream, Luxembourg shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer and the Agent.

2. Status of the Notes

The Notes and the relative Receipts and Coupons constitute direct, general and unconditional obligations of the Issuer and rank *pari passu* without any preference among themselves. The payment obligations of the Issuer under the Notes will at all times rank at least equally with all other payment obligations of the Issuer relating to unsecured, unsubordinated External Indebtedness. For the purposes of this Condition 2, "External Indebtedness" means any Indebtedness which is payable by its terms or at the option of its holder in any currency other than the currency of Israel and "Indebtedness" means all obligations of the Issuer in respect of borrowed money and guarantees given by the Issuer in respect of money borrowed by others.

3. Interest

(a) *Interest on Fixed Rate Notes*

Each Fixed Rate Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest payable in arrear on the Interest Payment Date(s) in each year and on the Maturity Date if that does not fall on an Interest Payment Date.

Except as provided in the applicable Pricing Supplement, the amount of interest payable on each Interest Payment Date will amount to the Fixed Coupon Amount. Payments of interest on any Interest Payment Date will, if so specified in the applicable Pricing Supplement, amount to the Broken Amount so specified.

The amount of interest payable in respect of each Note for any period for which a Fixed Coupon Amount is not specified shall be calculated by applying the Rate of Interest to the principal amount of such Note, multiplying the product by the Fixed Day Count Fraction and rounding the resulting figure to the nearest sub-unit of the Specified Currency (half a sub-unit being rounded upwards).

For the purposes of these Conditions, "Fixed Day Count Fraction" means, in respect of the calculation of an amount for any period of time (the "Calculation Period"), such day count fraction as may be specified in these Conditions or the relevant Pricing Supplement and:

(i) if "Actual/Actual (ISMA)" is so specified, means:

(a) where the Calculation Period is equal to or shorter than the Regular Period during which it falls, the actual number of days in the Calculation Period divided by the product of (1) the actual number of days in such Regular Period and (2) the number of Regular Periods in any year; and

(b) where the Calculation Period is longer than one Regular Period, the sum of:

(A) the actual number of days in such Calculation Period falling in the Regular Period in which it begins divided by the product of (1) the actual number of days in such Regular Period and (2) the number of Regular Periods in any year; and

(B) the actual number of days in such Calculation Period falling in the next Regular Period divided by the product of (1) the actual number of days in such Regular Period and (2) the number of Regular Periods in any year;

(ii) if "30/360" is specified, on the basis of a 360-day year consisting of 12 months of 30 days each and, in the case of an incomplete month, the number of days elapsed.

"Regular Period" means:

(i) in the case of Notes where interest is scheduled to be paid only by means of regular payments, each period from and including the Interest Commencement Date to but excluding the first Interest Payment Date and each successive period from and including one Interest Payment Date to but excluding the next Interest Payment Date;

(ii) in the case of Notes where, except for the first Interest Period, interest is scheduled to be paid only by means of regular payments, each period from and including a Regular Date falling in any year to but excluding the next Regular Date, where "Regular Date" means the day and month (but not the year) on which any Interest Payment Date falls; and

(iii) in the case of Notes where, apart from one Interest Period other than the first Interest Period, interest is scheduled to be paid only by means of regular payments, each period from and including a Regular Date falling in any year to but excluding the next Regular Date, where "Regular Date" means the day and month (but not the year) on which any Interest Payment Date falls other than the Interest Payment Date falling at the end of the irregular Interest Period.

"Sub-unit" means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, means one cent.

(b) *Interest on Floating Rate Notes and Indexed Interest Notes*

(i) Interest Payment Dates

Each Floating Rate Note and Indexed Interest Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date and such interest will be payable in arrear on either:—

(A) the Specified Interest Payment Date(s) in each year (the period from and including the Interest Commencement Date to but excluding the first Interest Payment Date and each successive period from and including an Interest Payment Date to but excluding the next Interest Payment Date each being an "Interest Period"); or

(B) if no Specified Interest Payment Date(s) is/are specified in the applicable Pricing Supplement, each date (each an "Interest Payment Date", which terms shall hereinafter in these Terms and Conditions include a Specified Interest Payment Date) which falls the number of months or other period specified as the Interest Period in the applicable Pricing Supplement after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period (which expression shall, in these Terms and Conditions, mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date).

If a Business Day Convention is specified in the applicable Pricing Supplement and (x) if there is no numerically corresponding day in the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:—

(1) in any case where Interest Periods are specified in accordance with Condition 3(b)(i)(B) above, the Floating Rate Convention, such Interest Payment Date (i) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (B) below shall apply *mutatis mutandis* or (ii) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (A) such Interest Payment Date shall be brought forward to the immediately preceding Business Day and (B) each subsequent Interest Payment Date shall be the last Business Day in the month which falls the number of months or other period specified as the Interest Period in the applicable Pricing Supplement after the preceding applicable Interest Payment Date occurred; or

(2) the Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day; or

(3) the Modified Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or

(4) the Preceding Business Day Convention, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

In this Condition (subject as otherwise provided in the applicable Pricing Supplement), "Business Day" means a day which is both:—

(A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London and any Additional Business Centre specified in the applicable Pricing Supplement; and

(B) either (1) in relation to any sum payable in a specified currency other than euro, a day on which commercial banks and foreign exchange markets settle payments in the principal financial centre of the country of the relevant Specified Currency (if other than London and any Additional Business Centre) and which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney or Auckland, respectively or (2) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System ("TARGET System") is operating.

(ii) *Rate of Interest*

The Rate of Interest payable from time to time in respect of Floating Rate Notes and Indexed Interest Notes will be determined in the manner specified in the applicable Pricing Supplement.

(A) *ISDA Determination for Floating Rate Notes*

Where ISDA Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any). For the purposes of this sub-paragraph (A), "ISDA Rate" for an Interest Period means a rate equal to the Floating Rate that would be determined by the Agent under an interest rate swap transaction if the Agent were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 2000 ISDA Definitions, as amended, updated or replaced from time to time, published by the International Swaps and Derivatives Association, Inc. (the "ISDA Definitions"), and under which:—

(1) the Floating Rate Option is as specified in the applicable Pricing Supplement;

(2) the Designated Maturity is a period specified in the applicable Pricing Supplement; and

(3) the relevant Reset Date is either (i) if the applicable Floating Rate Option is based on the London inter-bank offered rate (LIBOR) or on the Euro zone (as defined below) inter-bank offered rate (EURIBOR) for a currency, the first day of that Interest Period or (ii) in any other case, as specified in the applicable Pricing Supplement.

For the purposes of this sub-paragraph (A), "Floating Rate", "Calculation Agent", "Floating Rate Option", "Designated Maturity" and "Reset Date" have the meanings given to those terms in the ISDA Definitions.

(B) *Screen Rate Determination for Floating Rate Notes*

Where Screen Rate Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:—

(A) the offered quotation (if there is only one quotation on the Relevant Screen Page (as indicated in the applicable Pricing Supplement)), expressed as a percentage rate per annum; or

(B) the arithmetic mean (rounded if necessary to the fifth decimal place with 0.000005 being rounded upwards) of the offered quotations (expressed as a percentage rate per annum),

for deposits in the Specified Currency for that Interest Period which appears or appear, as the case may be, on the Relevant Screen Page as at the Relevant Time on the Interest Determination Date in question plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any), all as determined by the Agent. If five or more such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) shall be disregarded by the Agent for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

If the Relevant Screen Page is not available or if, in the case of (A) above, no such quotation appears or, in the case of (B) above, fewer than three of such offered quotations appear, in each case as at such time, the Agent shall request the principal London office of each of the Reference Banks (as defined below) or, in the case of the determination of EURIBOR, the principal office of each of four EURIBOR Reference Banks to provide the Agent with its offered quotation (expressed as a percentage rate per annum) for deposits in the Specified Currency for the relevant Interest Period to leading banks in the London inter-bank market (or, in the case of the determination of EURIBOR, where the Reference Rate of EURIBOR is used for euro Notes, the Euro zone inter-bank market) at approximately the Relevant Time on the Interest Determination Date in question. If two or more of the Reference Banks or, as the case may be, EURIBOR Reference Banks, provide the Agent with such offered quotations, the Rate of Interest for such Interest Period shall be the arithmetic mean (rounded as provided above) of such offered quotations plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any), all as determined by the Agent.

If on any Interest Determination Date one only or none of the Reference Banks or, as the case may be, EURIBOR Reference Banks, provides the Agent with such an offered quotation as provided above, the Rate of Interest for the relevant Interest Period shall be the rate per annum which the Agent determines as being the arithmetic mean (rounded as provided above) of the rates, as communicated to (and at the request of) the Agent by the Reference Banks or, as the case may be, EURIBOR Reference Banks, or any two or more of them, at which such banks were offered, as at the Relevant Time on the relevant Interest Determination Date, deposits in the Specified Currency for the relevant Interest Period by leading banks in the London inter-bank market (or, in the case of the determination of EURIBOR, where Reference Rate of

EURIBOR is used for euro Notes, the Euro zone inter-bank market) plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any) or, if fewer than two of the Reference Banks or, as the case may be, EURIBOR Reference Banks, provide the Agent with such offered rates, the offered rate for deposits in the Specified Currency for the relevant Interest Period, or the arithmetic mean (rounded as provided above) of the offered rates for deposits in the Specified Currency for the relevant Interest Period, at which, on the relevant Interest Determination Date, any one or more banks (which bank or banks is or are suitable for such purpose) informs the Agent it is quoting to leading banks in the London inter-bank market or in the case of the determination of EURIBOR, the Euro zone inter-bank market (or, as the case may be, the quotations of such bank or banks to the Calculation Agent) plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any), provided that, if the Rate of Interest cannot be determined in accordance with the foregoing provisions of this paragraph, the Rate of Interest shall be that determined as at the last preceding Interest Period from that which applied to the last preceding Interest Period, the Margin relating to the relevant Interest Period in place of the Margin relating to that last preceding Interest Period.

In this Condition:—

"Reference Banks" means, in the case of (A) above, those banks whose offered rate were used to determine such quotation when such quotation last appeared on the Relevant Screen Page and, in the case of (B) above, those banks whose offered quotations last appeared on the Relevant Screen Page when no fewer than three such offered quotations appeared;

"EURIBOR Reference Bank" means a major bank operating in the Euro zone inter-bank market and "EURIBOR Reference Banks" shall be construed accordingly;

"Euro zone" means the zone comprising the member states of the European Union which adopt or have adopted the euro as their lawful currency in accordance with the Treaty establishing the European Community, as amended; and

"Relevant Time" means, in the case of LIBOR, 11:00 am (London time) or, in the case of EURIBOR, 11:00 am (Brussels time) or, as the case may be, as specified in the relevant Pricing Supplement.

If the Reference Rate from time to time in respect of Floating Rate Notes is specified as being other than LIBOR or EURIBOR, the Rate of Interest in respect of such Notes will be determined as provided in the applicable Pricing Supplement.

(iii) *Minimum and/or Maximum Interest Rate*

If the applicable Pricing Supplement specifies a Minimum Interest Rate for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is less than such Minimum Interest Rate, the Rate of Interest for such Interest Period shall be such Minimum Interest Rate.

If the applicable Pricing Supplement specifies a Maximum Interest Rate for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is greater than such Maximum Interest Rate, the Rate of Interest for such Interest Period shall be such Maximum Interest Rate.

(iv) *Determination of Rate of Interest and Calculation of Interest Amounts*

The Agent, in the case of Floating Rate Notes, or the Calculation Agent, in the case of Indexed Interest Notes will, at or as soon as practicable after each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period. In the case of Indexed Interest Notes, the Calculation Agent will notify the Agent of the Rate of Interest for the relevant Interest Period as soon as practicable after calculating the same. The Agent will calculate the amount of interest (the "Interest Amount") payable on the Floating Rate Notes or Indexed Interest Notes in respect of each Specified Denomination for the relevant Interest Period. Each Interest Amount shall be calculated by applying the Rate of Interest to each Specified Denomination multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

"Day Count Fraction" means, in respect of the calculation of an amount of interest for any Interest Period, and unless any other basis is specified in the relevant Pricing Supplement:—

(i) if "Actual/365" or "Actual/Actual (ISDA)" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 (or, if any portion of that Interest Period falls in leap year, the sum of (A) the actual number of days in that portion of the Interest Period falling in a leap year divided by 366 and (B) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);

(ii) if "Actual/365 (Fixed)" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365;

(iii) if "Actual/365 (Sterling)" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 or, in the case of any Interest Payment Date falling in a leap year, 366;

(iv) if "Actual/360" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 360;

(v) if "30/360", "360/360" or "Bond Basis" is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months (unless (a) the last day of the Interest Period is the 31st day of a month but the first day of the Interest Period is a day other than the 30th or 31st day of a month, in which case the month that includes that last day shall not be considered to be shortened to a 30-day month, or (b) the last day of the Interest Period is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month)); and

(vi) if "30E/360" or "Eurobond Basis" is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months, without regard to the date of the first day or last day of the Interest Period unless, in the case of an Interest Period ending on the Maturity Date, the Maturity Date is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month).

(v) *Notification of Rate of Interest and Interest Amounts*

The Agent will cause the Rate of Interest and each Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Issuer and any listing authority, stock exchange and/or quotation system by which the relevant Floating Rate Notes or Indexed Interest Notes are for the time being listed and notice thereof to be published in accordance with Condition 12 as soon as possible after their determination but in no event later than the fourth London Business Day. For the purposes of this paragraph (v) the expression "London Business Day" means a day (other than a Saturday or Sunday on which banks and foreign exchange markets are open for business in London. Each Interest Amount and Interest Payment Date so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without prior notice in the event of an extension or shortening of the Interest Period. Any such amendment will be promptly notified to each listing authority, stock exchange and/or quotation system by which the relevant Floating Rate Notes or Indexed Interest Notes are for the time being listed and to the Noteholders in accordance with Condition 12.

(vi) *Certificates to be Final*

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition 3(b), whether by the Agent or, if applicable, the Calculation Agent, shall (in the absence of wilful default, bad faith or manifest error) be binding on the Issuer, the Agent, the Calculation Agent (if applicable), the other Paying Agents and all Noteholders, Receiptholders and Couponholders and (in the absence as aforesaid) no liability to the Issuer, the Noteholders, the Receiptholders or the Couponholders shall attach to the Agent or the Calculation Agent (if applicable) in connection with the exercise or non-exercise by it of its powers, duties and discretions pursuant to such provisions.

(c) *Dual Currency Notes*

In the case of Dual Currency Notes, if the rate or amount of interest falls to be determined by reference to an exchange rate, the rate or amount of interest payable shall be determined in the manner specified in the applicable Pricing Supplement.

(d) *Partly Paid Notes*

In the case of Partly Paid Notes (other than Partly Paid Notes which are Zero Coupon Notes), interest will accrue as aforesaid on the paid-up nominal amount of such Notes and otherwise as specified in the applicable Pricing Supplement.

(e) *Accrual of Interest*

Each Note (or in the case of the redemption of part only of a Note, that part only of such Note) will cease to bear interest (if any) from the date for its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue until whichever is the earlier of:—

(1) the date on which all amounts due in respect of such Note have been paid; and

(2) the date on which the full amount of the moneys payable has been received by the Agent and notice to that effect has been given in accordance with Condition 12 or individually.

4. Payments

(a) *Method of Payment*

Subject as provided below:—

(i) payments in a Specified Currency other than euro will be made by transfer to an account in the relevant Specified Currency maintained by the payee with, or at the option of the payee by a cheque in such Specified Currency drawn on, a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney or Auckland, respectively); and

(ii) payments in euro will be made by euro cheque drawn on a bank in a principal financial centre of a state participating in the European economic and monetary union or by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment, but without prejudice to the provisions of Condition 6.

(b) *Presentation of Notes, Receipts and Coupons*

Payments of principal in respect of definitive Notes will (subject as provided below) be made in the manner provided in paragraph (a) above only against surrender of definitive Notes, and payments of interest in respect of definitive Notes will (subject as provided below) be made as aforesaid only against surrender of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia, its territories, its possessions and other areas subject to its jurisdiction)).

Payments of instalments of principal (if any), other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph (a) above against surrender of the relevant Receipt. Payment of the final instalment will be made in the manner provided in paragraph (a) above only against surrender of the relevant Note. Each Receipt must be presented for payment of the relevant instalment together with the definitive Note to which it appertains. Receipts presented without the definitive Note to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any definitive Note becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Notes in definitive form (other than Dual Currency Notes, Indexed Interest Notes or Indexed Redemption Amount Notes) should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of seven years after the Relevant Date (as defined in Condition 6) in respect of such principal or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Note in definitive form becoming due and repayable prior to its Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Note, Dual Currency Note or Indexed Note in definitive form becomes due and repayable, unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof.

If the due date for redemption of any definitive Note is not a Fixed Interest Date or an Interest Payment Date, interest (if any) accrued in respect of such Note from (and including) the preceding Fixed Interest Date or Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Note.

Payments of principal and interest (if any) in respect of Notes represented by any global Note will (subject as provided below) be made in the manner specified above in relation to definitive Notes and otherwise in the manner specified in the relevant global Note against presentation or surrender, as the case may be, of such global Note at the specified office of any Paying Agent. A record of each payment made against presentation or surrender of such global Note, distinguishing between any payment of principal and any payment of interest, will be made on such global Note by such Paying Agent and such record shall be *prima facie* evidence that the payment in question has been made.

The holder of a global Note shall be the only person entitled to receive payments in respect of Notes represented by such global Note and the Issuer will be discharged by payment to, or to the order of, the holder of such global Note in respect of each amount so paid. Each of the persons shown in the records of

Euroclear or Clearstream, Luxembourg as the beneficial holder of a particular nominal amount of Notes represented by such global Note must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for his share of each payment so made by the Issuer to, or to the order of, the holder of such global Note.

Notwithstanding the foregoing, if any amount of principal and/or interest in respect of this Note is payable in U.S. dollars, such U.S. dollar payments of principal and/or interest in respect of this Note will be made at the specified office of a Paying Agent in the United States if:—

(i) the Issuer has appointed Paying Agents with specified offices outside the United States with the reasonable expectation that such Paying Agents would be able to make payment in U.S. dollars at such specified offices outside the United States of the full amount of principal and interest on the Notes in the manner provided above when due;

(ii) payment of the full amount of such principal and interest at all such specified offices outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions on the full payment or receipt of principal and interest in U.S. dollars; and

(iii) such payment is then permitted under United States law without involving, in the opinion of the Issuer, adverse tax consequences to the Issuer.

(c) *Payment Day*

If the date for payment of any amount in respect of any Note, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment until the next following Payment Day in the relevant place and shall not be entitled to further interest or other payment in respect of such delay. For these purposes, "Payment Day" means any day which is:—

(i) if the currency of payment is euro, any day (except Saturday or Sunday) which is:

(A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the relevant place of presentation, London and any Additional Financial Centre specified in the applicable Pricing Supplement; and

(B) in the case of payment by transfer to an account, a TARGET Settlement Day and a day on which the relevant Clearing System settles payments; or

(ii) if the currency of payment is not euro, any day (except Saturday or Sunday) which is:

(A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the relevant place of presentation, London and any Additional Financial Centre specified in the applicable Pricing Supplement; and

(B) in the case of payment by transfer to an account, a day on which dealings in foreign currencies may be carried on in the principal financial centre of the currency of payment and in each (if any) Additional Financial Centre specified in the relevant Pricing Supplement;

"TARGET Settlement Day" means a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System is open.

(d) *Interpretation of Principal and Interest*

Any reference in these Terms and Conditions to principal in respect of the Notes shall be deemed to include, as applicable:—

(i) any additional amounts which may be payable with respect to principal under Condition 6;

(ii) the Final Redemption Amount of the Notes;

(iii) the Early Redemption Amount of the Notes;

(iv) the Optional Redemption Amount(s) (if any) of the Notes;

(v) in relation to Notes redeemable in instalments, the Instalment Amounts;

(vi) in relation to Zero Coupon Notes, the Amortised Face Amount; and (vii) any premium and any other amounts which may be payable by the Issuer under or in respect of the Notes.

5. Redemption and Purchase

(a) *At Maturity*

Unless previously redeemed or purchased and cancelled as specified below, each Note will be redeemed by the Issuer at its Final Redemption Amount specified in, or determined in the manner specified in, the applicable Pricing Supplement in the relevant Specified Currency on the Maturity Date.

(b) *Redemption at the Option of the Issuer (Issuer Call)*

If Issuer Call is specified in the applicable Pricing Supplement, the Issuer may, having given:—

(i) not less than 30 nor more than 60 days' notice (or such other notice period as is indicated in the applicable Pricing Supplement) to the Noteholders in accordance with Condition 12; and

(ii) not less than 15 days before the giving of the notice referred to in (i), notice to the Agent;

(which notices shall be irrevocable), redeem all or some only of the Notes then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the applicable Pricing Supplement together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount equal to the Minimum Redemption Amount or a Higher Redemption Amount. In the case of a partial redemption of Notes, the Notes to be redeemed ("Redeemed Notes") will be selected individually by lot, in the case of Redeemed Notes represented by definitive Notes, and in accordance with the rules of Euroclear and/or Clearstream, Luxembourg, in the case of Redeemed Notes represented by a global Note, not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the "Selection Date"). In the case of Redeemed Notes represented by definitive Notes, a list of the serial numbers of such Redeemed Notes will be published in accordance with Condition 12 not less than 15 days prior to the date fixed for redemption. The aggregate nominal amount of Redeemed Notes represented by definitive Notes shall bear the same proportion to the aggregate nominal amount of all Redeemed Notes as the aggregate nominal amount of definitive Notes outstanding bears to the aggregate nominal amount of the Notes outstanding, in each case on the Selection Date, provided that such first mentioned nominal amount shall, if necessary, be rounded downwards to the nearest integral multiple of the Specified Denomination, and the aggregate nominal amount of Redeemed Notes represented by a global Note shall be equal to the balance of the Redeemed Notes. No exchange of the relevant global Note will be permitted during the period from and including the Selection Date to and including the date fixed for redemption pursuant to this paragraph (c) and notice to that effect shall be given by the Issuer to the Noteholders in accordance with Condition 12 at least 5 days prior to the Selection Date.

(c) *Redemption at the Option of the Noteholders (Investor Put)*

If Investor Put are specified in the applicable Pricing Supplement, upon the holder of any Note giving to the Issuer in accordance with Condition 12 not less than 30 nor more than 60 days' notice (or such other period of notice as is specified in the applicable Pricing Supplement) the Issuer will, upon the expiry of such notice, redeem, subject to, and in accordance with, the terms specified in the applicable Pricing Supplement, in whole (but not in part), such Note on the Optional Redemption Date and at the Optional Redemption Amount specified in, or determined in the manner specified in, the applicable Pricing Supplement together, if appropriate, with interest accrued to (but excluding) the Optional Redemption Date.

If this Note is in definitive form, to exercise the right to require redemption of this Note the holder of this Note must deliver such Note at the specified office of any Paying Agent at any time during normal business hours of such Paying Agent falling within the notice period, accompanied by a duly completed and signed notice of exercise in the form (for the time being current) obtainable from any specified office of any Paying Agent (a "Put Notice") and in which the holder must specify a bank account (or, if payment is to be made by cheque, an address) to which payment is to be made under this Condition.

Any Put Notice given by a holder of any Note pursuant to this paragraph shall be irrevocable except where prior to the due date of redemption an Event of Default shall have occurred and be continuing in which event such holder, at its option, may elect by notice to the Issuer to withdraw the notice given pursuant to this paragraph and instead to declare such Note forthwith due and payable pursuant to Condition 8.

(d) *Early Redemption Amounts*

For the purpose of Condition 8, the Notes will be redeemed at the Early Redemption Amount calculated as follows:—

(i) in the case of Notes with a Final Redemption Amount equal to the Issue Price, at the Final Redemption Amount thereof;

(ii) in the case of Notes (other than Zero Coupon Notes but including Instalment Notes and Partly Paid Notes) with a Final Redemption Amount which is or may be less or greater than the Issue Price or which is payable in a Specified Currency other than that in which the Notes are denominated, at the amount specified in, or determined in the manner specified in, the applicable Pricing Supplement or, if no such amount or manner is so specified in the Pricing Supplement, at their nominal amount outstanding; or

(iii) in the case of Zero Coupon Notes, at an amount (the "Amortised Face Amount") equal to the sum of:—

(A) the Reference Price; and

(B) the product of the Accrual Yield (compounded annually) being applied to the Reference Price from (and including) the Issue Date to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Note becomes due and repayable.

Where such calculation is to be made for a period which is not a whole number of years, it shall be made on the basis of a 360-day year consisting of 12 months of 30 days each or such other calculation basis as may be specified in the applicable Pricing Supplement.

(e) *Instalments*

If the Notes are repayable in instalments, they will be redeemed in the Instalment Amounts and on the Instalment Dates. In the case of early redemption, the Early Redemption Amount will be determined pursuant to paragraph (d) above.

(f) *Partly Paid Notes*

If the Notes are Partly Paid Notes, they will be redeemed, whether at maturity, early redemption or otherwise, in accordance with the provisions of this Condition and the applicable Pricing Supplement.

(g) *Purchases*

The Issuer, may at any time purchase Notes (provided that, in the case of definitive Notes, all unmatured Receipts and Coupons appertaining thereto are purchased therewith) in any manner and at any price. If purchases are made by tender, tenders must be available to all Noteholders of the same Series alike.

Such Notes may be held, reissued, resold or, at the option of the Issuer, surrendered to any Paying Agent for cancellation.

(h) *Cancellation*

All Notes which are redeemed or purchased and surrendered for cancellation pursuant to paragraph (g) above will forthwith be cancelled (together with all unmatured Receipts and Coupons attached thereto or surrendered therewith at the time of redemption or purchase). All Notes so cancelled (together with all unmatured Receipts and Coupons cancelled therewith) shall be forwarded to the Agent and cannot be reissued or resold.

(i) *Late payment on Zero Coupon Notes*

If the amount payable in respect of any Zero Coupon Note upon redemption of such Zero Coupon Note pursuant to paragraph (a), (b) or (c) above or upon its becoming due and repayable as provided in Condition 8 is improperly withheld or refused, the amount due and repayable in respect of such Zero Coupon Note shall be the amount calculated as provided in paragraph (d)(iii) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Note becomes due and payable were replaced by references to the date which is the earlier of:—

(i) the date on which all amounts due in respect of such Zero Coupon Note have been paid; and

(ii) the date on which the full amount of the moneys payable has been received by the Agent and notice to that effect has been given to the Noteholders either in accordance with Condition 12 or individually.

6. Taxation

All payments of principal and interest in respect of the Notes, Receipts and Coupons by the Issuer will be made free and clear of, and without withholding or deduction for or on account of any present or future taxes imposed by or within the State of Israel or any authority therein or thereof having power to tax (together "Taxes") unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amounts as will result in receipt by the holders of the Notes, Receipts or Coupons of such amounts as would have been received by them in respect of the Notes, Receipts or Coupons, as the case may be, had no such withholding or deduction been required; except that no such additional amounts shall be payable with respect to any Note, Receipt or Coupon:—

(i) presented for payment by or by a third party on behalf of a Noteholder, Receiptholder or Couponholder who is liable for such Taxes in respect of such Note, Receipt or Coupon by reason of his having some connection with the State of Israel other than the mere holding of such Note, Receipt or Coupon; or

(ii) presented for payment more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on the last day of such period of 30 days; or

(iii) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to any European Union Directive on the taxation of savings implementing the conclusions of the ECOFIN Council meeting of November 26-27 2000 (the "Directive") or any law implementing or complying with, or introduced in order to conform to, the Directive; or

(iv) presented for payment by, or on behalf of a Noteholder, Receiptholder or Couponholder who would have been able to avoid such withholding or deduction by presenting the relevant Note, Receipt or Coupon to another Paying Agent in a Member State of the European Union.

As used herein, the "Relevant Date" means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Agent on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Noteholders in accordance with Condition 12.

7. Prescription

The Notes, Receipts and Coupons will become void unless presented for payment within a period of seven years after the Relevant Date (as defined in Condition 6) therefor.

There shall not be included in any Coupon sheet issued on exchange of a Talon any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 4(*b*) or any Talon which would be void pursuant to Condition 4(*b*).

8. Events of Default

If any one or more of the following events (each an "Event of Default") shall occur:—

(i) default is made for more than 30 days in the payment of any amount in respect of any of the Notes; or

(ii) default is made in the performance by the Issuer of any other obligation of the Issuer in respect of the Notes (other than any obligation for the payment of any amount due in respect of any of the Notes) and such default continues for a period of 60 days after written notification requiring such default to be remedied has been given to the Issuer by any Noteholder; or

(iii) the Issuer declares a moratorium with respect to the payment of any amount in respect of any of the Notes;

then any Noteholder may, by written notice to the Issuer at the specified office of the Agent, effective upon the date of receipt thereof by the Agent, declare its Note to be forthwith due and payable whereupon the same shall become forthwith due and payable at the Early Redemption Amount (as described in Condition 5(d)), together with accrued interest (if any) to the date of repayment unless, prior to receipt of such notice, all such defaults shall have been cured.

9. Replacement of Notes, Receipts, Coupons and Talons

Should any Note, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Agent upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Notes, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

10. Agent and Paying Agents

The names of the initial Agent and the other initial Paying Agents and their initial specified offices are set out below.

The Issuer is entitled to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/or approve any change in the specified office though which any Paying Agent acts, provided that:—

(i) so long as the Notes are admitted to listing, trading and/or quotation by any listing authority, stock exchange and/or quotation system, there will at all times be a Paying Agent with a specified office in such place as may be required by the rules and regulations of the relevant listing authority, stock exchange and/or quotation system;

(ii) if the Directive or any law implementing or complying with, or introduced in order to conform to, the Directive is introduced, there will at all times be a Paying Agent (which may be the Agent) with a specified office in a city in a Member State of the European Union that will not be obliged to withhold or deduct taxes pursuant to the Directive;

(iii) there will at all times be a Paying Agent with a specified office in a city in continental Europe; and

(iv) there will at all times be an Agent.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in the final paragraph of Condition 4(b). Any variation, termination, appointment or change shall only take effect (other than in the case of insolvency, when it shall be of immediate effect) after not less than 30 nor more than 45 days' prior notice thereof shall have been given to the Noteholders in accordance with Condition 12.

11. Exchange of Talons

On and after the Interest Payment Date, on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Note to which it appertains) a further Talon, subject to the provisions of Condition 7. Each Talon shall, for the purposes of these Terms and Conditions, be deemed to mature on the Fixed Interest Date or the Interest Payment Date (as the case may be) on which the final Coupon comprised in the relative Coupon sheet matures.

12. Notices

All notices regarding the Notes shall be published in a leading English language daily newspaper of general circulation in London. It is expected that such publication will be made in the *Financial Times* in London. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any other listing authority or stock exchange by which the Notes are for the time being listed. Any such notice will be deemed to have been given on the date of the first publication in both such newspapers.

Until such time as any definitive Notes are issued, there may (provided that, in the case of Notes listed by a listing authority or on a stock exchange, the listing authority or stock exchange agrees), so long as the global Note(s) is or are held in its/their entirety on behalf of Euroclear and Clearstream, Luxembourg, be substituted for such publication in such newspaper(s) the delivery of the relevant notice to Euroclear and Clearstream, Luxembourg for communication by them to the holders of the Notes. Any such notice shall be deemed to have been given to the holders of the Notes on the seventh day after the day on which the said notice was given to Euroclear and Clearstream, Luxembourg.

Notices to be given by any holder of the Notes shall be in writing and given by lodging the same, together with the relative Note or Notes, with the Agent. Whilst any of the Notes are represented by a global Note, such notice may be given by any holder of a Note to the Agent via Euroclear and/or Clearstream, Luxembourg, as the case may be, in such manner as the Agent and Euroclear and/or Clearstream, Luxembourg, as the case may be, may approve for this purpose.

13. Meetings of Noteholders, Modification and Waiver

The Agency Agreement contains provisions for convening meetings of the Noteholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of the Notes, the Receipts, the Coupons or any of the provisions of the Agency Agreement. Such a meeting may be convened by the Issuer or Noteholders holding not less than ten per cent. in nominal amount of the Notes for the time being remaining outstanding. The quorum at any such meeting for passing an Extraordinary Resolution is one or more persons holding or representing a clear majority in nominal amount of the Notes for the time being outstanding, or at any adjourned meeting one or more persons being or representing Noteholders whatever the nominal amount of the Notes so held or represented, except that at any meeting the business of which includes the modification of certain provisions of the Notes, Receipts or Coupons (including modifying the date of maturity of the Notes or any date for payment of interest thereof, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Notes or altering the currency of payment of the Notes, Receipts or Coupons), the quorum shall be one or more persons holding or representing not less than two-thirds in nominal amount of the Notes for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third, in nominal amount of the Notes for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Noteholders shall be binding on all the Noteholders, whether or not they are present at the meeting, and on all Receiptholders and Couponholders.

The Agent and the Issuer may agree, without the consent of the Noteholders, Receiptholders or Couponholders, to:—

(i) any modification (except as mentioned above) of the Agency Agreement which is not prejudicial to the interests of the Noteholders; or

(ii) any modification of the Notes, the Receipts, the Coupons or the Agency Agreement which is of a formal, minor or technical nature or is made to correct a manifest error or to comply with mandatory provisions of the laws of the State of Israel.

Any such modification shall be binding on the Noteholders, the Receiptholders and the Couponholders and any such modification shall be notified to the Noteholders in accordance with Condition 12 as soon as practicable thereafter.

14. Further Issues

The Issuer shall be at liberty from time to time without the consent of the Noteholders, Receiptholders or Couponholders to create and issue further notes having terms and conditions the same as the Notes or the same in all respects save for the amount and date of the first payment of interest thereon and so that the same shall be consolidated and form a single Series with the outstanding Notes.

15. Governing law and submission to jurisdiction

(a) The Agency Agreement, the Notes, the Receipts and the Coupons are governed by, and shall be construed in accordance with, English law.

(b) The Issuer agrees, for the exclusive benefit of the Paying Agents, the Noteholders, the Receiptholders and the Couponholders that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Agency Agreement, the Notes, the Receipts and/or the Coupons and that accordingly any suit, action or proceedings (together referred to as "Proceedings") arising out of or in connection with the Agency Agreement, the Notes, the Receipts and the Coupons may be brought in such courts.

The Issuer hereby irrevocably waives any objection which it may have now or hereafter to the laying of the venue of any such Proceedings in any such court and any claim that any such Proceedings have been brought in an inconvenient forum and hereby further irrevocably agrees that a judgment in any such Proceedings brought in the English courts shall be conclusive and binding upon it and may be enforced in the courts of any other jurisdiction.

Nothing contained in this Condition shall limit any right to take Proceedings against the Issuer in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings in any other jurisdiction, whether concurrently or not.

The Issuer appoints the Economic Minister at the Embassy of Israel in the United Kingdom whose address is 2 Palace Green, London W8 4QB as its agent for service of process, (with a copy to the Ministry of Finance, Accountant General's Office, 1 Kaplan Street/Hakiria, POB13185, Jerusalem 91131, Israel) and undertakes that, in the event of such person ceasing so to act or ceasing to be effectively appointed to accept service of process on the Issuer's behalf, it will appoint another person as its agent for service of process in England in respect of any Proceedings.

Nothing herein shall affect the right to serve proceedings in any other manner permitted by law.

The Issuer hereby irrevocably and unconditionally agrees not to claim with respect to the Agency Agreement, the Notes, the Receipts and/or the Coupons any right to sovereign or other immunity from jurisdiction or execution and any similar defence and irrevocably and unconditionally consents to the giving of any relief or the issue of any process, including without limitation, the making, enforcement or execution against any property whatsoever (irrespective of its use or intended use) of any order or judgment made or given in connection with any proceedings.

Notwithstanding the foregoing, under the laws of the State of Israel, the funds, assets, rights and general property of the Issuer located in the State of Israel are immune from execution and attachment and any process in the nature thereof and the foregoing waiver shall not constitute a waiver of such immunity or of any immunity from execution or attachment or process in the nature thereof with respect to the premises of the Issuer's diplomatic missions in any jurisdiction outside the State of Israel or with respect to the assets of the Issuer necessary for the proper functioning of the Issuer as a sovereign power.

16. Third Party Rights

No person shall have any right under the Contract (Rights of Third Parties) Act 1999 to enforce any term or condition of the Notes, but this does not affect any right or remedy of any person which exists or is available apart from under that Act.

USE OF PROCEEDS

The net proceeds from each issue of Notes will be added to the foreign exchange reserves of the Issuer and may be used to finance the budgeted foreign currency expenditures of the Government of the State of Israel, including refinancing of existing external debt.

STATE OF ISRAEL

Introduction

The State of Israel (the "State" or "Israel") is a highly developed, industrialized democracy. Since 1990, Israel has achieved improvements in most economic indicators. GDP growth, which had been 5% annually on average between 1990 and 1999, reached 6.4% in 2000. A significant factor affecting GDP growth in 2000 was the contribution of start-up companies, exports by high-tech companies, such as electronics and high-technology medical equipment, tourism and private consumption. The last quarter of 2000 showed a marked decrease in GDP, due to a variety of factors, mainly the tense situation with the Palestinian Authority, which negatively affected tourism in particular, the drop in the Nasdaq index, which slowed investments in high tech companies, and the economic slowdown in the U.S. economy, which lowered exports. As these factors persisted and worsened during 2001, the domestic slowdown intensified and GDP decreased by 0.6%.

In recent years, Israel has made substantial progress in opening its economy and major trade barriers and tariffs have been removed. Total exports of goods and services increased by 7.6% annually on average between 1990 and 1999, rose by 23.8% in 2000, and declined by 11% in 2001. Israel has concluded free trade agreements with its major trading partners, and is the only nation, except for Mexico and Jordan, that is a party to free trade agreements with both the United States and the European Union. In recent years Israel has signed free trade agreements with Switzerland, Norway, Iceland, Liechtenstein, Canada, Turkey, the Czech Republic, Slovakia, Slovenia, Poland, Hungary, Mexico, Bulgaria and Romania.

Since 1990, Israel's fiscal and monetary policies have been formulated and coordinated with the goals of reducing Israel's high tax burden, narrowing the Government's fiscal deficits, attaining levels of inflation similar to those in other industrialized countries, and enhancing economic growth. In connection with its economic policies, the Government has also pursued a policy of privatizing State-owned enterprises, including banks. After periods of high inflation in the early 1980s, inflation has been reduced and stabilized. The annual average inflation rate between 1990 and 1999 was 11.2% and in both 2000 and 2001 the annual average was 1.1%. The total budget deficit (excluding net lending and the realized profits of the Bank of Israel) averaged 3.7% of GDP per year between 1995 and 1999 and dropped to 0.7% of GDP in 2000. In 2001 the total budget deficit increased to 4.6% of GDP mainly as a result of a sharp decrease in tax collection in light of the deepening recession. The current account deficit, which averaged \$3.8 billion per year between 1995 and 1999, decreased to \$1.4 billion in 2000 and \$1.7 billion in 2001. The unemployment rate was 8.8% in 2000 and rose to 9.3% in 2001.

Israel's productive and highly educated population remains a principal strength. Based on a 1999 survey, approximately 37% of the Israeli population over the age of 15 has a university or other advanced degree. In addition, from 1990 through 2001, approximately 1.6 million immigrants arrived, increasing Israel's population by approximately 23.2%. The new immigrants are generally highly educated and include a high percentage of scientific, academic, technical and other professional workers. Although this wave of immigration initially placed strains on the economy by raising the budget and trade deficits and contributing to a relatively high level of unemployment, these immigrants have been successfully integrated into the economy. Today, the employment rate of immigrants who came to Israel in the first half of the 1990s is similar to that of native-born Israelis.

Over the past two decades, Israel has made progress in reducing the state of hostility that has existed with Arab countries in the region since the establishment of the State in 1948, although the unrest that began in September 2000 and intensified during 2001 is a major setback. The first peace agreement between Israel and its neighbors was the 1979 accord with Egypt. In September 1993, Israel and the Palestinian Liberation Organization signed a Declaration of Principles, a turning point in Israeli-Arab relations. Since that time, the peace process has progressed with further agreements between Israel and the Palestinians and the signing of a peace treaty with Jordan in 1994. Further agreements have also been signed between Israel and the

Palestinians. As part of the 1994 Gaza Strip and Jericho Agreement signed in Cairo, and the 1996 Interim Agreement on the West Bank and the Gaza Strip signed in Washington, D.C., Israel withdrew from Jericho and much of the Gaza Strip, as well as from six additional West Bank towns. Further progress was made in October 1998, when Israel and the Palestinian Authority signed the Wye River Memorandum restating their commitment to the implementation of the outstanding interim obligations and the resolution of permanent issues through negotiations. In January 2000, the peace talks with Syria resumed at Shepherdstown, West Virginia. The unrest in the areas administrated by the Palestinian Authority, which began in September 2000, has been a major setback in the peace process. At the end of March 2002, as a result of a massive terror attack perpetrated against the Israeli civilian population by Palestinian extremists, Israel launched a military operation into the Palestinian Authority-controlled areas to root out the terror infrastructure. This military operation has been substantially completed, although future operations may be necessary.

Geography

Israel lies on the western edge of Asia bordering the Mediterranean Sea. It is bounded on the north by Lebanon and Syria, on the east by Jordan, on the west by the Mediterranean Sea and Egypt, and on the south by Egypt and the Gulf of Eilat. Israel has a total land area (excluding the Gaza Strip and the West Bank) of approximately 21,500 square kilometers or 8,305 square miles, approximately the size of the State of New Jersey. Jerusalem is the capital of Israel.

Israel's climate varies considerably from region to region, with distinct seasons. In the south, rainfall is light, amounting to about one inch per year in the Arava Valley south of the Dead Sea, while in the north it is relatively heavy, amounting to about 44 inches per year in the Upper Galilee region. Generally, Israel has between 40 and 60 days of rain annually, mainly in the period from October through April. The average daily maximum temperature in the coastal areas ranges from 65°F in January to 90°F in August. In Eilat, located in the south, daytime temperatures reach about 70°F in January and may rise as high as 114°F in August.

Population

Israel's population, including Israeli citizens living in the West Bank and the Gaza Strip, was estimated as of December 31, 2001 to be 6.5 million. During the period from 1990 through 2001, Israel's population grew by more than 43%, largely as a result of immigration. In 2000, less than 10% of the population was 65 years of age or older, approximately 30% was between the ages of 35 and 64, approximately 32% was between the ages of 15 and 34, and approximately 30% was under the age of 15. Approximately 91% of the population lives in urban areas. 20% of the population lives in Israel's three largest cities: Jerusalem (population 657,000), Tel Aviv (population 354,000), and Haifa (population 270,500).

The Israeli population is composed of a variety of ethnic and religious groups. As of the end of 2000, out of the total Israeli population, 77.9% was Jewish, 15.2% was Moslem, 2.1% was Christian, and 1.6% was Druze. Israel's Declaration of Independence and various decisions by Israel's Supreme Court guarantee the freedom of worship for all Israeli citizens. Hebrew and Arabic are the official languages of Israel; English is commonly used.

Education. One year of kindergarten and ten years of primary school are compulsory for all Israeli children and are provided free of charge by the State. In addition, two more years of schooling, though not compulsory, are provided free of charge to all students. Twelve years of schooling are required for admission to a university in Israel. Based on a 1999 survey, approximately 37% of the Israeli population over the age of 15 has a university or other advanced degree. Israel has a large number of high quality educational institutions.

Health and Human Services. Israel has a ratio of approximately one doctor to every 300 people. All residents of Israel have access to medical care funded through a national health care fee. In addition, the Government makes available a wide range of social benefits to ensure support for children, the elderly, expectant mothers, and the disabled. Israel's hospitals are of high quality, with technologically advanced facilities.

Immigration. Israel has experienced a continuous flow of immigrants over time, made possible in part by Israel's Law of Return, which provides that any Jewish immigrant is entitled to become a citizen of Israel. Since 1990, the flow of immigrants has increased dramatically. During 1990 and 1991, a total of 375,600 immigrants arrived in Israel, while the average annual number of immigrants to Israel from 1992 through 2000 was 71,200. The annual number of immigrants to Israel decreased to 43,400 in 2001. The substantial flow of immigrants since 1990, totaling 1,060,000, increased Israel's population by 23.2%. Over the same period, total population growth was approximately 43%.

Approximately 86% of all immigrants to Israel since 1990 have come from the former Soviet Union. Many of these immigrants are highly educated. Of the immigrants who arrived between 1990 and 1998 and who were above 15 years of age, 65% had over 13 years of schooling. Approximately 63% of immigrants who worked in their place of last residence had scientific, academic, technical or other skilled jobs. This influx of highly skilled workers has contributed to the growth of the Israeli economy since 1990.

Table No. 2 Immigrants by Place of Last Residence(1)

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
Asia	815	573	629	793	529
Africa					
Ethiopia	1,661	3,110	2,290	2,201	3,272
Other	622	404	391	306	301
Europe					
Former U.S.S.R., including Central Asian republics	54,818	46,032	66,848	50,816	33,521
Other	4,100	3,269	2,994	2,717	2,215
Americas and Oceania					
U.S.A.	1,800	1,600	1,515	1,238	1,200
Other	2,448	1,716	2,065	2,119	2,403
Not known	18	33	34	0	0
Total	66,221	56,730	76,766	60,192	43,441

(1) Includes tourists who changed their status to immigrants or potential immigrants, and excludes citizens who were born abroad to Israeli citizens and came to Israel to settle permanently.

Source: Central Bureau of Statistics.

Form of Government and Political Parties

The State of Israel was established in 1948. Israel is a parliamentary democracy, with governmental powers divided among separate legislative, executive, and judicial branches. Israel has no formal written constitution. Rather, a number of basic laws govern the fundamental functions of the State, including the electoral system, the government, the legislature, and the judiciary. These laws are given special status by Israeli courts relative to other laws and, in some cases, cannot be amended except by an absolute majority vote of the legislature (the "Knesset"). In 1992, the Knesset adopted two additional basic laws that guarantee the protection of property, life, body and dignity, as well as the right to privacy and freedom of occupation. All citizens of Israel, regardless of race, religion or sex, are guaranteed full democratic rights. Freedom of worship, speech, assembly, press and political affiliation are embodied in the country's laws, judicial decisions, and Declaration of Independence.

The President is the head of state and is elected by the Knesset for a single seven-year term. The President has no veto powers and the duties of the office are mainly ceremonial. The current President, Moshe Katsav, was elected in July 2000.

The legislative power of the State resides in the Knesset, a unicameral parliament that consists of 120 members elected by universal suffrage under a system of proportional representation. The entire country constitutes a single electoral constituency. Each party receiving more than 1.5% of the total votes cast is assigned Knesset seats in proportion to its percentage of the total national vote. Knesset elections are held every four years, unless the Knesset votes for elections to take place earlier.

The Prime Minister is the head of Israel's government and appoints a cabinet to assist in governing the country. Prior to the 1996 election, Israeli citizens voted for a particular party and its slate of legislative candidates, which included that party's candidate for Prime Minister in the top slot. In the 1996 elections, for the first time, the Prime Minister was elected by a direct vote, separate from, but simultaneous with, the vote for a party slate. Israel has three major political parties, Avoda (Labor)-Meimad, Likud and Shas. Since the establishment of the State of Israel in 1948, the Government has been a coalition government led by Avoda or Likud and supported by a majority of the members of the Knesset.

The following table presents the distribution of Knesset seats by party resulting from the 1999 election:

Table No. 3 Distribution of Knesset Seats by Party

	Number of Seats
Avoda (Labor) – Meimad	24
Likud	19
Sefardi Observants of the Torah ("Shas")	17
Meretz	10
Ihud Leumi – Israel Beitenu	7
Israel Bamercaz (Center Party)	5
Shinui	6
National Religious Party ("Mafdal")	5
National Arab Party	2
United Torah Judaism ("Agudah")	5
Israel Bealiya	4
Democratic List for Peace and Equality (Hadash)	3
Gesher	3
Democratic Choice	2
Am Echad (One Nation)	2
Ta-Al (Arab Movement for Change)	1
Herut (National Movement)	1
R.A.M (United Arab List)	3
B.L.D (National Democratic Alliance)	1
Total	120

Following the resignation of Prime Minister Ehud Barak on December 9, 2000, direct elections for the Prime Minister were held on February 6, 2001. The two candidates for the position were Mr. Ehud Barak from the Avoda-Meimad party and Mr. Ariel Sharon from the Likud party. Mr. Ariel Sharon was elected Prime Minister with over 60% of the votes.

In March 2001 the election system was changed once again. Beginning with the elections for the next Knesset, currently scheduled for October 2003, the system will revert to one that is similar to the one that was in effect until 1996, with voters choosing a party slate. According to this system, the President assigns one of the Knesset members to form the government, after consulting with different segments' representatives. If a 61-vote majority of the Knesset subsequently votes no confidence in the government and proposes an alternative candidate, the government will dissolve. The Prime Minister, with the approval of the President, also has the authority to dissolve the Knesset.

The judicial power in Israel is exercised by the Supreme Court, District Courts, and Magistrate Courts, as well as municipal courts, labor courts, administrative tribunals, and religious courts. The five District Courts (located in Jerusalem, Tel Aviv, Haifa, Beersheva, and Nazareth) hear all cases not within the limited jurisdiction of the Magistrate Courts or the specialized courts and also hear appeals from the Magistrate Courts. The Supreme Court has ultimate appellate jurisdiction over all decisions rendered by District Courts. The Supreme Court also exercises original jurisdiction sitting as the High Court of Justice in matters in which it considers it necessary to grant relief in the interests of justice and that are not within the jurisdiction of any other court or tribunal. In its capacity as the High Court of Justice, the Supreme Court hears petitions in matters of constitutional and administrative law, reviewing acts of the executive branch and the Knesset. In addition, the High Court of Justice may order religious courts and labor courts to adjudicate any particular matter, or to set aside any proceeding held, or decision given. Judges are appointed by the President upon election by the Judges' Election Committee, the majority of whose members represent the legal profession. Marital and family matters, and certain other personal matters, are handled by religious courts. Separate religious courts exist for the various religions.

National Institutions

Israel has four so-called National Institutions: the Jewish Agency for Israel (the "Jewish Agency"), the World Zionist Organization, Keren Hayesod, and the Jewish National Fund. The National Institutions, which predate the formation of the State, perform a variety of non-governmental charitable functions. Each of the National Institutions is independent of the Government and finances its activities through private and public sources, including donations from abroad. In 2001, the National Institutions were responsible for net unilateral transfers into Israel of $256 million.

International Relations

Over the past two decades, Israel has made progress in reducing the state of hostility that has existed between itself and the Arab countries in the region since the establishment of the State of Israel in 1948. As a result of the historic visit to Israel by the president of Egypt in 1977 and intensive negotiations held by the two countries, Egypt and Israel signed a peace treaty on March 26, 1979, which was the first between Israel and one of its neighboring countries. In 1991, the Madrid Conference marked the start of a broader peace process in the Middle East.

In September 1993, the mutual recognition and the signing of a Declaration of Principles between Israel and the Palestinian Liberation Organization (the "PLO") was a turning point in Israeli-Arab relations. Negotiations between Israel and the PLO progressed, and steps toward a longer-term understanding between the parties have been taken. A number of interim agreements were concluded and the Palestinian Authority (the "PA") was established. The PA has gradually taken responsibility for administering self-rule areas. In October 1998, Israel and the PA signed the Wye River Memorandum restating their commitment to the implementation of the outstanding interim obligations and the resolution of permanent issues through negotiations. Several rounds of negotiations were held between Israel and the PA during the year 2000, aimed at achieving a permanent peace agreement and an end to the conflict. These negotiations did not result in a permanent agreement. Since September 2000 the relations between Israel and the PA have deteriorated due to the violence and terror attacks conducted by Palestinian organizations against Israeli targets and citizens, in violation of all bilateral agreements signed since 1993. Significant damage has been caused to the economic relations in most fields, primarily in the area of bilateral trade. Early 2002 saw an intensification of terror attacks by Palestinian extremists against Israeli citizens, resulting in more than 130 deaths and hundreds wounded in March 2002 alone. As a result, at the end of March 2002, Israel launched a large-scale military operation into the Palestinian Authority controlled areas, to root out the terror infrastructure. This military operation has been substantially completed, although future operations may be necessary. Efforts are being made to bring the Palestinian violence to an end in order to be able to renew the peace negotiations in a suitable atmosphere.

On October 26, 1994, Israel and Jordan signed a peace treaty. After resolving issues relating to borders and water, Israel and Jordan entered into negotiations to promote economic cooperation and planning of regional economic development initiatives. In addition to political and economic discussions between Israel, Egypt and Jordan, in recent years, Israel has begun to establish economic and political relations with other countries in the region, both in Africa and the Gulf states. On October 28, 1999, Israel and Mauritania established full diplomatic relations. Mauritania is the third country after Egypt and Jordan with whom Israel has exchanged ambassadors. As a result of the modification of the Palestinian attitude towards Israel in September 2000, several Arab states reduced the level of relations with the State of Israel, principally regarding economic and commercial activities. Nevertheless, Israeli authorities continue their efforts to increase economic opportunities, especially with the goal of enhancing regional development.

Although Israel has entered into various agreements with Arab countries and the PLO, and various declarations have been signed in connection with the efforts to resolve some of the economic and political problems in the Middle East, no prediction can be made as to whether, and under what terms, a full resolution of these problems will be achieved. To date, Israel has not entered into a peace treaty with either Lebanon or Syria. In January 2000, Israel and Syria renewed the peace talks in Shepherdstown, which were the first talks between the countries after more than three years, but no breakthrough was achieved. On May 23, 2000 the Israeli military forces withdrew from South Lebanon, in accordance with a government decision to implement United Nations Resolutions 425 and 426.

Since 1948, the members of the Arab League have maintained a trade boycott of Israel. The primary tier of the boycott prohibits the importation of Israeli-origin goods and services by member states. The secondary tier of the boycott prohibits individuals in Arab League states from engaging in business with foreign firms that contribute to Israel's military or economic development, and the tertiary tier of the boycott prohibits business dealings with firms that do business with blacklisted entities. In September 1994, the Gulf Cooperation Council (which includes Qatar, Oman, Bahrain, United Arab Emirates, Saudi Arabia, and Kuwait) declared their intention to lift the secondary and tertiary trade boycotts of Israel, signifying a major shift in Israel's relations with several Arab nations in the region. In addition, four other Arab League members (Algeria, Djibuti, Mauritania, and Somalia) do not enforce the secondary and tertiary boycotts of Israel.

Prior to the recent unrest in the area administrated by the Palestinian Authority, Israel and its Arab neighbors had taken several initiatives to encourage the development of economic relations among the countries of the region. The formation of additional regional economic organizations had been proposed to enhance cooperation between Israel and other countries of the region. Among these, the most important are the Middle East Development Bank ("MEDB"), the Middle Eastern-Mediterranean Tourist and Travel Association ("MEMTTA") and the Regional Business Council ("RBC").

Israel maintains a close economic, diplomatic and military relationship with the United States. Israel receives economic and military assistance from the United States in amounts that have averaged approximately $3 billion per year since 1987. In 1991, the United States provided Israel with an additional one-time special grant of $650 million due to expenses incurred by Israel as a result of the Gulf War. In 1992, the United States approved up to $10 billion of loan guarantees during U.S. fiscal years 1993 through 1998 to help Israel absorb the recent influx of immigrants. (See "Public Debt—External Public Debt.")

The Government of Israel and the United States have agreed to reduce U.S. foreign assistance to Israel. This reduction involves a phase out of U.S. Economic Support Fund ("ESF") assistance to Israel through incremental annual reductions in the level of such annual assistance over a ten-year period that began in fiscal year 1999. Over the same time period, the United States will increase annually the level of its Foreign Military Financing ("FMF") assistance to Israel in amounts equal to half the amount of the annual reduction in ESF assistance. Subject to Congressional appropriations, from fiscal year 1999 through 2008 the level of ESF assistance will be reduced by $120 million and the level of FMF assistance will be increased by $60 million.

As a result of the peace process and the end of the Cold War, the number of countries that have diplomatic relations with Israel has risen significantly. Israel currently maintains diplomatic relations with more than 160 countries. Israel has established or re-established commercial, trade, and diplomatic relations with several republics of the former Soviet Union, nations of Eastern Europe, and other countries that had been aligned politically with the former Soviet Union. Furthermore, the developments toward peace in the region in the last decade have facilitated the growth of commercial, trade and diplomatic relations with several Asian countries, including Japan, South Korea, China, and India.

Membership in International Organizations and International Economic Agreements

Israel is a member of a number of international organizations, including the United Nations, the World Bank Group (including the International Finance Corporation), the International Monetary Fund (the "IMF"), the European Bank for Reconstruction and Development, and the Inter-American Development Bank.

Israel was a signatory to the General Agreement on Tariffs and Trade ("GATT") of 1947 from 1962 and a founding member of the the World Trade Organization Agreement (the "WTO"), which provides for the lowering of tariffs and elimination of non-trade barriers among members. Israel is one of the 26 members of the WTO Government Procurement Agreement, which provides for mutual market access for government purchases among its members.

In March 1996, the Council of Ministers of the Organization for Economic Co-operation and Development ("OECD") approved Israel's request to participate in the organization's activities, and Israel has accordingly joined certain OECD committees as an observer. Since February 2000, Israel has had a dialogue with the OECD leadership in order to promote Israel's admission to the organization as a full member.

Israel has concluded free trade area ("FTA") agreements with its major trading partners and is the only nation, except for Mexico and Jordan, that is a party to free trade agreements with both the United States and the European Union (the "EU"). Israel's FTA agreements allow Israel to export industrial products duty free to the United States and to most Western industrialized nations. In addition, Israel has free trade area agreements with the Czech and Slovak Republics, Hungary, Poland, Slovenia, Turkey, Canada, Mexico, Bulgaria and Romania, Switzerland, Norway, Iceland, and Liechtenstein.

In 1975, Israel established an FTA agreement with the European Economic Community ("EEC") that provided for the gradual reduction and ultimate elimination of tariffs on manufactured goods and certain agricultural products. In July 1995, Israel signed an Association Agreement with the EU which came into force in June 2000. The new agreement, which replaced the 1975 Agreement, contains clauses on financial services, competition, government procurement, and cooperation in research and development. It also expands the list of agricultural products under the 1975 FTA, and in an extension of the agreement improves Israel's access to European government procurement markets in the field of telecommunications. Israel, in a separate agreement, became a member of the EU's Fourth and Fifth Framework Programs for Research and Development, allowing Israeli firms and academic institutions to participate in EU research and development projects. An FTA agreement with the European Free Trade Association that applies to most manufactured goods has been in effect since 1993. In 1985, Israel and the United States entered into an FTA agreement that resulted in the elimination of all tariffs on all industrial products effective January 1, 1995. The FTA agreement with the United States also has resulted in the elimination of certain non-tariff barriers to trade between the two countries.

On February 22, 1999 Israel's admission to the EU's Fifth Research and Development Program was approved, recognizing the special status of Israel as a key technological player in the global arena. The program gives Israel access to $15 billion of research and development tenders within the EU countries. Israel is currently negotiating with the EU on its participation in the EU's sixth research and development program that will begin in November 2002.

In order to promote its international economic cooperation, and in particular Israeli investments in emerging markets, Israel has signed 32 bilateral investment treaties. The treaties provide investors from countries that are party to the treaties, with basic security and protection rights when investing in the other party's territory, including repatriation of investments and returns, no expropriation or nationalization other than for public purposes, prompt, adequate and effective compensation, and no less favorable treatment as compared to investors from countries that are not party to the treaties.

Israel is also a party to over 30 conventions for the avoidance of double taxation that cover most aspects of income and capital gains tax. The convention provides investors from countries that are parties to the convention with greater certainty when investing in the other party's territory and contributes to economic cooperation between the countries that are parties to the convention.

THE ECONOMY

Overview

Israel's economy is industrialized and diversified. Gross domestic product ("GDP") per capita in 2001 was $17,184. From 1990 through 2001, real GDP growth has averaged 5.0% per year (1.53% per capita). Growth was based largely on increased domestic demand due to the large volume of new immigrants and the growth of high value-added industries, such as electronics and high-tech medical equipment. The GDP growth rate in 1998 and 1999 slowed to 2.6-2.7% in each year, as a result of cyclical factors, the global financial crisis, restrictive monetary and fiscal policies, and other factors. During the period between the second quarter of 1999 until the third quarter of 2000, GDP growth recovered dramatically and reached an average annual rate of 10.4%. Growth during this period was led by high-tech exports and start-up companies. A number of negative factors converged in the last quarter of 2000 and resulted in a drop of 9.9% (at annual rate) compared to the third quarter of 2000. These factors included the security unrest with the Palestinian Authority, which negatively affected tourism, the drop in the Nasdaq index, which slowed investments in high-tech companies, and the economic slowdown in the U.S. economy, which lowered exports. As those factors persisted and worsened during the year, the domestic slowdown intensified and GDP decreased by 0.6% in 2001 and is also expected to decline in 2002 (on an annual basis), despite a small positive growth rate (2.4% at annual rate) in the first quarter of 2002, compared to the previous quarter.

The composition of Israel's trade sector reflects the industrialized nature of its economy. Exports consist primarily of manufactured goods, in particular high-tech goods (whose share in total exports increased rapidly in recent years), while raw materials and investment goods comprise approximately 86% of goods imports. Exports have played a significant role in Israel's economic growth, especially since 1992. Exports of industrialized goods (excluding diamonds) grew by an annual average of close to 9% during 1995-2001. In 2000, due to rapid growth in the US and the EU economies, Israel's exports of industrialized goods (excluding diamonds) increased by 28.7%. Total exports of goods and services increased by 23.7%. However, in 2001 exports of industrialized goods decreased by 6.8% in 2001 and total exports of goods and services decreased by 12.7%. The main factors behind the contraction of exports of goods were the global slowdown – which dampened global trade – and, especially, the high-tech crisis. Exports of services were severely affected by the large decline in exports of tourism services, caused by the security and political situation and the decline, to nearly zero, of start-up exports (sales of successful start-up companies to international buyers) due to the global high-tech crisis. Notwithstanding the steady growth in Israel's exports, Israel continues to experience deficits in its balance of civilian trade, although they have been decreasing in size since 1997. See "Balance of Payments and Foreign Trade—Foreign Trade."

Historically, the Government has had a substantial involvement in nearly all sectors of the Israeli economy. In the past decade, however, a central aim of the Government's economic policy has been to reduce its role in the economy and to promote private sector growth. In order to advance these goals, the Government has pursued a policy of privatizing State-owned enterprises, including banks. (See "Role of the State in the Economy") The Government has also pursued stability-oriented monetary and fiscal policies. These policies build upon the economic stabilization program established by the Government in 1985.

The 1985 economic stabilization program was a comprehensive plan designed mainly to reduce the high rates of inflation and the chronic balance of trade deficits experienced by Israel as a result of high levels of defense expenditures, rising Government spending and rising oil prices.

Since 1985, Israel has made significant progress in stabilizing inflation through effective implementation of monetary policy by the Bank of Israel, and fiscal restraint and trade liberalization by the Government. During the period 1986 through 1991, inflation stabilized to an annual average rate of 18.1%. During the period between 1992 and 1999, the annual rate decreased to an average of 9.5%. In 2000 and in 2001, average inflation dropped to a mere 1.1% in each year (but is expected to rise in 2002 as a result of the depreciation since December 2001).

Table No. 4 Main Economic Indicators

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
	(in millions of NIS unless noted)				
Percent Change:					
Real gross domestic product	3.3%	2.7%	2.6%	6.4%	(0.6%)
GDP per capita.	0.7%	0.2%	0.0%	3.5%	(2.9%)
Inflation (change in CPI – annual average)	9.0%	5.4%	5.2%	1.1%	1.1%
Industrial production	1.7%	3.0%	1.3%	9.7%	(5.0%)
Constant 1995 Prices:					
GDP	291,714	299,650	307,392	326,930	325,114
Business sector product	199,768	205,611	210,599	228,554	224,190
Permanent average population (thousands)	5,829	5,971	6,125	6,289	6,439
Current Prices:					
GDP	352,331	387,211	423,127	458,807	465,339
Business sector product	238,601	263,339	289,360	317,950	314,685
GNP	341,942	376,053	406,923	437,203	454,644

Source: Central Bureau of Statistics.

GDP equals GNP minus income of Israeli residents from investments abroad, earnings of Israeli residents working abroad, and other income from work and leases abroad, less corresponding payments made abroad (after deduction of payments to foreign companies with respect to production facilities located in Israel). Business sector product in Israel equals GDP less general Government services, services of private non-profit institutions, and housing services (representing the imputed value of the use of owner-occupied residential property).

Gross Domestic Product

GDP growth averaged 5% per year between 1990 and 1999, reached 6.4% in 2000 and decreased to –0.6% in 2001. From 1990 through 2001, Israel's aggregate real GDP grew by 69.7%, which reflects an annual real growth of 4.5%.

The most notable changes in the economy's use of domestic resources during 1990-1995 were the rise in private consumption, reductions in the level of defense expenditures as a percentage of GDP, an increase in investments in fixed assets and, since 1992, a significant increase in exports. From 1996 to 1999, rates of growth in private consumption dropped while the absolute level of investments decreased from its 1996 peak. After a major increase in tourism and exports of goods in 2000, the unrest in the Palestinian Authority and the terror attacks on Israel caused a sharp drop in tourism starting in the fourth quarter of 2000 and continuing during 2001. The recession in 2001 was attributed to a decrease in exports, which declined in volume terms (excluding diamonds and start-up companies) by 6.2%. In contrast to exports, domestic uses increased in 2001. An increase in public and private consumption and a decline in investment were conspicuous among the components of domestic uses.

Table No. 5 Resources and Use of Resources

	Year 1997	1998	1999	2000	2001
	(in millions of NIS at constant 1995 prices)				
Resources					
GDP	291,714	299,650	307,392	326,930	325,114
Imports of goods and services(1)	135,362	137,728	158,109	177,437	169,609
Total	427,076	437,378	465,501	504,367	494,723
Use of Resources					
Private consumption	172,126	179,528	185,265	197,515	203,962
Public consumption	84,946	86,988	89,663	90,658	93,276
Gross domestic investment	75,958	70,602	77,277	74,547	71,668
Exports of goods and services(1)	93,967	100,149	111,785	138,495	123,222
Total(2)	426,997	437,267	463,990	501,215	492,128

(1) Imports (f.o.b.), exports (f.o.b.), excluding factor payments and Government interest from or to the rest of the world.

(2) The estimates at 1995 prices were obtained by chaining estimates computed each year to previous year prices. Due to the chaining, the sum of the components of resources and of the use of resources may be different.

Source: Central Bureau of Statistics.

In 2001, total private consumption increased by 3.2%, compared to an increase of 6.6% in 2000. The purchase of durable goods decreased in 2001 by 1.7%, mainly due to the recession and the slower growth of personal income.

Israel's gross national savings rate as a percentage of GDP rose in 2001 to 18.2%, after dropping in 2000 to 17.6% from 19.3% in 1998 and 1999.

In 2001, total gross domestic investment (the sum of investments in fixed assets and the change in inventories) decreased by 3.8% in real terms, following a 3.5% decrease in 2000 and a 9.4% increase in 1999. Investment in fixed assets decreased by 6.5% in 2001 after increasing by 1.1% in 2000. The change in inventories in 2000 and 2001 was smaller than in the past due to a decrease in investments in start-up technology, which, like other investments in R&D, are counted as increases in inventories.

Investment in residential construction in 2001 decreased by 10% over the prior year, following a decrease of 6.4% in 2000 and a decrease of 10% in 1999. The three-year shrinking process of the construction sector is explained by the very fast expansion in the first half of the 1990s with the onset of the immigration wave. The cyclical shrinking of this economic branch was exacerbated by the unrest in the last quarter of 2000 and during 2001, which resulted in the absence from work of Palestinians, who accounted for 25-30% of the employees in this sector.

Business Sector Product

From the beginning of 1990 through the end of 1999, business sector product grew at an average annual rate of 5.9% in real terms, increased by 8.5% in 2000, and decreased by 1.9% in 2001 due to the abovementioned reasons.

Table No. 6 Composition and Growth of the Business Sector Product

	Real Annual Sector Growth					Percentage of Total
	1997	1998	1999	2000	2001	2001
Trade and services	1.1%	11.9%	7.4%	14.7%	(0.1%)	59.3%
Manufacturing	5.6%	4.7%	1.9%	9.9%	(6.9%)	25.3%
Transport and communications	5.1%	6.1%	3.5%	6.6%	(0.1%)	11.8%
Construction	2.1%	(7.2%)	(9.0%)	(4.7%)	(9.2%)	7.0%
Agriculture	0.2%	9.6%	(3.0%)	7.9%	5.4%	2.7%
Water and electricity	6.4%	5.4%	3.5%	7.3%	0.4%	2.9%
Total business sector	3.7%	2.9%	2.4%	8.5%	(1.9%)	100.0%

Source: Bank of Israel.

Trade and Services. The trade and services sector consists of retail and wholesale sales, professional services, banking, hotels, and other services. The product of trade and services industries increased by 14.7% in real terms in 2000 and decreased by 0.1% in 2001.

Manufacturing. Manufacturing production increased in real terms by 9.9% in 2000 and decreased by 6.9% in 2001. Both the increase in 2000 and the decline in 2001 were due to changes in the production of electronic components and communication equipment, the two biggest manufacturing sectors.

Table No. 7 Manufacturing Production by Category

	Annual Real Percentage Change					Percentage of Total
	1997	1998	1999	2000	2001	2001
Food, beverages, and tobacco	3.0%	0.8%	1.4%	0.1%	(0.8%)	10.5%
Mining of minerals and quarrying of stone and sand	(2.6)	4.0	(0.9)	(2.3)	1.5	2.7%
Textiles and clothing	(3.9)	1.3	2.7	(2.6)	(4.7)	4.7%
Leather and leather products	(13.6)	(14.9)	(13.4)	(10.2)	(13.9)	0.2%
Wood and wood products	(0.5)	(8.7)	(2.6)	4.5	(14.0)	2.2%
Paper and paper products	(1.3)	1.7	(2.5)	(0.1)	(3.9)	1.9%
Publishing and printing	(0.1)	3.0	(0.9)	(0.4)	(3.6)	4.1%
Chemicals products and refined petroleum	1.4	12.7	(3.5)	3.4	0.6	10.7%
Rubber and plastic products	(1.1)	3.2	4.6	3.3	1.9	4.8%
Non-metallic mineral products	(9.2)	(12.3)	(8.2)	(8.3)	(6.1)	2.6%
Basic metal	1.4	(5.8)	(0.5)	1.9	(6.5)	1.5%
Metal products	5.2	(0.9)	(3.4)	8.9	(4.0)	9.6%
Machinery and equipment	(8.8)	(0.2)	3.6	12.8	(7.6)	4.4%
Electric motors	(1.0)	10.3	0.1	2.0	(10.7)	2.1%
Electronic components	5.5	4.1	8.4	43.1	(9.9)	21.0%
Communication equipment	12.5	11.8	8.8	16.0	(17.4)	10.7%
Transport equipment	5.8	6.6	3.1	4.9	0.5	5.1%
Jewelry and goldsmiths	(1.5)	(6.1)	(14.9)	2.8	(7.4)	0.5%
Others	(8.9)	(1.4)	(3.6)	(0.5)	9.7	0.5%
Total excluding diamonds	1.7%	2.9%	1.4%	10.0%	(5.7%)	100%

Source: Bank of Israel.

Transport. Buses are the major form of public transportation. Bus routes exist in all cities in Israel and connect Israel's major cities, smaller towns, and rural areas. Israel also has a network of over 15,000 kilometers of roads, including highways that link Tel Aviv with Haifa, Jerusalem, and Beersheva. During the period from 1991 through 1999, the transport and communications sector product increased by an annual average of 8.0%. Government-owned railways run from Nahariya on the northern coastline to Be'er Sheva in the south, linking some of Israel's major cities and the southern part of the country.

The Government considers the development of an advanced railway system a top priority, and decided in December 1996 to establish a separate Railways Authority and a State-owned company for the development and promotion of rail transportation. In addition, the Government is exploring various alternatives for involving the private sector in rail infrastructure and operation, and has recently decided to allow a number of lines to be operated and built by the private sector. In April 1996, the Government established a special State-owned company for the purpose of planning and promoting a mass transportation system in metropolitan Tel Aviv. In early 2002, the Government announced a public pre-qualification tender for this purpose. In 2000, the Government issued a tender to establish a light rail build-operate-transfer ("B.O.T.") project in Jerusalem. The first line is expected to operate in 2006.

In 1997, the Government made initiatives to increase efficiency in the field of transportation. Following a tender, the first private bus lines went into operation in 1997. Tenders for more than 200 additional private bus lines were announced in 2000 and 2001. In January 1998, the Government decided to implement a reform in the procedure for obtaining taxi licenses, eliminating fixed quotas and gradually reducing license fees until 2007. As a result, the number of taxi licenses increased by more than 20% in 1998 and 1999, and by 8% in 2000 and 2001, respectively.

Since 1993, the Government has identified infrastructure improvement as one of its top priorities. From 1993 through 2001, the Government spent NIS 24.4 billion (in 2001 prices) on infrastructure improvements. From the beginning of 1993 through the end of 2001, NIS 18.3 billion (in 2001 prices) were spent on road projects. Traditionally, the Government financed the entire cost of all Israeli highways, while the cost of local roads was financed jointly by the Government and local authorities. The Government has approved a number of road construction projects, including the Israeli North-South toll highway and the Carmel Tunnel, which, unlike existing highways, will be privately funded. In January 1998, a company was granted the concession by the Government for the construction of the North-South toll highway. Construction of the project began in late 1999; its main section is expected to be completed in 2003.

Israel has three major seaports: Haifa and Ashdod on the Mediterranean coast and Eilat by the Red Sea. In 1999, 22.2 million tons of freight were unloaded and 12.9 million tons of freight were loaded at Israeli ports. The Government has approved in principle the construction of two new ports in Ashdod and Haifa. The cost of the proposed ports is expected to be financed by the Ports and Railways Authority.

Israel has three international airports. The main airport is Ben Gurion Airport in Lod, which is located approximately 40 kilometers from Jerusalem and 20 kilometers from Tel Aviv. Ben Gurion Airport served approximately 8 million passengers in 2001, compared to 10 million in 2000, and 9 million in 1999, with flights to most major cities in Europe, Asia, and North America. During the 1990s, air traffic to Israel increased by more than 100%, but declined in 2001. Plans are underway to expand Ben Gurion Airport, in order to increase the annual capacity for passenger arrivals and departures to approximately 16 million. The financing for this expansion is expected to be derived exclusively from Airports Authority revenues and project financing.

Communications. As of the end of 2000, 96.5% of Israeli households had at least one direct telephone line. In addition to the wire telephone network, Israel has four cellular telephone networks. More than 5 million cellular phones were in use in Israel in 2001. Since 1997, two consortia, in addition to the previous monopoly of Bezeq, the Israel Telecommunication Corp. Ltd., have been operating international communications services. Moreover, in March 2002, the cable stations were given licenses to provide internet services, using their cable infrastructures.

Until 1990, the Public Broadcasting Authority had an official monopoly on television broadcasts. In 1990, a second, privately run commercial television station began to operate. In addition, in 1990 a number of private local radio stations began to serve certain urban areas. In 1990, the first licensed cable television stations went into operation in Israel and, as of December 2001, more than 1.8 million Israeli households had access to cable television. On January 1, 1998, the Government decided to authorize another private television station and to issue a direct broadcast satellite ("DBS") television operating license to one or two operators. One DBS license was granted in January 1999 and satellite broadcasting began in July 2000. In December 2001 the Second Authority for T.V. and Radio granted an eight-year concession for the operation of another commercial television channel. Experimental broadcasting began in January 2002.

Construction. In 2001, investment in residential construction decreased by 12.8%, following a 7.2% decrease in 2000 and a 10.7% decrease in 1999. The consumer price index ("CPI")-adjusted price of owner-occupied apartments decreased by 4.7% in 2001, following a 5.7% decrease in 2000 and a 1.0% decrease in 1999. These decreases followed a period, from the end of 1993 through 1996, during which the demand for housing in the central regions of Israel had increased substantially. This increased demand resulted in a 12% increase in the CPI-adjusted prices of owner-occupied apartments in 1994 and a further increase of 6% and 3% in 1995 and 1996, respectively.

Agriculture. In 2001, agricultural exports totaled $638.8 million, representing only 3.2% of total merchandise exports (excluding diamonds).

In 2001, the major categories of agricultural production were livestock (46% of total agricultural revenues), vegetables (20%), non-citrus fruits (14%), ornamental plants and seeds (6%), field products (7%), and citrus fruits (6%). In 2001, 2.2% of all Israeli employees were employed in agriculture and investments in agriculture contributed to 1.9% of gross capital formation (excluding dwellings).

In order to increase competition and productivity in the agricultural sector, the Government has implemented structural reforms, including the elimination of production quotas for the major categories of agricultural products. These reforms encouraged a large shift from manufacturing, marketing, and financing of agricultural products through large cooperatives, which were heavily subsidized by the Government, to a system in which decisions regarding these matters are made by individual production units, which receive fewer subsidies from the Government.

Water and Electricity. In 2000, the water and electricity sector grew by 13.5%. The scarcity of fresh water is a major problem in the Middle East, and Israel is conducting discussions with various parties in the region with respect to the allocation of water resources. The primary sources of fresh water in Israel are the Sea of Galilee, the mountain aquifer (a portion of which is under the West Bank) and the coastline aquifer along Israel's western border. Water from these sources is distributed by pipeline throughout Israel, including the arid areas in the south.

Approximately 60% of Israel's fresh water is supplied through Mekorot Water Co. Ltd. ("Mekorot"), a State-owned company. See "Role of the State in the Economy." The remaining 40% of Israel's fresh water is supplied by private water associations established by agricultural users, and by certain municipalities. During 2001, Mekorot spent NIS 450 million on capital investments related to water, compared to NIS 470 million during 2000.

Approximately 60% of Israel's total water use and 45% of Israel's fresh water use is attributable to agriculture. The Government subsidizes approximately 30% of the cost of water used by the agricultural sector. Because of the utilization of practically all of Israel's existing fresh water resources, further development of agriculture involves intensifying the yield from land already irrigated and intense reuse of treated wastewater to reduce the use of fresh water that is needed for household consumption. Accordingly, in recent years, there has been a reduction in the size of agricultural crops, such as cotton, that require large amounts of water. To address the relative shortage of water, Israeli companies have developed a number of sophisticated irrigation systems, including micro-drip systems that permit efficient irrigation.

Israel has also increased its investment in purification and improvement of wells and sewage treatment plants. The 2002 Government budget includes provisions for both grants and loans to stimulate capital investment in these programs. The Government has also taken steps to facilitate the establishment of regional companies to assume responsibility from Israel's municipalities for the treatment of water and sewage. In July 2001, the Knesset passed a law regulating the commercial relationship between these regional companies, the municipalities and consumers. In April 2001, the government decided to increase the desalination of sea water to 200 million cubic meters, 100 million cubic meters of which will be provided by a B.O.T. project in Ashkelon.

Almost all electric power in Israel is provided by the Israel Electric Corporation ("IEC"), a State-owned company that generates virtually all its own power. See "Role of the State in the Economy." In 1996, the Knesset approved the Electricity Industry Law. According to the law, separate licenses for each type of activity in the electricity industry (generation, distribution and transmission) replace a concession that had been given to IEC. This law enables independent power producers to sell up to 20% of Israel's electricity to users through the existing transmission infrastructure of IEC. IEC has an exclusive license to distribute and transmit electricity through March 2006. A public utility commission has been established to supervise electric utility services, including the regulation of prices of electricity.

Energy

Israel's main sources of energy are oil and coal. Israel is almost totally dependent on imported fuel for its energy requirements, since domestic production of crude petroleum is negligible and Israel has no domestic production of coal. Most of Israel's foreign oil is purchased in the open market. The United States has agreed to supply Israel with oil pursuant to the Oil Supply Arrangement in the event of a failure of Israel's oil supply. In 2000, a substantial amount of natural gas was discovered near the shores of Israel.

Israel has succeeded in significantly reducing its dependence on oil for the production of electricity by switching to coal-fired power stations located along Israel's coastline, and by expanding a facility in Ashkelon. All of the coal used in Israel is imported. Israel purchases most of its coal from South Africa, the United States, Colombia and Australia, but it also purchases coal from other countries, including China. The shift to coal has not had a significant environmental impact in Israel, because the majority of coal used in Israel is low sulfur coal.

In 1997, the Government decided to establish a natural gas infrastructure in Israel. As the first stage of this initiative, IEC is negotiating the purchase of natural gas to be used in IEC's power stations. The second stage will include the establishment and operation of a natural gas infrastructure in Israel by a private or government owned company. Procedures for the selection of the company have already begun.

The legislative process for regulating the natural gas market was completed in 2001. According to the law, a Gas Authority will be established within the Ministry of National Infrastructure. The new authority will be responsible for, among other things, approving market development plans, establishing the safety standards for the transmission infrastructure, and determining prices. The law also defines the status of the company that will be responsible for the transmission of gas and the pipeline expropriation rights.

Table No. 8 Imports and Production of Crude Oil, Natural Gas, etc.

	Year			
	1997	**1998**	**1999**	**2000**
	(in thousands of tons oil equivalent)			
Imports:				
Crude Oil	14,081	11,875	12,404	12,597
Coal	5,063	5,925	5,709	6,178
Production:				
Crude oil	4.7	5.8	4.1	5.1
Natural gas	13.0	10.5	9.5	11.0
Hydroelectricity, solar and other solid fuel	559.8	491	449.1	460

Note: 2001 figures not yet available.

Source: Central Bureau of Statistics and Ministry of Infrastructure.

Tourism

Tourism plays an important role in the Israeli economy. Receipts from foreign tourism in 2001 decreased to $2.1 billion compared to approximately $3.8 billion in 2000, a record year. The 2001 receipts represented 5.1% of total exports (8.4% in 2000), and approximately 1.9% of GDP (3.4% in 2000).

The major tourist centers are Jerusalem, other significant religious sites, the Eilat area, the Dead Sea and its environs, and the Mediterranean coast.

From 1992 through 1995, aided by the peace process, the number of tourist arrivals to Israel increased by an average annual rate of 25%. Following terrorist attacks in central Israel, the number of tourist arrivals decreased by a total of 8.4% between 1996 and 1998, compared to the record high set in 1995. After a three-year slump, the number of tourist arrivals increased by 17.2% in 1999 compared to 1998, and by a further 8.5% in 2000.

The unrest in the areas administrated by the Palestinian Authority that began in September 2000 resulted in an immediate drop of 42% in the number of tourists entering Israel by air. The total number of tourists entering by air decreased by an additional 40% during 2001. At the beginning of 2002, the number of tourists further decreased as a result of the increasing security unrest. In the first four months of 2002, the number of tourists entering Israel by air was 250,400, compared to 414,200 and 704,800 in the first four months of 2001 and 2000, respectively.

Table No. 9 Tourist Arrivals by Area of Origin and Receipts

	Year					
	1996	1997	1998	1999	2000	2001
	(arrivals in thousands and receipts in millions of USD)					
Asia	213.8	204.9	177.4	228.7	226.3	115.3
Africa	64.5	56.8	49.4	48.0	59.5	40.9
Europe	1,212.5	1,146.9	1,082.3	1,293.4	1,414.5	669.0
Americas						
United States	435.1	420.7	451.0	515.2	485.1	266.2
Other	123.9	127.7	120.4	130.5	189.6	84.3
Oceania	27.9	29.4	25.0	28.9	28.4	12.6
Other	22.3	24.0	36.3	67.6	12.9	7.3
Total arrivals	2,100.0	2,010.4	1,941.8	2,312.3	2,320.6	1,195.7
Total receipts	$2,953.0	$2,876.1	$2,761.0	$3,559.0	$3,816.7	$2,163.0

Source: Central Bureau of Statistics.

Research and Development

The Government encourages investment in industrial research and development through support and incentive programs created under the Law for the Encouragement of Industrial Research and Development. The objectives of the Government's support for industrial research and development are to foster the development of technology-related industries, to create employment opportunities for Israel's scientific and technological labor force, and to improve Israel's balance of payments by increasing exports of high-technology products and reducing reliance on imports of such products. In 2000, 3.5% of GDP was invested in civilian research and development. Government support of civilian research and development (not including general university funds financed by the Government) totaled NIS 1.75 billion in the 2000 budget, NIS 1.7 billion in the 1999 budget and NIS 1.6 billion in the 1998 budget.

Israel participates in 17 international and bi-national research and development joint ventures, of which three are with the United States, two each with Canada, South Korea, and the EC Research and Development Program, and one each with Germany, India, China, France, United Kingdom, Japan, Singapore, and the Netherlands. The annual budget for the activity of these joint ventures is NIS 337 million in 2002. Five of these joint ventures are funded through an interest-bearing fixed deposit by the participants. The annual interest income finances the fund's activities.

Wages and Prices

In the early and mid-1980s, Israel's economy experienced high rates of inflation, reaching a peak of 445% in 1984. In response to this crisis, in 1985, the Government implemented the Economic Stabilization Program, which succeeded in reducing the rate of inflation to 19.6% in 1986, and maintaining the annual rate of inflation during the period from 1987 through 1991 at an annual average of 17.8%. As a result, price controls that were introduced as part of the Economic Stabilization Program were largely eliminated by mid-1988.

The inflation rate, measured by the Israeli consumer price index ("CPI"), averaged 10.9% during the period from 1992 to 1997, with fluctuations between 9% and 12.3% on an annual average basis. The annual average inflation rate was 5.4% in 1998 and 5.2% in 1999 and dropped to 1.1% in 2000 and 2001, due to the appreciation of the NIS, the cut in purchase taxes, and the restrictive monetary and fiscal policies.

Both the Ministry of Finance and the Bank of Israel have stated that reaching and maintaining price stability is one of their main priorities. Since the end of 1991, the Government has announced annual inflation targets as part of its effort to further reduce inflation. See "Public Finance – The Budget Process and Deficit Reduction." Since November 1993, the Bank of Israel has adjusted its key rate of interest on lending to banks on a monthly basis. With the lowering of inflation in the last two years, that interest rate has been lowered gradually. In December 2001, that rate was 5.8%, compared to 7.2% in April 2001. By the end of December 2001 the interest rate was sharply lowered to 3.8%. During May and June 2002, in light of a continuous and fast exchange rate depreciation and a subsequent rise in inflation expectations, the Bank of Israel raised the interest rate on several occasions up to 9.1% by June 24, 2002, resulting in a total increase of 5.3% since the beginning of 2002.

Table No. 10 Selected Price Indices

Period	CPI (excluding housing, fruits, and vegetables)	CPI	Wholesale Price of Manufacturing Output
	(Percentage change, annual average)		
1996	10.2	11.3	8.6
1997	8.3	9.0	6.3
1998	5.5	5.4	4.2
1999	6.0	5.2	7.1
2000	2.0	1.1	3.6
2001	0.3	1.1	(0.1)

Source: Central Bureau of Statistics.

The wage system in Israel is subject to comprehensive indexation under nationwide cost-of-living agreements. These agreements, negotiated by Israel's primary nationwide labor union and representatives of the major employers' organizations in the private sector (subsequently adopted by the public service employees), provide for partial indexation of wages for all employees every six months based on agreed-upon percentages of year-to-year changes of 4.25% or more in the CPI. Furthermore, wages in certain industries are subject to labor agreements that guarantee additional periodic wage increases, as well as equality of treatment with respect to wage increases with workers in other specified industries. In the past decade, wage linkage between sectors weakened as a result of the decreasing scope of unionization and the widening use of personal wage contracts.

In 2001, as a result of the lower than anticipated inflation rate, wages per employee post in the business sector increased by 2.9% in real terms after an increase of 6.9% in 2000, while public sector wages grew by 3% (4.7% in 2000).

Employment and Labor

One of Israel's most important resources is its experienced and highly educated work force. In 1999, approximately 37% of the Israeli population over 15 years of age had university or other advanced degrees. With this highly educated population, Israel has developed an export-oriented, technology-based industrialized economy. Over 28% of the Israeli work force consists of scientific, academic, and other professional, technical, and related workers, while 6% consists of administrative or managerial workers. These percentages compare favorably with the percentages of similar workers found in the United States and Japan. The employment qualifications of the recent immigrants have been consistent with the high quality of the Israeli work force, with two-thirds of immigrants from the former Soviet Union having been employed there as professionals, scientists, engineers, and technical staff.

The wave of immigrants since 1990 has led to significant growth in the Israeli labor force. In 2001, Israel's civilian labor force averaged a total of 2.5 million compared to an average of 1.7 million during 1992.

After peaking at 11.2% at the end of 1992, Israel's unemployment rate decreased substantially during the period from 1994 through 1996, as the creation of jobs outpaced the growth of the civilian work force. In 1997-1999, due to the economic slowdown, the unemployment rate increased. As a result of a marked increase in the participation rate in the work force, from 53.8% in 1999 to 54.3% in 2000 and 54.4% in 2001, unemployment increased from 8.9% in 1999 and 8.8% in 2000 to 9.4% in 2001. Due to the deepening of the recession during 2001, the unemployment rate increased further reaching 10.6% in the first quarter of 2002.

Table No. 11 Structure of Employment in Israel(1)

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
Percent of labor force					
Business sector					
Manufacturing	19.6	18.9	18.4	18.0	17.5
Agriculture	2.4	2.3	2.3	2.2	1.9
Water and electricity	0.9	1.0	0.9	0.9	0.9
Construction	7.2	6.3	5.7	5.3	5.1
Trade and catering	16.7	17.0	17.7	18.7	17.2
Financial and business services	13.7	14.1	14.1	15.0	15.5
Transport, storage and communications	6.1	6.0	6.4	6.6	6.6
Personal and other services	1.6	1.5	1.9	1.6	1.6
Total	67.4	67.2	68.2	68.5	66.3
Public service(2)	32.6	32.8	31.8	31.5	33.7
	100.0	100.0	100.0	100.0	100.0
Total workers (in thousands)	2,040.2	2,072.6	2,136.7	2,221.3	2,270.1

(1) Israeli workers only.

(2) Including part of the personal services.

Source: Central Bureau of Statistics.

Surveys undertaken by the Israeli Central Bureau of Statistics regarding immigrants who came to Israel in 1990 indicate that immigrant unemployment declines with length of stay in the country. In 2001, the unemployment rate among immigrants was 10.5% compared to 9.4% for the total population. Among immigrants who came to Israel in 1990-1991, unemployment stood at 7.5% in 2001, compared to 9.3% for the population as a whole. Immigrant participation rate in the labor force stood at 57.8% in 2001 (60.6% for immigrants arriving in 1990-1991), compared to 54.4% for the working age population as a whole.

Despite the initial difficulties experienced by many of the professional and other highly-skilled immigrants in finding suitable employment, statistical data regarding employment in Israel suggests that immigrants have moved from their original jobs into jobs better suited to their education and other employment qualifications. One important factor in this transition has been the professional requirements of Israel's high-tech companies, which matched well with the educational and professional background of the immigrants.

Table No. 12 Principal Labor Market Indicators

	Year				
	1997	1998	1999	2000	2001
	(annual average)				
Permanent average population (thousands)	5,829	5,971	6,125	6,289	6,439
Population aged 15+	4,129	4,243	4,358	4,487	4,605
Civilian labor force (thousands)(1)	2,210	2,266	2,345	2,437	2,503
Labor-force participation rate(2)	53.5%	53.4%	53.8%	54.3%	54.4%
Unemployment rate – new definition	7.7%	8.5%	8.9%	8.8%	9.4%

(1) The sum of the number of civilian workers and the number of job seekers.

(2) Civilian labor force as a percentage of the population over the age of 15.

Source: Central Bureau of Statistics.

The General Federation of Labor in Israel (the "Histadrut") has historically played a significant role in the Israeli economy and social system. As part of a structural and organizational reform, the Histadrut concentrates today on its function as a trade union and as a social organization. The Histadrut also has a major influence on labor legislation and social legislation in the Knesset.

Over 30 trade unions are members of the Histadrut. Although the percentage of union workers has been declining, mainly due to the abolishment of the linkage between membership in the Histadrut and the Kupat Holim (the largest provider of health services), a considerable part of the Israeli labor market is unionized. The coverage of collective agreements is much more comprehensive. The Histadrut signs collective bargaining agreements, affecting workers in both the public and private sectors. In addition to the nationwide agreements (such as the cost-of-living agreement), the collective bargaining network includes collective agreements between occupational or industry unions and employers associations. These agreements are predominant in the public sector. Collective agreements cover issues related to wages, conditions of employment, and social benefits.

Role of the State in the Economy

Historically, the Government has been involved in nearly all sectors of the Israeli economy, particularly in defense-related businesses. Traditionally, ownership of industry in Israel was divided between the Government, the Histadrut and the private sector, with the Government and the Histadrut prominent in heavy and basic industry. The Government has also participated in the economy through significant subsidization of certain industries and products, and through financial support of private sector investments. In recent years, the Government has made significant progress towards the privatization of State-owned enterprises and the reduction of its subsidization of industry. At the same time, the Histadrut has disposed of most of its commercial holdings.

As of December 31, 2001, there were 101 State-owned companies, 43 of which are commercial enterprises. The remainder of the State-owned companies, such as funds established as vehicles for employee savings, are not commercial. State-owned enterprises are divided into two categories: Government Companies and Mixed Companies.

Government Companies, which exclude State-owned banks acquired pursuant to the Bank Shares Arrangement (defined below under "Privatization"), are those in which the Government owns more than 50% of the voting shares and are subject to the provisions of the Israeli Government Companies Law and the regulations promulgated thereunder (the "GCL"), as well as the directives of the Government Companies Authority (as defined below under "Privatization"). The provisions of the GCL regulate the management and operations of Government Companies and the circumstances under and procedures by which the Government may sell shares in Government Companies.

Mixed Companies are companies in which the State owns less than 50% of the voting shares. Under the GCL, Mixed Companies are not subject to the same degree of regulation as Government Companies. However, Mixed Companies do remain subject to certain provisions, including the appointment and qualification of the directors chosen by the Government and the establishment of terms of employment.

Government Companies play a significant role in the Israeli economy. In 2000, Government Companies accounted for 7.5% of total exports, although they employed only 2.2% of the Israeli workforce. These companies include several public service monopolies and a number of companies that either engage in activities considered crucial to Israeli national security or provide important services to the Government.

The Government has initiated a number of regulatory arrangements with the major Government Companies that are designed to increase competition in the markets in which these companies participate, and thus prepare them for privatization. Nevertheless, the pace of privatization may be affected by the need for further regulatory and structural reforms and formulation of policies that will define the post-privatization environment in which these companies will operate. The development and implementation of some of these policies and reforms may take a considerable period of time.

Privatization. An essential element of the broader structural reforms initiated by the Government over the past several years to promote the growth of the private sector and to enhance competition was the Government's move towards privatizing its business holdings. Privatization efforts have included the full or partial sale of State-owned companies, banks and activities which were previously performed by the Government or statutory authorities. From 1986 through June 2001, the Government received approximately $8.7 billion from privatizations. From 1986 through June 2001, 79 companies ceased to be Governmental Companies.

Privatization of all State-owned enterprises, other than banks, is conducted by the Government Companies Authority (the "Government Companies Authority"). Pursuant to the Bank Shares Arrangement (as described below), the responsibility for privatization of banks is in the hands of the Ministry of Finance through MI Holding, a wholly-owned government entity. MI Holding advises the Minister of Finance regarding bank privatizations and manages the process according to the Minister's instructions. The previous Government transferred the responsibility for the Government Companies Authority from the Ministry of Finance to the Prime Minister's Office. The ministerial privatization committee, consisting of the Prime Minister, as chairman, the Minister of Finance, and the Minister of Justice (the "Privatization Committee"), has the power to initiate the privatization of any Government Company or Mixed Company without the consent of the minister directly responsible for such Government Company or Mixed Company, and to authorize preparatory measures necessary to effect such privatization. The Government Companies Authority also has general authority relating to the supervision of Government Companies, including the right to convene board meetings and the authority to issue directives to Government Companies in relation to decisions of the Privatization Committee.

In 1983, as a result of the collapse in the share prices of several large banking institutions on the Tel Aviv Stock Exchange (the "TASE"), the Government entered into an arrangement (the "Bank Shares Arrangement") with shareholders. Under the Bank Shares Arrangement, the State purchased shares from the banks' shareholders at the time of the crisis. As a result, the State gained a controlling stake in five of the six largest Israeli banks (though it did not exercise any management control over these banks). The Government's ongoing privatization program is intended to result in the sale of the State's controlling interest in these banks. Implementation of this program continues to progress as the Government has reduced its bank holdings through a variety of public and private transactions.

In July 1999, the State sold 3.96% of the shares in Bank Hapoalim, resulting in proceeds of $120 million. In June 2000, the State sold the rest of its holdings in Bank Hapoalim (17.3% of the shares) for $574 million, and since then the State has minimal holdings (of less than 1%) in Bank Hapoalim.

In December 1999, the State sold its remaining holdings in United Mizrahi Bank of 4.5% through the exercise of options by the public and sales on the TASE. Proceeds from United Mizrahi Bank shares were $28.5 million.

In January 2000, the public exercised options to purchase 8.35% of the shares in Bank Leumi for $184 million. In accordance with the decision of a joint committee of the Bank of Israel (Supervisor of the Banks) and the Ministry of Finance (Accountant General), the Government intends to continue privatizing Bank Leumi by selling the remaining State-owned shares through the capital market.

As of December 31, 2001, the State owns 41.73% (fully diluted) of Bank Leumi and 57.09% of Israel Discount Bank.

Table No. 13 Selected State-Owned Companies(1) (at, or for the period ended, December 31, 2001)

	Percentage Direct and Indirect Ownership of Government	Total Assets	Long-Term Liabilities	Total Revenues
	(in millions of dollars, except percentages)			
Bezeq, the Israel Telecommunications Corp. Ltd.	54.6%	$3,890	$1,142	$1,848
Israel Electric Corporation Ltd.	99.8	11,891	8,525	2,376
Oil Refineries Ltd.	74.0	1,282	464	2,540
Zim Israel Navigation, Ltd.	48.6	1,246	697	167
El Al Israel Airlines, Ltd.	100.0	1,509	1,418	1,111
Israel Aircraft Industries, Ltd.	100.0	1,825	269	2,089

(1) Based on consolidated and NIS adjusted financial statements as of December 31, 2001 according to Israeli accepted accounting principles. Amounts converted from NIS to Dollars at the exchange rate on December 31, 2000 ($1=NIS 4.41).

Source: Ministry of Finance; Government Companies Authority.

Set forth below are summary descriptions of the State-owned companies included in the above table. Also described below are specific steps taken or planned by the Government to prepare those companies for privatization or to reform their structure and operations.

Bezeq, the Israel Telecommunications Corp. Ltd. ("Bezeq"), is the State-owned telecommunication corporation. Its operations are subject to regulatory arrangements by the Government, including tariff and structural supervision. Arrangements implemented since 1994 are designed to increase competition in the communications sector. International telephony services are provided by three companies (of which one is a fully owned subsidiary of Bezeq). Cellular services are provided by three companies (of which one is 50% owned by Bezeq). In June 1999 Bezeq's legal right to exclusivity in supplying fixed telecom services was terminated. One license to a new operator was granted, but no services have been provided to date. The State holds 54.6% of the share capital of Bezeq. The remaining shares are held by the public, of which approximately 20% is held by Zeevi Communications Holding Ltd. Bezeq's shares are traded on the TASE.

In July 1997, the State reduced its interest in Bezeq to 63.6% (fully diluted) by selling a 12.4% interest to Merrill Lynch & Co. for $250 million, $50 million of which was included in the 1997 budget and the balance of which was recognized in the 1998 budget. In February 1998, the State sold additional shares in a public offering in Israel, raising $138 million and reducing the State's ownership level to 54.6% (fully diluted).

On August 27, 2000, the Privatization Committee decided to privatize the State's holding in Bezeq by way of a private sale. The sale will include shares representing at least 50.01% of the fully diluted share capital of Bezeq. The Knesset Finance Committee approved this plan at its meeting on September 6, 2000, in accordance with the Government Companies Law. During November 2001, announcements were published in the media in Israel and abroad inviting interested parties to participate in the sale process. In March 2002, applications to the Government Companies Authority were submitted. Applicants that comply with threshold conditions will be invited by the Government to continue participation in the process and provide additional information.

Israel Electric Corporation Ltd. ("IEC") is a legal monopoly with responsibility for the entire Israeli electricity industry. Since 1992, IEC has been subject to tariff supervision that includes efficiency incentives. In March 1996, IEC's exclusive concession from the Government expired and the Electricity Industry Act was enacted. Additionally, an authority for the supervision of public electric utility services was established. The purpose of the new law is to regulate activity in the electricity industry for the benefit of the public, and to achieve reliability, availability, quality and efficiency, while guaranteeing cost minimization within a competitive market. The new law provides for a ten-year transition period, during which IEC has a license to transmit, distribute, supply and market electricity. According to the new law, the owner of the license for transmission or distribution functions will be required to purchase electricity from other generators of electricity, and to enable other licensed producers to use the same transmission and distribution channels to supply electricity to its consumers. On January 1, 1998, IEC received licenses, valid until March 3, 2006, to produce electricity at each of its 63 generation units. In August 1999, the Government decided to establish a ministerial committee on reform in the electricity market infrastructure, which appointed an international consultant to advise the committee. The committee has not yet finalized its conclusions, but it has already decided that the electricity market's future structure will be competitive and decentralized. The IEC decided to purchase natural gas from two suppliers to be used in IEC's power stations. The natural gas power stations are expected to replace the oil-fired power stations that operate together with the coal-fired power stations.

Oil Refineries Ltd. ("Oil Refineries") is the only oil refinery company in Israel. Oil Refineries operates in the framework of Government reforms that have linked fuel prices in Israel to fuel prices in the international market. Oil Refineries is entitled to sell its products strictly to wholesalers and to certain key customers. The Government is currently exploring various methods of increasing competition in the Israeli oil sector, including the allocation of the two refinery facilities to separate companies, one in Haifa and one in Ashdod, and the deregulation of tariffs.

Israel Chemicals Ltd. ("Israel Chemicals") is an integrated group of companies engaged in obtaining the minerals and chemicals of the Dead Sea, and in the manufacturing, development, marketing, and sale of chemical and fertilizer products. Most of Israel Chemicals' sales are to markets outside of Israel. In February 1995, the State sold a 24.9% stake in Israel Chemicals to two private investors (under common control). In March 1997, the State sold an additional 17% stake to the same investors. In addition, 25.5% of the shares are held by the public and traded on the TASE. In June 1998, the Finance Committee of the Knesset approved the Government's decision to sell the remainder of the State's shares in Israel Chemicals in public offerings on the TASE. In December 1998, the State sold 29.3% of outstanding ICL shares in a public offering in Israel, raising $302 million and reducing the State's ownership in the company to 2.2%. In 1999, the State sold 0.52% of its shares on the TASE, raising approximately $7 million, and continued to reduce its holdings to 0.11% by April 2000, raising approximately $20 million.

Zim Israel Navigation, Ltd. ("Zim"), which is privately managed, is Israel's major shipping company. Zim is a Mixed Company. The State holds approximately 48.6% of its shares and The Israel Corporation holds approximately 48.8% of its shares. In 1970, The Israel Corporation was granted first right of refusal over the State's shares in Zim. On August 17, 2000, the Ministerial Committee on Privatization decided to sell all of the State's holdings in Zim, other than a special State Share that grants the State certain veto powers over corporate decisions. On October 4, 2000, the Finance Committee of the Knesset approved the method of privatization of Zim as stated in the above decision of the Ministerial Privatization Committee. During May 2001, announcements were published in the media inviting interested parties to participate in the sale process. On July 26, 2001, applications to the Government Companies Authority were submitted. During January 2002, applicants were invited to enter the company's dataroom. In the next stage of the process, the invited applicants will be required to sign the agreement for the sale of the State's shares, prior to submitting their bids.

El Al Israel Airlines, Ltd. ("El Al") is the Israeli national air carrier. The Government is in the process of preparing for the privatization of El Al. Important elements of this preparation will be the restructuring of El Al's capital structure, the formulation of a plan to finance El Al's expenses for security measures (at least a portion of which are expected to continue to be financed by the Government), and the issue of flights on the Jewish Sabbath and holidays (days on which El Al currently does not fly due to Government regulations enacted in 1982). In 1995, El Al emerged from a reorganization program under which it had operated since 1982 due to labor difficulties at that time. The Privatization Committee decided in June 1998 to privatize up to 50% of El Al by means of a public offering of state shares and newly issued stock in proportions yet to be determined. The privatization is conditional upon the authorization of the Knesset Finance Committee, which has yet to be granted.

The Mekorot Water Company Ltd. ("Mekorot") is the State-owned water company. It supplies approximately 65% of Israel's consumption of water. Approximately 14% of Mekorot's income from supplying water is subsidized by the Government through payments intended to compensate Mekorot for the below-market tariffs charged mainly to agricultural and other consumers. In 1993, Mekorot and the Government agreed on an arrangement establishing efficiency incentives for the years 1993 through 1997 and securing Mekorot a normative return on equity, enabling it to raise capital in private capital markets rather than receiving subsidized loans from the Government. The Government and Mekorot continue to operate under this arrangement, which is extended every few months.

Petroleum and Energy Infrastructures Ltd. ("PENIN") provides infrastructure services for the petroleum industry, including acting as the sole provider of storage and transportation services for refined oil. PENIN's subsidiaries plan, build, operate, and maintain systems and facilities for the transportation and distribution of petroleum products. The State controls the tariff rates of its products and services. Until January 2001, PENIN operated under a concession from the Government. In January 2001, an agreement in principle was signed between the State and PENIN to govern PENIN's activities after the end of the concession. Implementation of this agreement is currently under negotiation.

In October 2000, the State and Israel Industrial Development Bank Ltd. sold their holdings in Israel Industrial Development Investment Company Ltd. for NIS 212 million, of which the State received 50%.

In February 2001, the State (together with the three major banks) sold its holdings in Otzar Hashilton Hamekomi Ltd. for NIS 71 million, of which the State received NIS 42 million.

The Israeli Credit Insurance Company Ltd. ("B.S.S.CH") operates in the short-term export credit insurance sector (commercial and political risk insurance activity). The State sold its 100% holdings in B.S.S.CH in November 2001 for NIS 37 million.

Shekem Ltd. operates in retail commerce. The State sold its holdings of 23.33% for NIS 20 million in May 2001.

Afridar Housing and Development Corp. operates as an initiator of development and construction projects. The State sold its 100% holdings in Afridar for NIS 80.5 million in February 2001.

Two other Government Companies, Israel Aircraft Industries, Ltd. and Israel Military Industries, Ltd., are, like other defense-related industries worldwide, in the process of undergoing major restructuring in response to changing market conditions. As part of the restructuring process, the number of employees of these companies has been reduced significantly, resulting in large severance pay expenditures by Israel Military Industries, which have had a negative effect on their recent operating results.

Government Subsidies. Prior to 1985, the Government heavily subsidized certain segments of the Israeli economy, including basic foodstuffs and agricultural products. The level of direct Government subsidies has been reduced significantly since 1985. The remaining direct Government subsidies consist primarily of subsidies for water, for public transportation, and for agricultural production. Government subsidies for basic products totaled NIS 2.1 billion during 2001, of which NIS 313 million were agricultural subsidies.

Economic Incentives. The Government provides significant assistance to the manufacturing sector under laws designed to encourage investments in "approved enterprises," mainly in peripheral regions of the country. A project that qualifies as an "approved enterprise" is eligible for assistance in the form of cash grants or tax benefits.

Beginning in January 1997, the Government implemented a significant reduction in the rate of grants. For the purpose of determining eligibility for grants, three industrial regions have been identified: Region A, the most remote regions of the country; Region B, the peripheral regions of the country (closer to the central regions than A); and Region C, all other regions. The rate of grants as of January 1998 for Region A is 24% for investments up to NIS 140 million, and 20% for investments above this limit, compared to 10% for Region B for all levels of investments, and 0% for Region C for all levels of investments. Two regions have unique grants programs. In the northern border area the rate of grants is 30% for investments up to NIS 140 million, and 26% for investments above this limit, and in the Negev area the rate of grants is 30% for investments up to NIS 140 million, and 32% for investments above this limit.

During 2001, Government commitment for grants and tax benefits to the manufacturing sector totaled NIS 1.1 billion, compared to NIS 2.4 billion in 2000, NIS 1.3 billion in 1999 and NIS 1.4 billion in 1998. Almost all of the increase in 2000 was due to one unusually large investment of NIS 1 billion. The decrease in 2001 was attributable to a decline in demand for government investment support, as a result of the economic slowdown and the reduction in overall investments.

Kibbutzim and Moshavim

Kibbutzim are collective settlements that traditionally were primarily agricultural. However, most kibbutzim now derive a majority of their revenues from manufacturing, tourism, and other services. There are approximately 270 kibbutzim in Israel with approximately 117,000 members. Moshavim are cooperative settlements, most of which consist of individual owners of small farms. Moshavim derive a large percentage of their revenues from agriculture. There are approximately 455 moshavim with approximately 185,000 members. Both the kibbutzim and the moshavim experienced financial crises in the 1980s.

In 1988, the Government and the bank creditors of the moshavim agreed upon a rescue and recovery program for the moshavim. In 1992, the Knesset approved legislation requiring partial debt forgiveness by the moshavim's bank creditors, partial repayment of moshavim debt using the proceeds of certain required asset sales by the moshavim, and the restructuring of the remaining moshavim debt at below-market interest rates. The total outstanding amount of the moshavim debt as of December 31, 2001, subject to the 1992 legislation is NIS 11.4 billion. The implementation of the 1992 legislation is ongoing. As of December 31, 2001, the 1992 legislation had been implemented with respect to approximately 84.8% of the individual moshavim members and 82.8% of the moshavim union obligors on the moshavim debt. By December 31, 2001, NIS 8.6 billion, representing 70.0% of the debt, was settled.

The agreement establishing the main rescue and recovery program for the kibbutzim was signed by the bank creditors of the kibbutzim, the kibbutzim, and the Government in 1989. The plan provided for a reduction in the kibbutzim's outstanding indebtedness by NIS 5.676 billion (December 31, 1988 data as calculated for December 31, 2001 on a 3.5% interest + index basis), of which 40% was to be paid by the Government and the remainder was to be written off by the bank creditors. The plan also provided for the restructuring of NIS 17.504 billion of the kibbutzim's outstanding loans from the banks. This restructuring was to be funded in its entirety by below-market loans by the Government to the kibbutzim's creditors.

By early 1995, it had become clear that the NIS 5.676 billion in debt reduction for the kibbutzim, negotiated in 1989, was inadequate. On May 6, 1996, a supplemental agreement was signed by the kibbutzim, the Government, and the seven relevant banks. The principles of the supplemental agreement included the following: (a) The debt, which had been rescheduled in the first arrangement (1989) was divided into two categories: a "refund debt," which the kibbutzim are able to repay, and a "balloon debt," which the kibbutzim are unable to repay and which is covered by the supplemental agreement; (b) NIS 5.63 billion indebtedness of the kibbutzim and the corporations they own was to be written off (in addition to amounts provided for in the 1989 agreement) by their bank creditors; (c) NIS 1.073 billion was to be written off by the banks, provided the kibbutzim pay their debts regularly in the first three years following the signing of the agreement (the "Incentives"); (d) the kibbutzim will surrender to the Government their rights to use 27% of their land leased from the Government; and (e) the Government would pay the banks between 25% and 35% of the aggregate sum of the indebtedness to be written off and of any Incentives. In April 1999, an amendment to the supplemental agreement between the Government, the banks and the kibbutzim was signed, and was approved by the Knesset Finance Committee. The principles of this agreement are: (i) the kibbutzim will surrender to the Government their rights to use 27% of their land leased from the Government (as in the supplemental agreement), (ii) the banks will continue to write off the kibbutzim debt under the supplemental agreement, where 35% will be paid to the banks by the Government in five annual payments bearing interest of 1.5% over the CPI, and 65% will be written off by the banks, and (iii) the Government will market the land surrendered by the kibbutzim and the proceeds of the sales will be distributed between the Government (35%) and the banks (65%).

Pursuant to the first agreement, the supplemental agreement and the amendment, an aggregate of NIS 12.4 billion was written off by the banks, of which 5.6 billion was paid to the banks by the Government. If the remainder of the agreement is executed, then 18 additional kibbutzim, owing an additional debt of NIS 1.284 billion to the banks, will join the agreement. In this case, the government will cover 35% of the debt.

The Environment

Since the establishment of the Ministry of the Environment ("MOE") in 1989, many environmental laws and regulations have been formulated and promulgated. In 1998, a new procedure for establishing environmental regulations has been implemented. Under this procedure, the MOE formulates environmental standards after consulting with representatives of relevant government ministries and bodies that are likely to be affected by the proposed regulations. The timetable for preparing each standard is not to exceed 24 months. Recently, proposed regulations regarding packaging, fuel storage, ozone-depleting compounds, radio frequency radiation, hazardous waste, and reuse of waste water have been under consideration through this procedure.

In January 1998, a new covenant was signed between the MOE and the Israel Manufacturers' Association concerning reductions in pollutant emissions. The landmark decision to sign such a covenant is the first example in Israel of voluntary compliance by industry with emission standards that have yet to be promulgated. The largest Israeli industries also signed the covenant. In addition, the MOE has concluded an agreement in principle with IEC, the Israeli electric provider. In this agreement, which is to be ratified shortly, emission standards in the company's power plants were defined.

In 1999 the Knesset approved a landfill fee, which is expected to be introduced, for the first time in Israel, during 2002.

Recognizing the importance of adopting environmental management systems, such as ISO 14000, in creating international business opportunities, many Israeli companies are adopting such management systems voluntarily.

In May 1999, Israel signed the Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals in International Trade ("PIC"). Israel has been party to the Convention on Biological Diversity since 1995 and is working towards signing the Cartagena Protocol on Biosafety to the Convention on Biological Diversity. Israel attaches great importance to the issue of climate change. After signing The United Nations Framework Convention on Climate Change in 1992 and ratifying it in 1996, the State of Israel signed the Kyoto Protocol to the United Nations Framework Convention of Climate Change in December 1998.

In 2000, the Palestinian and Israeli Ministries of the Environment held two meetings to discuss common environmental problems and ideas for improving cooperation in the environmental field. Israeli experts provided professional answers to their Palestinian counterparts following concerns raised at the meeting, and cooperation in the field of nature conservation was agreed upon. In 2000, the Jordanian and Israeli Ministries of the Environment held a meeting to promote cooperation on various environmental issues of common concern, and in particular on the rehabilitation of an agreed portion of the Jordan River. Cooperation on this issue is now high on the list of priorities of both Ministries.

BALANCE OF PAYMENTS AND FOREIGN TRADE

General

As a small country with a relatively limited domestic market, Israel is highly dependent on foreign trade. International trade (exports plus imports) in goods and services amounted to approximately 79% of GDP in 2001 (up from approximately 74% in 1997-1998).

The goods and services trade deficit increased in 2001 to $4.7 billion compared to $1.4 billion in 2000, as a result of a dramatic decrease in exports, which had a nominal decrease of 14% to $38.7 billion, and a more moderate decrease in imports of 6.6%, to $43.4 billion. The factor income payments (the sum of profits and interest from international investments and payments to foreign workers) deficit decreased by 49.5% to $3.4 billion in 2001 after a 30.3% increase in 2000.

Economic and military assistance furnished by the United States, German reparations, and personal and institutional remittances decreased by 3.5% in 2001 after increasing by 0.5%-4.3% in the preceding years.

Foreign currency reserves grew from $6.9 billion at the end of 1994 to $23.3 billion at the end of 2001. The three-fold increase is explained by a real 150% increase in exports and imports, as well as the Bank of Israel's monetary policy. High interest rates led to an appreciation of the NIS over the benchmark basket of foreign currencies. In 1996 and 1997 the Bank of Israel chose to purchase foreign currency in order to protect the bottom of the exchange rate diagonal band rather than decrease the interest rate.

As of December 31, 2001, Israel's net foreign debt (as reported by the Central Bureau of Statistics) was $4.5 billion (4% of GDP), as compared to $20.8 billion (23.1% of GDP) at the end of 1995.

Balance of Payments

The balance of payments consists of two parts: (i) the current account, which measures the trade balance (receipts and payments derived from the sale of goods and rendering of services) and transfer payments, and (ii) the capital and financial account, which reflects borrowing by the Government and the private sector, direct investment in Israel and abroad, and assets and liabilities of commercial banks.

The current account deficit remained stable at $1.7 billion in 2001. In the second half of the 1990s the current account deficit decreased steadily, due mainly to an improvement in Israel's terms of trade and a greater increase in exports than the increase in imports.

Table No. 14 Balance of Payments

	Year			
	1998	1999	2000	2001
	(in millions of dollars)[4]			
Current account (net):				
Exports[1]	$ 35,013	$ 39,181	$ 49,421	$ 42,412
Imports[1]	(42,536)	(48,556)	(57,439)	(50,512)
Trade balance (net)[1]	(7,523)	(9,375)	(8,018)	(8,100)
Transfer payments (net)				
Personal restitutions from Germany	789	737	614	727
Other personal remittances (net)	992	1,151	1,273	1,170
Institutional remittances	386	416	559	439
Intergovernmental remittances	3,916	4,026	4,156	4,034
Total	6,083	6,330	6,602	6,370
Current account balance	$ (1,440)	$ (3,045)	$ (1,416)	$ (1,730)
Capital and financial account:				
Capital transfers	577	569	494	446
By the Government	180	163	161	160
By other	397	406	333	285
Financial account				
Direct investments	697	2,083	1,591	1,856
Abroad	(1,063)	(806)	(2,802)	(1,188)
In Israel	1,760	2,889	4,392	3,044
Portfolio investment	2,495	1,775	2,131	(598)
Assets	21	(936)	(2,879)	(706)
Equity securities	103	255	(1,617)	(208)
Debt securities	(82)	(1,191)	(1,263)	(497)
Liabilities	2,474	2,711	5,011	108
Other investments	(1,925)	(222)	(654)	(2,589)
Assets	(2,319)	(4,085)	(2,432)	(3,818)
Government	(13)	(188)	(142)	(887)
Private sector	(497)	(3,131)	(1,084)	(2,567)
Banks	(1,809)	(766)	(1,206)	(584)
Liabilities	394	3,863	1,778	1,229
Government – long term	(278)	236	249	273
Government – short term	(12)	23	0	0
Private sector – long term	(57)	(66)	(70)	111
Private sector – short term	(784)	1,271	(58)	(1,038)
Banks	1,524	2,400	1,657	1,883
Reserve assets (net)	(1,880)	(1,108)	(591)	124
Capital and financial account balance[2]	$ (36)	$ 3,097	$ 2,971	$ (761)
Statistical discrepancies[3]	1,475	(52)	(1,555)	2,491

(1) Includes exports and imports of goods, services, and income payments. The data on exports and imports of goods are based on current foreign trade statistics, adjusted for the balance of payments definitions established by the International Monetary Fund. The value of imports and exports is recorded on a f.o.b. basis. Defense imports, which are not included in the foreign trade statistics, are included in the Balance of Payments table.

(2) Excluding central monetary institutions.

(3) Statistical discrepancies are, without accounting for the signs of the component terms, the difference between the current account balance and the capital and financial account balance less the change in reserves.

(4) In 1999, some definitions were changed to conform to international standards. Consequently, certain figures for prior periods were revised.

Source: Central Bureau of Statistics.

Foreign Trade

Export growth has played a significant part in Israel's overall economic growth and demonstrates the growing competitiveness of the Israeli economy. In 2000, industrial exports (excluding diamonds) grew by 25.9% due to the fast growth in the US and the EU and a world-wide technology boom. In 2001, as a result of the economic activity slowdown in the EU and the USA and the global crisis in the high-tech sector, industrial exports (excluding diamonds) decreased by 6.8%.

In 2001, imported goods decreased by 8.3%, the result of a decrease in imports of raw materials and investment goods due to the substantial decline in the level of economic activity. Imports of services decreased by 1%.

Trade Liberalization

The principal features of the Government's trade liberalization policy included the elimination of certain compulsory licensing requirements designed to protect local manufacturers (with the exception of agriculture), the Government's review of other licensing requirements with an intention to eliminate those imposed for protection purposes, and the replacement of administrative and other non-tariff barriers to imports with tariffs, which are being reduced over time. Tariffs were reduced in September 1996 for most sectors, and in September 1998 for certain sensitive products such as wood and footwear. In September 2000 they were lowered for textiles. In September, 2001 the tariff reduction process concluded with average customs duties reaching a level of 8%-12%, down from 25% (or more) at the time the new trade liberalization was introduced in September 1991. The trade liberalization program also provided for assistance to certain enterprises that would suffer seriously from the implementation of the program. In 1996, Israel signed the GATT accords on agricultural products, and replaced import restrictions with import duties. Since then, duties on processed agricultural products have been reduced gradually from 100%, to eventually be reduced to a level of 50% by 2003.

Notwithstanding the Government's trade liberalization policy, Israel has a number of trade restrictions, including quotas, licensing restrictions, and outright prohibitions on certain goods (including a ban on the importation of non-kosher meats imposed at the end of 1994). The non-tariff barriers have diminished both in number and in size as part of Israel's trade liberalization scheme, embarked upon in 1991. Israel also imposes a post-duty surcharge, called TAMA, that varies in amount by product and is applied after the imposition of an import duty, but before any assessment of purchase taxes. The rate is determined according to the importer's average profit margins in a specific category of goods, and reflects the difference between the retail price in Israel for a domestic product and the import price of the imported good. Israel also maintains product standards that, in certain instances, favor domestic producers of consumer goods over importers. In November 1998, 140 official standards pertaining to the food industry and an additional 130 standards in other industries were abolished. Israel also charges importers 1.3% of c.i.f. cost of imports into Israel for the use of Israeli ports and stevedores. The Ministry of Industry and Trade is in the process of revising the standards law to limit the Government's authority in setting compulsory standards for products sold in Israel for certain purposes, such as safety, public health, protection of the environment, and to prevent any potential use of this authority for protectionist purposes. During the past three years, many standards have been changed to conform with international standards.

Although the U.S. and the EU currently account for approximately 61% of Israel's exports of goods (excluding diamonds), the percentage of exports sold to these countries has been declining in recent years. This decline is a result of an increase in the level of exports to existing Asian markets and the opening of new markets, particularly in Asia and Eastern Europe. Historically, exports to Asia were low due to the effects of the Arab boycott. Exports to countries other than the U.S. and the EU accounted for 38.2% of Israel's non-diamond exports in 2000 and 39.0% of the non-diamond exports in 2001. Exports of non-diamond goods to Asia accounted for 16% of Israel's total non-diamond exports in 2001.

In 2001, Israel had a trade surplus of $4.3 billion with the U.S., compared with a surplus of $2.9 billion in 1998. The surplus disappears when the trade in diamonds is excluded. In 2001, Israel had a $6.2 billion trade deficit with the EU, compared with a deficit of $7.2 billion in 1998. The deficit decreases to $5 billion when diamonds are excluded.

Israel is primarily an exporter of manufactured goods. Exports of the high-tech industries of the manufacturing sector experienced a decline of approximately 7% in 2001. Exports of communication, control, and scientific equipment, which account for 27% of industrial non-diamond goods, decreased by 11.8%.

Approximately 66% of Israel's imports are production inputs (including diamonds and fuels). The remainder of imports are made up of investment goods and consumer products.

Since 1948, members of the Arab League have maintained a trade boycott of Israel. See "State of Israel–International Relations." In September 1994, a number of the Gulf States (Qatar, Oman, Bahrain, United Arab Emirates, Saudi Arabia, and Kuwait) declared their intention to lift the secondary and tertiary trade boycotts of Israel. In fact, these Gulf States, as well as four other Arab League members (Algeria, Djibuti, Mauritania, and Somalia) no longer enforce the secondary and tertiary boycotts of Israel. Nevertheless, some Arab states continue to maintain their trade boycott of Israel. It is difficult to determine the impact on Israeli trade of the remaining elements of the boycott.

Table No. 15 Exports of Goods by Major Groups(1)

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
	(in millions of dollars, f.o.b.)				
A. Agricultural					
Vegetables and field crops	$ 243.2	$ 250.8	$ 248.7	$ 240.5	$ 230.9
Fruits	242.6	235.6	214.1	178.9	168.0
Other	316.3	322.1	319.5	283.3	239.9
Total	802.1	809.1	782.3	702.1	638.8
B. Industrial					
Mining, quarrying and non-metal minerals	422.5	442.1	417.8	451.1	420.3
Food and beverages	527.3	476.0	439.4	443.6	416.8
Textiles, clothing and leather	997.8	1,063.8	1,136.1	1,144.1	1,041.0
Wood, furniture, paper and printing	171.4	188.8	197.6	224.2	238.7
Chemicals and refined petroleum	2,867.7	2,964.4	3,121.9	3,698.7	3,744.7
Rubber and plastics	868.0	887.2	1,028.5	1,069.9	1,075.3
Products, metal basic	940.5	1,022.3	973.0	1,060.0	1,011.6
Machinery and equipment	987.7	1,079.4	1012.9	1,124.0	1,148.7
Electronic components and computers	1,416.8	1,451.5	1,474.7	3,641.7	3,057.1
Communication, control, medical, and scientific equipment	3,468.4	4,031.0	4,602.1	6,021.0	5,240.1
Electrical equipment and motors	420.9	497.1	473.7	528.5	533.8
Transport equipment	698.2	883.3	969.7	1,012.0	1,047.7
Jewelry, goldsmith and silversmith	25.5	478.1	463.6	472.6	459.5
Miscellaneous	124.3	110.6	113.8	113.2	116.5
Total (excl. diamonds)	14,437.0	15,575.6	16,424.8	21,004.6	19,551.8
Diamonds	5,097.3	4,345.4	5,681.2	6,815.7	5,672.0
Polished	4,186.1	3,701.8	4,589.2	5,437.0	4,646.4
Rough	911.2	643.6	1,092.0	1,378.7	1,025.6
Other	39.2	41.6	41.0	35.3	45.7
Returned goods	77.1	138.4	151.2	216.9	212.2
Total (net)	$ 20,298.5	$ 20,633.3	$ 22,778.1	$ 28,340.8	$ 25,696.1

(1) Excludes trade with the West Bank and the Gaza Strip.

Source: Central Bureau of Statistics.

Table No. 16 Imports of Goods by Major Groups[1]

	Year				
	1997	1998	1999	2000	2001
	(in millions of dollars, c.i.f.)				
Consumer Goods:					
Durables					
Vehicles	$ 819.2	$ 731.4	$ 748.4	$ 947.8	$ 894.9
Other	986.8	998.1	1,048.0	1,186.9	1,207.6
Non-Durables	2,070.1	2,145.9	2,154.9	2,362.9	2,554.0
Total	3,876.1	3,875.4	3,951.3	4,497.6	4,656.5
Production Inputs:					
For agriculture	365.2	264.4	289.9	292.7	300.6
Raw food products	943.4	898.6	862.8	825.1	825.6
Fabrics and yarn	710.5	703.0	694.1	685.8	582.7
Wood and related products	303.8	286.5	280.4	296.9	255.3
Chemical products	1,758.9	1,758.1	1,832.5	2,094.5	2,061.4
Rubber and plastics	872.8	907.6	900.0	990.0	920.3
Paper-making material	547.1	544.8	557.0	615.8	568.6
Metals					
Iron and steel	1,003.6	914.8	774.6	833.7	759.9
Precious metals	228.3	201.9	169.9	130.3	147.6
Non-ferrous metals	536.1	536.9	531.3	547.9	503.0
Machines, electronics and other industries	5,710.1	5,006.5	5,257.2	6,458.5	5,454.8
Fuels	2,259.9	1,800.1	2,109.5	3,497.9	3,094.7
Total (excl. diamonds)	15,239.7	14,767.6	15,208.8	18,333.6	16,453.2
Diamonds (net)	4,779.2	3,839.4	5,456.2	6,746.3	5,588.1
Investment Goods:					
Machinery and equipment	3,557.7	3,660.9	4,500.0	4,764.3	4,809.1
Transport vehicles[2]	1,002.8	889.7	891.4	1,145.3	1,109.7
Ships and aircraft	278.1	84.1	733.0	239.4	667.5
Total	4,838.6	4,634.7	6,124.2	6,149.0	6,586.3
Other Goods	2.7	12.3	16.6	23.0	19.1
Returned goods	(111.5)	(118.7)	(127.6)	(140.7)	(182.9)
Total (net)[3]	$ 28,624.8	$ 27,010.7	$ 30,629.7	$ 35,221.0	$ 32,711.8

(1) Excludes trade with the West Bank and the Gaza Strip.

(2) Excluding ships and aircraft.

(3) Net imports equal gross imports less unworked diamonds returned to the supplier and other returned goods.

Source: Central Bureau of Statistics.

Table No. 17 Exports of Goods by Region[1]

Region	1997		1998		1999		2000		2001	
	(in millions of dollars, f.o.b., except percentages)									
EFTA	$ 439.9	1.9%	$ 424.8	1.9%	$ 405.7	1.6%	$ 549.4	1.7%	$ 395.5	1.4%
EU	6,788.0	30.0	7,090.9	31.2	7,560.9	30.2	8,562.8	27.3	7633.5	26.3
Americas	8,203.2	36.4	9,009.4	39.6	9,775.9	39.1	12,933.4	41.2	12484.6	43.0
Asia	4,196.3	18.6	3,241.6	14.3	4,109.2	16.4	5,817.0	18.5	5244.9	18.0
Africa	477.0	2.1	479.2	2.1	469.6	1.9	546.0	1.7	457.8	1.6
Other	2,486.4	11.0	2,488.1	10.9	2,668.3	10.7	2,995.2	9.5	2,842.5	9.8
Total	$ 22,590.8	100.0%	$ 22,734.4	100.0%	$ 25,016.6	100.0%	$ 31,403.8	100.0%	$ 29,058.8	100.0%

(1) Gross exports (including diamonds returned by importers abroad and other returns to exporters in Israel).
Source: Central Bureau of Statistics.

Table No. 18 Imports of Goods by Region[1]

Region	1997		1998		1999		2000		2001	
	(in millions of dollars, c.i.f., except percentages)									
EFTA	$ 1,669.1	5.8%	$ 1,583.2	5.8%	$ 1,800.5	5.8%	$ 1994.7	5.6%	$ 1,859.1	5.6%
EU	14,858.9	51.0	13,335.4	48.5	14,386.4	46.3	15,466.2	43.3	13,920.4	41.8
Americas	6,061.8	20.9	6,081.9	22.1	7,002.3	22.5	7,323.4	20.5	7,325.9	22.0
Asia	3,134.1	10.8	3,417.5	12.4	4,087.5	13.1	5,202.0	14.6	4,697.2	14.1
Africa	387.8	1.3	354.6	1.3	363.3	1.2	372.9	1.0	428.6	1.3
Other	2,972.7	10.2	2,697.2	9.8	3,450.0	11.1	5,390.0	15.1	5,072.0	15.2
Total	$ 29,084.4	100.0%	$ 27,469.8	100.0%	$ 31,090.0	100.0%	$ 35,749.5	100.0%	$ 33,303.2	100.0%

(1) Gross imports (including unworked diamonds returned to suppliers abroad and other returns to exporters abroad).
Source: Central Bureau of Statistics.

Table No. 19 Merchandise Trade Indices (1995=100)

	1997	1998	1999	2000	2001
Indices of Physical Volume[2]					
Exports	123.8	126.1	138.8	174.6	164.9
Imports	108.6	108.6	124.3	141.1	131.3
Indices of Prices					
Exports	95.8	92.7	91.3	89.1	87.4
Imports[1]	93.3	87.5	85.4	87.6	85.7
Terms of Trade[2]	102.7	105.9	106.9	101.7	102.0

(1) Excluding ships, aircraft and diamonds.
(2) The price index of exports divided by the price index of imports, multiplied by 100.
Source: Central Bureau of Statistics.

Foreign Investments

In 2001, nonresidents invested $5.1 billion in Israel compared to $11.4 billion in 2000 and $8.4 billion per year on average between 1998 and 2000. These figures include direct foreign investments, investment in Israeli securities traded on the Tel Aviv Stock Exchange (TASE) and foreign exchanges, direct credit to the public sector and to residents (excluding trade finance and credit to suppliers), and deposits by nonresidents in Israeli banks. Investment by nonresidents in 2001 was significantly lower than in 2000 or 1999, and comparable to the figures in 1998, which, similarly to 2001, was characterized by a crisis in the international financial markets. The major cause for the decline in foreign investment was Israel's significant involvement in the high-tech industries, which experienced a worldwide slowdown. Nonresident investments were also affected by negative geopolitical developments, but their influence was to a much lower extent.

In 2001, Israeli firms issued $1.2 billion of debt and equity abroad, as compared to $4.3 billion in 2000 and $3.2 billion in 1999. The figure for 2001 consisted of $0.9 billion of debt and $0.3 billion of equity. In comparison, in 2000 Israeli firms issued $1.5 billion of debt and $2.8 billion of equity. The steep decrease in issuances was not unique to Israeli high-tech companies. During 2001, only $32 billion was raised on the NASDAQ stock market by 230 firms, compared to $134 billion by 700 firms in 2000. Direct investment by nonresidents in the non-tradable equity of Israeli firms also decreased in 2001 to $3.2 billion from $4.9 billion in 2000, but was greater than the figure in 1999, which was $2.5 billion. The decrease from 2000 reflects the sharp decline in the acquisition of Israeli high-tech industry firms by non-resident firms and the reduction of profits of non-tradable high-tech firms and the reinvestment thereof. The decline in investments in "start-up" companies was relatively moderate, given that Israeli and foreign venture capital funds raised $1.4 billion in 2001 compared to $2.4 billion in 2000.

In 2001, net foreign direct investment flows in Israeli shares traded on the TASE were close to zero, as compared to a marginal increase of $0.12 billion in 2000. Nonresident investors liquidated a net of $0.75 billion of their portfolio investments in securities traded on the TASE, of which $0.7 billion relates to shares and the rest to bonds. The net liquidation was mainly the result of the growing risk aversion, which characterized investors worldwide, as a result of the developments in the financial markets.

Net deposits by nonresidents in Israeli banks during 2001 totaled $1.8 billion, as compared to $1.6 billion in 2000 and $1.9 billion on average over the previous three years. The increase primarily reflects nonresidents' investment in local currency deposits, because of the increasing interest rate difference between the NIS and the USD during 2001. Simultaneously, there was a liquidation tendency in foreign exchange-denominated deposits, reflecting a reaction to geopolitical events.

Foreign Exchange Controls and International Reserves

On May 14, 1998, the process of removing foreign-currency restrictions on Israeli residents, individuals and businesses, which began in the late 1980s, was for the most part completed. However, certain restrictions on Israeli institutional investors and on some transactions in derivatives carried out with nonresidents remained in force.

As is customary in western countries, in Israel, the expansion and enhancement of reporting procedures regarding external transactions accompanied the process of removing foreign exchange controls. The freedom to engage in transactions with nonresidents is subject to the obligation, of either the person carrying out the transaction or the financial intermediary through which it is carried out, to report the transaction in detail to the Bank of Israel.

In October 2000, all restrictions on foreign currency derivative transactions with nonresidents were abolished. As of January 15, 2002, the 5% ceiling (of assets) on investments abroad of Israeli institutional investors was increased to 20%. Starting January 1, 2003, all activities and transactions in foreign currency between Israeli residents and nonresidents will be allowed.

As part of the deregulation of financial markets, the reserve requirements on domestic foreign-currency deposits were also reduced, and currently are 6% for current accounts (up to six days), 3% for time deposit accounts with maturity of up to one year, and 0% for time deposit accounts with maturity exceeding one year. Since January 1998, local currency has served as the reserve requirement on domestic foreign currency deposits (replacing foreign currency).

In recent years net external liabilities have been dramatically reduced, reaching a level of $4.4 billion, compared to $15.2 billion in 1997.

Table No. 20 External Assets and Liabilities (Debt Instruments)

	Balance at Year End				
	1997	**1998**	**1999**	**2000**	**2001**
	(in millions of dollars)				
External Liabilities					
Public sector	26,229	27,462	27,509	27,799	27,614
Nonbanking private sector	11,533	11,523	13,210	14,349	14,610
Banking system	17,471	19,129	21,218	22,669	24,402
Total	55,233	58,115	61,936	64,817	66,626
External Assets					
Public sector	20,766	23,183	23,388	23,969	24,005
Nonbanking private sector	8,115	10,185	14,031	17,578	21,448
Banking system	11,158	13,372	14,505	16,478	16,798
Total	40,039	46,740	51,924	58,025	62,251
Net External Debt	15,195	11,375	10,012	6,792	4,375

Source: Bank of Israel.

Foreign currency reserves grew from $8.3 billion at the end of 1995 to $23.2 billion at the end of 2001.

Foreign Exchange Rates

Until July 1985, the Israeli Shekel was periodically depreciated at a rate consistent with inflation. On September 2, 1985, the Knesset approved the New Israeli Shekel ("NIS"), valued at 1,000 times the then existing Shekel. Since August 1, 1986, only the NIS has circulated, and the NIS has been stabilized by reference to a basket of major currencies (U.S. dollar, German mark, British pound sterling, French franc, and Japanese yen) rather than in relation solely to the U.S. dollar. On August 1, 1986, the date the basket was introduced, the weighting of the component currencies in the basket was 60% U.S. dollar, 20% German mark, 10% British pound sterling, 5% French franc, and 5% Japanese yen. This basket approximates the composition of Israel's external trade, including both imports and exports. The number of each currency unit in the basket is constant, but the weight of each currency can change daily according to changes in cross rates. On June 5, 1995, the Bank of Israel adopted a policy requiring an automatic adjustment in the weighting of the currencies in the basket in any future year in which a cumulative change of more than 2% occurs in the value of Israeli trade in any single currency in the basket, relative to the value of Israeli foreign trade in the other currencies in the basket. Following that decision, in April 1996 the weight of the dollar was increased by 3.3 percentage points, and those of the other currencies reduced accordingly. The number of each currency unit remained constant until May 2000 when the pound sterling's share in the currency basket was reduced by 2.1 percentage points. The weights of the other currencies were adjusted according to Israel's foreign trade structure at that time. On December 31, 2001, the currencies' weights were 66.2% U.S. dollar, 21.8% euro, 6.5% pound sterling, and 5.5% Japanese yen.

In December 1991, the Bank of Israel introduced the "diagonal band" or "crawling peg system" to reduce business sector uncertainty and speculative cycles that had caused sharp capital movements under prior exchange rate systems. Under this system, the slope of the band was adjusted on a daily basis upon a gradual, constant and predetermined path. Initially, the slope of the band was derived from the difference between Israel's inflation target for the following year, as set by the government, and predicted inflation abroad. The width of the band, its midpoint rate and its slope were determined jointly by the Bank of Israel and the Ministry of Finance.

When the diagonal band was first established, its slope was 9% with limits of 5% above or below the midpoint rate. The slope was reduced further to 8% and then to 6% in November 1992 and July 1993, respectively. On May 31, 1995, the limits of the band were widened to plus minus 7% and the midpoint rate was increased by 0.8%, but no change was made to the slope of the band. The change in the midpoint rate was intended to offset the increase in port fees on exports.

In the last few years, the practice has changed such that only the slope of the lower limit of the band has been reduced, whenever possible, in accordance with the difference between the target rate of inflation in Israel and expected inflation abroad. The upper limit has remained unchanged at a steeper slope than the lower limit. As a result, the band is gradually becoming wider. On June 18, 1997, the upper limit of the exchange rate band was raised by approximately 15%, while maintaining its slope at 6%. The lower limit remained unchanged, while its slope was reduced to 4%. On August 7, 1998, the slope of the lower limit was reduced further, to 2%, while the slope of the upper limit again remained unchanged at 6%.

On December 24, 2001, the lower limit of the band was reduced by 1% and its slope was canceled. The lower limit of the band is currently at a constant rate of 4.1021 NIS to the currency basket. Therefore, the exchange rate band can no longer be considered a diagonal. At the end of 2001, the width of the band was 43.9%.

The Bank of Israel has sole responsibility for the daily management of exchange rates. Prior to February 1996, it was the practice of the Bank of Israel to use market intervention to maintain the exchange rate near the midpoint of the band. Since then, the policy has been to intervene only to prevent the rate from moving outside the band. Since June 1997, the Bank of Israel has not intervened in the foreign-currency market, with the exception of six days at the end of 1997.

During 2001, the NIS depreciated against the currency basket by 7.0% and against the US dollar by 9.3%. The difference reflects the strengthening of the US dollar against the other currencies in the basket, such as the euro, sterling and yen.

During the early months of 2002, the NIS also experienced a substantial depreciation (11.3% devaluation against the U.S. dollar between December 31 and May 31), leading to a rise in the prices of imported goods and overall consumer price index (CPI). In response, the Bank of Israel has raised its short-term interest rate by 5.3% (since the beginning of the year) to a level of 9.1% as of June 24, 2002.

Table No. 21 Average Exchange Rates

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
			(NIS per currency unit)		
U.S. dollar	3.449	3.800	4.140	4.077	4.240
British pound sterling	5.651	6.298	6.701	6.180	6.088
German mark	1.991	2.167	2.258	1.926	1.931
Japanese yen (per 100 yen)	2.854	2.928	3.658	3.785	3.453
French franc	0.591	0.646	0.673	0.574	0.576
Currency basket	3.733	4.091	4.432	4.223	4.307
Euro			4.416	3.768	3.776

Source: Bank of Israel.

THE FINANCIAL SYSTEM

Bank of Israel

The Bank of Israel is the country's central bank and functions independently of the Government. It is responsible for formulating and implementing Israel's monetary policy. The Bank of Israel also manages foreign exchange reserves, supervises Israel's banking system, issues bank notes and coins, and acts as the sole fiscal agent for the Government with respect to domestic indebtedness. The Governor of the Bank of Israel acts as an economic advisor to the Government. In addition, the Bank of Israel works jointly with the Government in formulating and implementing foreign exchange policy. See "Balance of Payments and Foreign Trade—Foreign Exchange Rates."

As stipulated in the Bank of Israel Law, the Bank of Israel is not allowed to finance Government deficits or to lend the Government money to finance its expenditures in any fiscal year, except to provide temporary advances to the Government to bridge seasonal cash flow requirements when expenditures exceed revenues during the fiscal year (provided that the outstanding amount of such temporary advances at any time does not exceed 1.6% of the Government's current expenditures budget for the year in which the advances are made). Twice a year, such advances are permitted to equal up to 3.2% of the current expenditure budget for a period of up to 30 days.

The Government is required to deposit all Government revenues, including proceeds of foreign debt (except for certain earmarked funds deposited with commercial banks), in the Bank of Israel, which is responsible for managing the Government's foreign exchange reserves. The Bank of Israel is prohibited by law from investing in equity securities or private bonds, and is subject to internal limitations on the amount of investments it may make in a single country or financial institution. The majority of the Bank of Israel's reserves is held in securities issued by foreign sovereign issuers.

At the end of 1997, the Prime Minister appointed a committee of outside experts to suggest changes in the Bank of Israel Law, in light of the considerable institutional and economic changes that have taken place in Israel since the Bank was set up in 1954, and similar actions taken in many countries in recent years. The committee report was submitted to the Government in December 1998. In March 2002, the government submitted to the Knesset a proposal for the amendment of the Bank of Israel Law. The Government's proposal modifies the Bank of Israel's role, making it similar to the role of central banks in other developed economies and defines price stability as the Bank of Israel's main objective. Furthermore, in order to improve the decision-making process of the Bank of Israel regarding its main policies, the Government's proposal establishes a monetary committee, comprised of well-recognized and experienced professionals in the fields of finance, monetary and macro-economic policies. In order to avoid any possibility of political interference in the nomination process, the members of the monetary committee will be nominated by an independent panel, chaired by a retired Supreme-Court judge. In addition, in order to expand its transparency, the Bank of Israel is required to report to the Government and the public on its monetary policy on a regular basis. The proposal is currently under discussion.

Monetary Policy

Since 1985, when the Economic Stabilization Plan was adopted, Israel has made significant progress in stabilizing inflation through effective implementation of monetary policy by the Bank of Israel, and fiscal restraint and trade liberalization by the Government. In recent years, the primary objective of Israel's monetary and exchange rate policy has been to gradually reduce inflation to attain levels of inflation similar to those prevailing in other industrialized countries. See "The Economy—Wages and Prices."

The Bank of Israel's principal instruments of monetary control are auctioned time deposits for banks and a discount window facility. Auctions for interest-bearing deposits are currently the main tool for implementing monetary policy and are similar to reverse repurchase agreements. The interest rate received by the banks is determined in the auction. Maturities are one-month, one-week and overnight. In the past, the Bank of Israel injected liquidity using monetary collateralized loans to banks which were allocated to the banking system by periodic auctions of a predetermined amount and were used in a manner similar to repurchase agreements. The auction of overnight funds and deposits of various maturities and the rate of interest determined therein is the key determinant of short-term interest rates in Israel. The Bank of Israel utilizes the daily auctions primarily to offset flows from Government activities and the balance of payments. Through the discount window, Israeli banks can obtain overnight loans to fill temporary funding needs.

In order to offset capital inflows, the Bank of Israel also operates NIS/dollar swaps, absorbing NIS in return for dollars for a given period of time. Allocation of the swaps is made by auction on the difference between the NIS interest rate and the going dollar interest rate. Since August 1997, the Bank of Israel has used this facility only to roll over existing swap stock of 1.4 billion dollars and has refrained from using the swap auctions as a monetary instrument.

Although the Bank of Israel does not issue its own securities, it may effect monetary policy by selling non-indexed zero-coupon Treasury bills of up to one year maturity. In recent years, the Bank of Israel has increasingly utilized such issuances. In 1995, the Government raised the ceiling on the outstanding amount of Treasury bills available to the Bank of Israel for purposes of effecting monetary policy to a total of NIS 15.5 billion, and provided for the automatic adjustment of that ceiling twice annually. Recently, however, the adjustments have only proved sufficient for rolling over principal and interest on the Treasury bills. In order to increase the effectiveness of monetary policy and to enhance the efficiency and completeness of the money and capital markets, the government decided, at the end of December 2001, to remove the ceiling on the outstanding amount of Treasury bills. This adjustment is part of the revised Budget Law for 2002.

At the end of 1991, the Bank of Israel and the Ministry of Finance began publicly announcing annual inflation targets, with the intention of reducing inflation gradually from the 15%-20% range that had prevailed since the Economic Stabilization Program of 1985 to low single-digit levels typical in developed countries. Israel was thus one of the first emerging market economies to adopt the inflation targeting approach to monetary policy, using this regime to reduce inflation rather than merely maintaining a low level that had already been attained. Inflation targeting in its first three years (1992-1994) was implemented with some ambivalence, but when actual inflation significantly exceeded its target in 1994, the Bank of Israel received a mandate from the Government to implement more restrictive monetary measures in order to prevent inflation from reverting to its pre-1992 levels.

The Bank's tight policy since the fourth quarter of 1994 has been a key factor in the attainment of the current, very low inflation levels. This monetary policy has been part of a three-pronged approach to macroeconomic policy that is designed to facilitate stable economic growth over the long run by prompting monetary and financial stability and providing a favorable business environment. The other key features are fiscal restraint and structural reform, the latter also geared to spurring economic growth from the supply side.

The Bank of Israel has been reducing gradually its interest rates since 1999. These rates reached unprecedented low levels in 2001 and in the first quarter of 2002 in light of the slowdown in economic activity and the below target annual inflation. The process of interest rate reduction has been recently reversed following a fast exchange rate depreciation and a subsequent rise in the inflation rate and inflation expectations.

Since the summer of 1997 until the end of 2001, the annual rate of inflation has been below 3%, with the exception of the last quarter of 1998, when an international financial crisis led to significant depreciation of the NIS and a significant "one-time" increase in price levels spaced over three months. A significant depreciation and an increase in the price level also took place in early 2002.

In August 2000, the Government set inflation targets for the years ahead. For 2001, the target was 2.5%-3.5%, for 2002 it is 2%-3%, and from 2003 onwards, it is set at 1%-3%, a level of measured inflation that is defined as "price stability." These targets are consistent with the inflation targets, explicit and implicit, of nearly all developed countries.

The end-of-year inflation rate was 1.3% in 1999, zero in 2000 and 1.4% in 2001. These rates were below the yearly targets, but in 2002 the end-of-year inflation rate is likely to exceed the target.

The focus of macroeconomic policy on financial stability during the past few years has paid off handsomely in the past two years, as most financial indicators suggest a degree of stability despite the very significant shocks that have hit the economy during this period. These shocks include the softening of the high-tech boom, the sharp decline of share prices on the NASDAQ and the Palestinian uprising.

Monetary policy since 1997 has emphasized the inflation-targeting regime, with exchange rate policy effectively having evolved to a free float. Until June 1997, the parameters of the upwardly sloping exchange rate band were such that the Bank was required to intervene frequently in the foreign exchange market to prevent appreciation. At that point, continued intervention was viewed as untenable and the band was widened considerably with provisions enacted for further gradual widening. These measures have thus far effectively removed the exchange rate constraint on monetary policy and the Bank has been able to adjust its key interest rate as required to meet the inflation target, without having had to intervene in the foreign exchange market. The perception of risk in the foreign exchange market is now centered on small, day-to-day fluctuations rather than the larger, less frequent ones that typified a more tightly managed exchange rate regime. The current perception is more amenable to creating a more stable financial system. While the crawling band has not yet been removed, it appears that the policy measures in 1997 sent a signal to the public about the policy makers' resolve to get inflation down to Western levels. At the end of December 2001, the Ministry of Finance and the Governor of the Bank of Israel decided to allow more flexibility in the foreign exchange market by flattening the slope of the lower band of the exchange rate (lowering the slope from 2% annually to 0%) and reducing its level by 1%.

Another key policy move was the significant increase of the interest rates in the wake of the sharp price level jump following the international financial crisis and the NIS depreciation in the autumn of 1998. The Bank's key rate was increased by 4 percentage points during the first two weeks of November, following growing evidence that the prevailing rates would not be sufficient to prevent the price shock from evolving to a new, higher inflation rate. The sharp increase in interest rates succeeded in reversing the depreciation of the NIS and led to a restoration of low inflation from 1999 to date. The Bank has gradually reduced its key rate since then, but recollection of episodes in 1993 and 1995, when the Bank eased rates too soon to lock-in low inflation, has led to a more cautious approach this time. Thus, while undershooting the target in these years was caused in part by unexpectedly low commodity price increases and unexpected appreciation of the NIS, the need for caution given Israel's inflation history also played a role. By the end of 2000, the Bank's key rate stood at 8% and it was reduced further to 5.8% by early December 2001.

In the last week of December 2001, the key rate was reduced by 2 percentage points, to 3.8%. This exceptional one-time measure was made possible by a combination of several factors: (i) the expression of readiness on the part of the government to cut the budget expenditure relative to the level initially approved and to return to a declining deficit path in 2002-2005; (ii) the Government's decision to take steps in the financial sphere, such as eliminating the ceiling on the issuance of treasury bills, making the exchange-rate band more flexible and completing the cancellation of foreign-currency control by expanding possibilities for institutional investors to diversify their asset portfolio abroad; and (iii) assessments regarding the moderation of actual and expected inflation, after the acceleration in the third quarter of 2001, as well as the exacerbation of the economic slowdown. The object of these shifts in the instruments of economic policy was to help the economy cope with the recession that has resulted from the economic slump worldwide, and in the US in particular, as well as from the tense situation with the Palestinian Authority.

During May and June 2002, in light of a continuous and fast exchange rate depreciation and a subsequent rise in inflation expectations, the Bank of Israel raised the interest rate on several occasions up to 9.1% by June 24, 2002, resulting in a total increase of 5.3% since the beginning of 2002.

Table No. 22 Selected Interest Rates

	Short-Term Local-Currency to the Public			
	Overdraft Facilities	Term Credit	Average Cost of Monetary Loans(1)	SROs (CDs)(2)
1996	22.9	18.8	16.2	13.8
1997	20.8	17.0	14.3	12.2
1998	18.3	14.7	12.0	10.3
1999	19.1	14.9	12.4	10.7
2000	15.8	11.6	9.3	8.0
2001	13.7	8.8	6.6	5.6

(1) The weighted average of the marginal cost of the monetary loans of various maturities.

(2) Excluding large negotiable SROs (self-renewing overnight, local currency, interest-bearing deposits).

Source: Bank of Israel.

Table No. 23 Monetary Indicators

	Year					
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Monetary aggregates (average)(1)(10)						
M1(2)	15.9	13.2	12.0	9.6	11.0	14.2
M2(3)	27.1	25.8	22.7	21.1	20.7	17.2
Public sector injection/GDP(5)	2.7	1.0	0.9	1.4	(0.1)	0.1
Bank of Israel injection/GDP(6)	(2.4)	(5.7)	(0.7)	(0.1)	0.6	1.6
Private sector foreign currency sales/GDP	1.8	6.5	0.3	(0.1)	(0.1)	(0.4)
Nominal interest rate						
SRO (CD)(7)	13.8	12.2	10.3	10.7	8.0	5.6
Unrestricted credit(8)(10)	20.7	18.7	16.2	16.4	12.8	10.0
Currency-basket interest rate (average)(9)	4.6	4.9	4.9	4.5	5.6	3.7
NIS/currency-basket (during period)(1)	3.0	3.7	20.6	(2.5)	(6.3)	3.7
Real yield to maturity on 5-year bonds	4.6	4.1	5.1	5.6	6.0	4.9
Nominal yield on equities (during period)(4)	(1.6)	36.1	2.9	65.7	0.5	(6.9)
Nominal GDP (average)(1)(11)	15.8	12.6	9.9	9.3	8.4	1.4

(1) Percentage change over previous period average.
(2) Currency in circulation plus demand deposits.
(3) M1 plus treasury bills and interest-bearing, local currency deposits with maturities shorter than 12 months.
(4) Includes convertible securities and warrants, as adjusted for dividends and stock splits.
(5) Contributions to monetary expansion.
(6) From 1995 includes SWAP transactions.
(7) Self-renewing, overnight deposit.
(8) In local currency.
(9) Weighted average of three-month LIBOR.
(10) Includes mortgage banks.
(11) Updated to May 2002.
Source: Bank of Israel.

Banking Institutions

Israel has a highly developed banking system. In 2001 there were 43 banking corporations operating in Israel, including 23 commercial banks, seven mortgage banks, one investment-finance bank, six financial institutions, one merchant bank, two joint-service companies, and three foreign banks. The total assets of banking corporations rose to NIS 747 billion by the end of 2001 (a 7% annual increase over the previous year), while the number of domestic branches was reduced from 1,032 in 2000 to 1,013 in 2001.

Israeli banks have maintained a relatively high rate of profitability since 1992. However, in 2001 banks reached a profitability of about 5.9%, compared to 11.7% in 2000.

Three banks, Bank Leumi Le-Israel, Bank Hapoalim, and Israel Discount Bank, and their subsidiaries, account for approximately 80% of the banking business in Israel. Prior to 1993, Israeli banks were permitted to conduct (in addition to traditional banking activities) a variety of non-banking activities, including underwriting securities, operating provident funds, intermediation, and trading in securities. Currently, banks are permitted to conduct such activities only through segregated non-bank subsidiaries. As part of recent banking reforms, distinctions between commercial banks and specialized banks (such as mortgage banks) are gradually being eliminated. Until the mid-1980s, the role of financial intermediation by banks and other private-sector financial institutions was limited due to large Government borrowings to finance the Government's activity, which severely limited the availability of capital resources. The reduction in Government deficits and borrowings since that time, along with capital market reforms, have significantly increased the availability of capital resources to the private sector, giving the banks a larger role in the financial system.

All Israeli banking groups and every banking corporation satisfy the minimum capital adequacy requirement of 9% prescribed by the Bank of Israel in accordance with international standards.

The banking reform included the reduction of reserve requirements to which the public's deposits are subject. Since the end of 1992, all types of deposits are subject to a nominal reserve requirement of 6% on deposits with maturity up to 6 days, 3% on deposits with maturity up to a year and 0% on longer-term deposits. In addition, banking reform has included the elimination of most restrictions on interest rates and minimum terms of indexed deposits and credit, and the removal of the prohibition against the issuance and trading of certain types of derivatives. The deregulation of bank activity, together with the liberalization of foreign exchange, helped to reduce the segmentation between different types of financial intermediation and augmented the substitutability between different types of credit.

The liberalization of foreign exchange narrows the gaps between domestic interest rates on foreign-currency denominated instruments and interest rates prevailing abroad, and also works indirectly to lower interest rate spreads in the local currency sectors. As a result, the cost of credit in Israel has decreased faster than has interest on deposits, causing interest-rate spreads to contract significantly during the 1990s.

Another main aspect of the banking reform is the privatization process, which received special emphasis in recent years. The State sold all of its shares in Bank Hapoalim, the largest bank in the Israeli banking system. Currently, the State owns 41.73% of Bank Leumi Le-Israel and 59.95% of Israel Discount Bank.

In past years, Israeli banks have had a large number of significant non-bank holdings in various sectors of the Israeli economy. In the last three years, the banks have been engaged in a process of reducing their holdings in non-financial firms. As a direct result of a joint report issued by three committees in December 1995, the Knesset approved an amendment to the Banking Licensing Law in May 1996, which, inter alia, provided for the following: (a) total non-financial holdings by the banks will be restricted to 15% of each bank's capital after 2001; (b) the percentage of such holdings can be augmented by an additional 5%, provided the holdings in each non-financial corporation are no more than 5% of the bank's capital, and can be augmented by an additional 5% if the investment is in a foreign corporation; and (c) the bank is authorized to hold a controlling interest in only one non-banking corporation in which its capital exceeds NIS 1.25 billion after 1997.

Table No. 24 Assets, Liabilities and Equity Capital of the Five Major Banking Groups

	At Year End				
	1997	**1998**	**1999**	**2000**	**2001**
	(in millions of NIS at constant December 2001 prices)				
Assets					
In local currency	346,544	361,591	400,161	432,199	452,127
In foreign currency	179,766	217,508	246,542	267,406	295,015
Total assets	526,312	579,099	646,703	699,605	747,142
Liabilities and Equity Capital					
In local currency.	356,224	373,646	418,941	453,276	477,517
In foreign currency	170,088	205,453	227,762	246,329	269,625
Total liabilities and equity capital	526,312	579,099	646,703	699,605	747,142
Equity capital	29,820	30,802	32,435	34,633	36,458

The division into local and foreign currency for 1997, 1998 and 1999 was adjusted according to the published financial statement for those years.

Source: Bank of Israel, Supervisor of Banks.

Capital Markets

Israel's capital markets and the laws regulating them are highly developed. The principal regulatory body responsible for administering the Israeli securities laws is the Israel Securities Authority ("ISA"). ISA's main function is to protect the interests of investors by overseeing the activities of the TASE, supervising public securities offerings, and mandating disclosure of material information by listed companies by means of publications such as prospectuses, financial reports, and other periodic reports. A company whose securities have been offered to the public in Israel by prospectus or whose securities are traded on the TASE is required to file quarterly and annual reports and certain current event reports with the ISA, the TASE, and the Registrar of Companies. These reporting requirements are enforceable by the Israeli courts upon the application of the ISA, which also has the power (under certain conditions) to direct the TASE to suspend trading of a company's securities.

The TASE is the only stock exchange and the only public market for the trading of securities in Israel. The TASE has 28 members, and as of December 31, 2001, 649 companies had equity securities listed on the TASE. The total market value of all listed equity securities as of December 31, 2001, was $57.6 billion, whereas the annual trading volume for equity securities in 2001 was $15.7 billion.

The Government bond market in Israel is highly developed, and Government bonds account for the vast majority of publicly issued debt securities. In 2001, the Government raised a net amount of $9.4 billion, mostly through non-indexed bonds. The bond market in Israel has been a growing source of capital for Israeli corporations. In 2001, the amount of capital raised through eight bond issues by the corporate sector totaled $639 million.

In recent years, the role of institutional investors in the Israeli capital markets has increased significantly. The principal types of institutional investors are provident funds (long-term savings), severance pay funds (special funds established to hold assets set aside by employers for the payment of severance obligations owed to their employees), advanced study funds, mutual funds, and a variety of life insurance savings schemes. As of December 31, 2001, assets held by provident funds, severance pay funds, and advanced study funds totaled $38.9 billion, assets of life insurance saving schemes totaled $17.5 billion and assets of mutual funds totaled $14.3 billion.

The active involvement of foreign investors in the TASE began in 1994. In 2001 international holdings declined to 8.7% of the total market capitalization, compared to 10.9% in 2000.

All shares, convertibles, treasury bills, government bonds and derivatives are traded via TACT, the TASE'S fully automated trading system. The Dual Listing Law enables U.S.-traded Israeli companies to dual-list on the TASE with no additional regulatory requirements. As of May 31, 2002 eighteen U.S.-traded Israeli companies have dual-listed on the TASE, based on the new regulatory framework.

Gold Reserves

The State has not maintained gold reserves since 1992.

PUBLIC FINANCE

General

The public sector in Israel is defined by Israel's Central Bureau of Statistics as the central Government, the Bank of Israel, and the National Institutions. The public sector does not include the local authorities or Government Companies. The Government's annual budget covers the expenditures and revenues of the Government only, and does not include the accounts of National Insurance Institute ("NII"), the National Institutions, the Bank of Israel, or surpluses and deficits of Government authorities, such as the Post Authority, the Airports Authority, and the Ports and Railways Authority.

The Budget Process and Deficit Reduction

The Government's fiscal year ends December 31. The Government's annual budget process is generally initiated in June by the Budget Department of the Ministry of Finance, which coordinates budget discussions with the various Government ministries. During September and October, the details of the budget are finalized within the Government. No later than 60 days before the end of the year, a budget bill, together with supporting information, is required to be submitted to the Knesset for its approval. At the time the Government submits the annual budget to the Knesset, it is required by law to submit a three-year projected budget, which is non-binding and does not require Knesset approval. No later than the end of the year, after discussions with respect to the proposed annual budget before the Finance Committee of the Knesset by the relevant Government Ministers and officials, the annual budget law is required to be approved by the Knesset.

In response to persistent budget deficits, the Knesset passed the Deficit Reduction Law in 1992. This law required that the targeted domestic budget deficit (excluding credit granted by the Government), as a percentage of GDP, decrease each year during the period between 1993 and 1997, as compared to the targeted domestic budget deficit (excluding credit granted by the Government) for the preceding year. The amount of the year-to-year decrease was not specified. However, in 1996, the Government submitted a new Deficit Reduction Law, which was approved by the Knesset in January 1997, with specific targets for the total deficit for each year until 2001, rather than for the domestic deficit only as under the previous law. In recent years, the Government submitted amendments to the Deficit Reduction Law, which were approved by the Knesset, with new specific deficit targets. According to the most recent amendment that was approved by the Knesset on June 5, 2002, the total budget deficit, as a percentage of GDP, will be targeted not to exceed 3.0%-3.5% in 2003 and 2.5%-3.0% in 2004. Moreover, from 2004 onward, the budget deficit target will be reduced by at least 0.5% a year, down to 1% of GDP. This amendment is required as a result of a sharp decrease in activity within the Israeli economy, caused by a world economic slowdown, a severe crisis in the high-tech sector and the deterioration of security conditions in Israel, which led to a substantial decrease in state revenues collection. Moreover, the deterioration of security conditions has elevated the need for an increased security budget.

Unless the Knesset approves an increase in budgeted expenditures, no ministry in the Government can spend any amount in excess of its budget. However, budgeted amounts that are not spent by the Government in any given year may, upon notice to the Finance Committee of the Knesset, be spent in the following year. The deficit target established pursuant to the Deficit Reduction Law refers to the budget as proposed by the Government, rather than actual expenditures and revenues. Therefore, no adjustment to Government expenditures is required by law if the actual deficit missed the targeted deficit because Government revenues or the actual GDP are different than anticipated. The Government finances its deficits through a combination of internal and external indebtedness and proceeds from privatization. See "Public Debt."

From 1992 through 1996, the domestic deficit, excluding net allocation of credit, was 4.9%, 2.4%, 2.0%, 3.2%, and 4.7% of GDP, respectively, in comparison with domestic deficit targets of 6.2%, 3.2%, 3.0%, 2.75%, and 2.5%, respectively. In 1997, as stated, the Government decided to replace the domestic deficit target with a total deficit target. From 1997 through 2001 the total deficit, excluding net allocation of credit, as a percentage of GDP was 2.8%, 2.4%, 2.5%, 0.7%, and 4.6%, respectively.

The following tables set forth the Government deficit and its financing on a total and domestic basis. Domestic expenditures constitute all expenditures by the Government made in Israel. Domestic revenues constitute all taxes raised in Israel. The Government accounts for domestic expenditures and revenues as a method of measuring the influence of the Government on the domestic economy. Tables 25 and 26 present the gross budget figures, including revenue-dependent expenditures and contributions from the budget to the National Insurance Institute; Table 28 presents the budget net of these expenditures.

Table No. 25 The Budget Deficit and Its Financing

	Actual 1998	Actual 1999	Actual 2000	Original Budget 2001	Original Budget 2002
	(in thousands of NIS at current prices)				
Revenues and Grants					
Tax revenues	116,762,309	127,887,996	146,589,004	153,920,000	155,337,035
Non-tax revenues	30,063,831	30,778,545	31,298,244	33,899,583	35,951,516
Foreign grants	12,572,226	11,048,502	11,588,028	11,466,000	12,281,100
Total	159,398,366	169,715,013	189,475,276	199,285,583	203,569,651
Gross Expenditure and Lending					
Current and capital expenditures	76,853,069	80,259,977	88,557,489	92,097,412	98,849,997
Transfer payments and subsidies	57,786,943	64,539,028	65,937,377	70,321,455	75,239,001
Interest payments and commissions(1)	24,562,573	24,972,911	27,795,386	28,608,032	28,980,221
Loans	3,467,467	3,715,087	3,657,136	4,586,276	5,002,303
Other expenditures	4,323,022	5,240,435	4,927,892	9,999,418	9,359,052
Total	166,993,074	178,727,438	190,875,280	205,587,593	217,430,574
Surplus (Deficit)	(7,594,708)	(9,012,425)	(1,400,004)	(6,302,010)	(13,860,923)
Financing					
Foreign borrowings(2)	4,973,270	6,727,569	5,706,518	10,259,262	9,286,687
Foreign loan repayments	6,467,726	7,008,338	6,457,465	10,259,262	10,286,687
Foreign financing (net)	(1,494,456)	(280,769)	(750,947)	0	(1,000,000)
Domestic borrowings	35,689,375	38,441,823	31,591,450	44,335,199	47,567,031
Domestic loan repayments	31,694,035	30,979,270	(408,571)	41,033,189	34,206,923
Domestic financing (net)	3,995,340	7,462,553	32,000,021	3,302,010	13,360,923
Proceeds from Privatization	5,093,824	2,121,565	2,889,053	3,000,000	1,500,000

	Actual 1998	Actual 1999	Actual 2000	Actual 2001
Cash Balance of the Government (at end of period)				
Deposits in NIS	(4,531,000)	(13,378,000)	(13,921,000)	(14,750,000)
Deposits in foreign currency				
included in budget	7,184,000	6,318,000	6,817,000	2,908,000
not included in budget	13,339,000	13,783,000	14,224,000	16,101,000
Total deposits in foreign currency	20,583,000	20,101,000	21,041,000	19,009,000
Total	16,052,000	6,723,000	7,120,000	4,259,000

(1) Interest payments and commissions are net of amounts attributable to indexation of NIS-linked Government bonds and that portion of the interest payments on NIS loans attributable to inflation for the year of payment. These amounts are included in the capital expenditures portion of the budget as domestic loan repayments.

(2) Excludes proceeds borrowed under the U.S. loan guarantee program which are not used for budget financing.

Source: Ministry of Finance.

Table No. 26 The Domestic Budget Deficit and Its Financing

	Actual 1998	Actual 1999	Actual 2000	Original Budget 2001	Original Budget 2002
	(in thousands of NIS at current prices)				
Revenues and grants	141,632,081	153,456,110	176,278,121	186,483,473	185,380,392
Gross expenditure and lending					
Current and capital expenditures	67,243,364	71,400,403	80,912,625	80,536,744	86,431,872
Transfer payments and subsidies	57,786,943	64,539,028	65,937,377	70,321,455	75,239,001
Interest payments (including credit subsidies)	18,688,194	19,167,849	21,606,855	21,519,151	22,542,201
Loans	3,467,467	3,715,087	3,657,136	4,586,276	5,002,303
Other expenditures	4,328,544	5,240,435	4,927,892	9,999,418	9,359,052
Total	151,514,494	164,061,334	177,026,237	186,963,044	197,638,540
Domestic surplus (deficit)	(9,882,413)	(10,605,224)	(748,116)	(479,571)	(12,258,148)
Financing					
Domestic borrowings	35,698,375	38,441,823	31,591,450	44,335,199	47,567,031
Domestic loan repayments	31,694,035	30,979,270	32,000,021	41,033,189	34,206,108
Domestic financing (net)	3,995,340	7,462,553	(408,571)	3,302,010	13,360,923

Source: Ministry of Finance.

Taxation and Tax Revenues

In 2001, the Israeli total tax burden reached 41.2% of GDP, compared to 41.3% in 2000 and 39.4% in 1999.

Israel has a progressive personal income tax with a top rate of 50%, supplemented by a 15% National Insurance fee (including the health tax and the employer's contribution) and a 36% corporate tax rate.

Indirect taxes consist primarily of a 17% VAT. In addition, a high purchase tax is levied on durable goods, fuel, and cigarettes. Imports from the European Union and the United States are duty-free, whereas customs are applied on imports from other countries.

In recent years, further changes to the tax system were adopted to integrate Israel more firmly into the global economy. As part of this policy, custom duties on imports continued to decline. Decisions taken under GATT in 1994, with respect to reducing duties on agricultural products, went into effect on January 1, 1996. Free trade agreements with Canada, Slovakia, the Czech Republic, Turkey, Poland, and Mexico were signed, lowering custom duties on imports from these countries.

On January 1, 1995, a double taxation treaty with the United States went into effect. This treaty governs the income taxation of residents of the United States or Israel, as the case may be, who conduct business or otherwise derive income in the other country subject to the treaty jurisdiction. Among other things, the treaty provides for reduced rates of withholding tax on certain nonbusiness income, such as dividends, interest, and royalties, which is sourced in Israel and derived by a resident of the United States. The treaty provides rules for the avoidance of double taxation through a foreign tax credit mechanism, and allows for the resolution of disputes arising under the treaty through a mutual agreement procedure involving the governing taxing authorities.

In February 2002, the Finance Minister appointed a committee for a comprehensive examination of the direct-tax system in Israel. The tax-reform committee was formed in response to the disparity between the high tax burden on labor income and the tax exemption on most interest income and capital gains on the stock exchange, in which the highest income decile has an especially large share. In June 2002, the committee presented its recommendations that focus on reducing direct taxes on labor while taxing capital income.

Table No. 27 Budgeted Taxes and Other Compulsory Payments

	Actual 1998	Actual 1999	Actual 2000	Original Budget 2001	Original Budget 2002
	(in millions of NIS at current prices)				
Income tax	55,310	60,471	75,589	73,300	76,250
Property, inheritance and other taxes	8,719	9,218	9,299	13,000	12,200
Customs, excise and sales tax	15,418	17,155	18,087	18,450	17,900
Value added tax.	34,002	37,304	39,657	43,720	43,780
Revenue stamp, license and registration fees	3,313	3,740	3,957	5,450	5,207
Total	116,762	127,888	146,589	153,920	155,337

Source: Ministry of Finance.

Table No. 28 Government of Israel Statement of Net Expenditures (Excluding Capital Expenditures)

	Actual 1998	Actual 1999	Actual 2000	Original Budget 2001	Original Budget 2002
	(in millions of NIS at current prices)				
Government Expenditures:					
Government administration.	13,225	14,221	15,856	16,808	18,101
Local authorities	3,863	4,482	4,442	4,244	4,297
Defense.	36,538	37,747	40,165	37,460	41,087
Social services	59,154	65,414	67,895	74,014	79,805
Economic services	8,306	9,611	9,125	9,179	9,336
Interest payments	24,424	24,930	27,748	28,570	28,948
Credit subsidies	138	43	48	39	24
Reserves	—	—	—	4,609	3,334
Total expenditures (other than capital expenditures)	145,648	156,448	165,279	174,923	184,931
Development and Capital Account Expenditures:					
Development expenditures (including repayments of debt)	52,361	52,366	51,637	69,840	64,676
Repayments of debt	42,485	42,737	43,378	56,697	50,521

Source: Ministry of Finance.

Government Budget for 2002

The original State budget for 2002 was NIS 251.6 billion. Government expenditures (excluding principal) were NIS 217.4 billion. Budget expenditures (excluding principal and including Government hospitals) were 46.3% of the projected 2002 GDP. In early 2002, the Government deficit had substantially increased in light of decreasing tax collections and the larger than expected defense-related expenditures. This resulted from the deepening recession and the security unrest. In order to deal with this challenge, on June 5, 2002, the Knesset approved a comprehensive set of emergency budgetary measures, many of them also affecting the 2003 fiscal year and the fiscal outlook in the medium term. These measures include Government expenditure cuts, tax raising, and setting a decreasing Government deficit target.

The original total deficit, excluding net allocation of credit, was expected to be NIS 14.65 billion. The total planned deficit in the 2002 budget was composed of a domestic deficit of 2.66% of GDP and a deficit in government activities abroad of 0.34% of GDP.

The budget policy for 2002 aims to achieve four major targets:

Budget framework. The 2002 budget emphasizes continued gradual reductions of the deficit, government expenditures, and debt measured as a percentage of GDP, in comparison to the actual deficit of 2001.

Increased infrastructure investment. The 2002 budget boosts government investments in infrastructure by NIS 1.7 billion relative to the 2001 budget. Most of the increase will be invested in transport. In addition to direct investment from the State budget, the Government will take action to attract private investments by using build-operate-transfer (B.O.T.) tenders for infrastructure projects. The expansion of infrastructure investments will help stimulate growth not only by creating added economic activity in the performance of the infrastructure projects themselves, but also by expanding the advanced infrastructure that the business sector needs to develop more rapidly.

Employment encouragement. The measures aim at reducing the number of foreign workers employed in Israel, encouraging populations dependent on government assistance to integrate into the labor market, and creating new jobs for Israelis. In 2001 unemployment rates increased due to the economic slowdown. The increase in the number of foreign workers has led to the crowding out of a large number of Israeli workers. Firm measures by the government, such as reducing the number of foreign workers and increasing employment possibilities, will lead to the creation of thousands of new jobs for Israelis.

Land planning and use improvement. In order to enhance activity within the construction sector, the government is required to make sure that there are no barriers in the fields of land administration and housing that prevent full adjustment of housing supply and demand within a reasonable time and without price increases. Therefore, in order to improve land use, the government has decided to take measures to increase the sale of land, to promote urban planning, especially in town centers, and to locate land, which is in possession of the government authorities and not needed for their activities.

Additional areas of emphasis in the 2002 budget include enhancing competitiveness in various industries, downsizing and reducing central government sectors, improving the health care services and making them more efficient and changing industry support criteria.

Local Authorities

Local authorities in Israel include 68 municipalities, 144 local councils, and 54 regional councils. The local authorities are obligated by law to provide a number of basic social services. Local authorities generally finance the provision of such services through local taxes (primarily taxes based on the use of property) and through transfer payments from the Government. In addition, under certain circumstances, local authorities may finance a portion of their activities through borrowings, while less financially sound local authorities may receive supplementary grants from the Ministry of Interior. As of December 31, 2000, the total outstanding debt of the local authorities was approximately NIS 13.4 billion. Transfer payments from the Government are allocated among all local authorities based on fixed criteria and for specific purposes, such as social services or education. The aggregate of the capital expenditures of all local authorities in 2000 was approximately NIS 7.0 billion, most of which was for construction of roads and public buildings and improvements of sewage systems. The Government currently maintains authority to approve changes in the level of taxes imposed by local authorities.

Social Security System

National Insurance Law. Under Israel's National Insurance Law, the National Insurance Institute (the "NII"), an independent institution, provides a wide range of social security benefits, including old-age pension benefits, unemployment insurance, long-term disability payments, workers' compensation benefits, maternity support benefits, and child support payments. In 2001, total expenditures by the NII were NIS 45.6 billion. The NII funds its expenditures using the proceeds of social security taxes paid by employers and employees, transfer payments from the Government required according to the National Insurance Law, and interest income on deposits representing surplus from previous years. The NII also receives separate funds for non-contributory NII benefit payments, including payments to new immigrants and other payments not covered by social insurance programs. In 2001, the Government's transfer payments to the NII (including Government payments replacing employers' contributions to the NII, pursuant to a Government program intended to reduce labor costs) and the Government's share of the NII provision for non-contributory payments totaled NIS 3.1 billion and NIS 9.5 billion, respectively. The aggregate amount of Government transfer payments to the NII in the 2002 budget is NIS 23.5 billion, compared to an actual total government transfer of NIS 21.2 billion in 2001.

Health Care. Israel has an advanced medical system and a ratio of one doctor for approximately every 300 people. Until 1993, the health organization operated by the General Federation of Labor in Israel (the "Histadrut") provided health care for more than 70% of the Israeli population. In 1994, as a result of significant deficits experienced by the Histadrut-sponsored health care organization, the Government implemented a recovery program for this organization, after which other health care organizations increased their share of the health care market. There are currently four public health insurance organizations in Israel. Under this program, the Government agreed to make transfer payments to those organizations in an aggregate amount of approximately NIS 2.4 billion (in 1994 prices) over a multi-year period. In 1994, the Government also enacted new health care legislation that came into effect in 1995, which instituted a new health care tax at a rate of 4.8% of an individual's gross salary, to fund part of the health care benefits, with the remaining part being funded by the government. The 1995 law, which provides equal health care services to all Israeli citizens and residents, has reformed the Israeli health care system in many aspects. According to the law, every resident of Israel is entitled to a wide range of medical benefits. In 1996, in order to curb the increase in the number of hospitalization days, the Ministry of Finance initiated a ceiling mechanism. The new mechanism provides for a ceiling for each hospital for income from each public health insurance organization. For every additional NIS beyond this ceiling, the public health insurance organization receives a discount from the hospital (since 1997 the discount rate has been 50%). In 1997, the Government enacted legislation in order to enhance efficiency in the health care market. The legislation reflects and expresses some of the structural changes proposed by the Ministry of Finance. These changes are mainly related to the framework of health funds under the national health care law by expanding their flexibility, authority, and responsibilities, thus giving them incentive to make their service more efficient. Additional changes are related to the reduction of systematic redundancies and introduction of reckoning arrangements among agencies in the system, leading to resources savings and efficiency. As a result of these changes, the health funds reduced their expenditures in the years 1998 and 1999, and their budget deficit decreased from NIS 1.6 billion in 1997 to NIS 0.4 billion in 1998 and NIS 0.3 billion in 1999. In 1998, due to long waiting periods for surgical operations, new health care corporations, alongside the government-owned hospitals, were established. These corporations operate the government owned hospitals beyond the regular operating hours, and each hospital has been given a share of their income in return for the use of the hospital's facilities.

In January 2002, the Government changed the formulas for calculating the ceiling mechanism between the health care organizations and the hospitals, so that the calculation will be based on three preceding years, rather than one. This change takes into account long term changes in the relationships between the hospital and the public health insurance organizations regarding the use of hospital facilities. In 2002, the Government also intends to regulate the financial relations between the health care corporations and the hospitals. In addition, the Government intends to authorize the sale of non-prescription drugs, sold over the counter, in places other than pharmacies. This reform is to be implemented in the second half of 2002. The 2002 government health care budget is approximately NIS 20 billion. The expense on health care is 9.2% of Israel's GNP.

Pension Funds

Pension funds, along with life insurance policies and provident funds, are the principal instruments in Israel for the accumulation of retirement savings and provision of retirement income. Most employees who participate in a pension fund do so pursuant to a collective agreement between the pension fund, the employer (or a representative organization for such employer), and the representative organization for such employees. These agreements require that the employer and the employee make contributions to the pension fund. At retirement age (or other insurable event), each employee becomes entitled to receive pension payments.

There are generally two types of pension funds in Israel: an old, mostly unbalanced defined benefits pension fund and a new, balanced defined contribution pension fund. In March 1995, in response to large and rising actuarial deficits of Israel's pension funds, the Government adopted a new policy, including a comprehensive plan of recovery for existing pension funds. The primary elements of the new Government policy are: (1) the existing pension funds will be closed to new participants, yet existing participants will continue to be covered under the existing plans for the life of such plans, subject to certain limitations on the future accumulation of benefits; (2) the Minister of Finance is empowered by the Government to draft recovery plans for pension funds in actuarial deficit positions, according to the principles established by the Government; (3) the Minister of Finance, at his discretion, is authorized to continue to issue special bonds to pension funds in actuarial deficit for an interim period; (4) new members enrolling in pension programs will join new, actuarially balanced funds that will operate separately and independently from existing funds, while benefits payable by the new pension funds will be subject to automatic reductions, to the extent necessary, to eliminate any actuarial funding deficit of such new funds; and (5) the Government will issue special bonds, bearing interest at above-market rates (real rate equal to approximately 5% per annum), to each new pension fund with respect to 70% of its assets, provided the contributions made to any such fund are made with respect to wages not exceeding twice the amount of the average market wage. The portion of the new pension funds' assets that is not invested in special bonds will be invested in the Israeli capital markets. As of December 31, 2000, the Government estimates that over the next 80 years, the total cost to the Government of the recovery plan for existing pension funds will be approximately NIS 132 billion, consisting of approximately NIS 56 billion for pension payments that the pension funds will be unable to make, and NIS 76 billion for the subsidy component of the special bonds.

Currently, approximately 85% of all assets held by Israeli pension funds are held in pension funds controlled and operated by the Histadrut (The General Federation of Labor in Israel), and approximately 30% of the workers in Israel participate in these funds. Generally, pension funds are funded through employer and employee contributions and are supported by the Government through significant tax benefits and special non-tradable bonds. The Government issues non-tradable bonds bearing real rates of 5.05% per annum to the new pension funds and non-tradable bonds bearing real rates of 5.57% per annum to the old pension funds. Since 1995, approximately 70% of the assets of all new pension funds are invested in such special bonds (as compared to 93% in old pension funds). During the period 1992 through 1994, the average annual above-market component of the interest paid on these special bonds (as compared with comparable Government bonds issued in the market) was approximately 2.5%. The spread for existing funds decreased to 0.5% in 1998, 0.5% in 1999, and 0.25% in 2000 and 0.8% in 2001. For new pension funds, after three continuous years of 0 spread in 1998, 1999 and 2000, the spread was 0.3% in 2001. Historically, all Israeli pension plans have been managed as non-profit organizations. In recent years, however, for-profit organizations have also begun to get involved in the operation of pension funds.

Public sector employees are presently participating in an unfunded Government pension plan mandated by the State Service (Benefits) Law. The actuarial liabilities of the Government with respect to pension benefits payable under this plan were approximately NIS 220.6 billion as of December 31, 2000. The Government has entered into an agreement with the Histadrut that provides that new Government employees will not participate in the existing unfunded Government pension plan, but will instead participate in the new funded pension plans (described above), to which the Government will make contributions on their behalf in the same manner as any other employer. This agreement prevents the participation of additional employees in the unfunded Government pension plan and is expected to reduce the actuarial Government liabilities in the long run.

PUBLIC DEBT

General

Public sector debt ("public debt") in Israel consists of the internal and external debt of the public sector. Net public debt as a percentage of GDP has generally declined over the last ten years to a level of 83.6% of GDP in the year 2001.

Table No. 29 Net Public Debt[1]

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
	(at end-of-year current prices in billions of NIS)				
Domestic[2]	292.0	326.4	353.0	354.8	378.9
External[3]	19.5	17.7	17.6	16.2	15.8
Total	311.5	344.2	370.7	371.1	394.7

(1) The net public debt includes debt of local authorities, except the local authorities debt to the central government.

(2) In 2001, the domestic net public debt decreased in real terms (at 2000 constant prices) by 5.6% to NIS 378.9 billion.

(3) External public debt equals the Government's foreign liabilities less foreign reserves (change in foreign reserves less repayment of principal). The local authorities debt and the external debt are estimates (based on the data for September 30, 2001).

Source: Bank of Israel.

Table No. 30 Ratio of Net Public Debt to GDP

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
	(percentage of GDP at end-of-year prices)				
Domestic	80.6%	81.2%	84.0%	76.7%	80.2%
External[1]	5.4%	4.4%	4.2%	3.5%	3.3%
Total	86.0%	85.6%	88.2%	80.2%	83.6%

(1) External public debt equals the Government's foreign liabilities less foreign reserves (change in foreign reserves less repayment of principal).

Source: Bank of Israel.

Domestic Public Debt

The domestic net public debt is defined in the consolidated balance sheet of the Government and the Bank of Israel as the Government debt and the debt of local authorities, less the liabilities of private sector debtors to the public sector. The net public debt includes debt of local authorities, except the local authorities' debt to the central government. In 2001, the domestic net public debt reached NIS 378.9 billion.

Table No. 31 Annual Domestic Government Debt Issuances

	Year				
	1997	**1998**	**1999**	**2000**	**2001**
	(gross proceeds in billions of NIS)				
Total Issuances					
Tradable	17.2	25.1	26.5	20.8	39.5
Non-tradable	9.5	10.7	11.4	10.6	13.0
Total	26.7	35.8	37.9	31.4	52.5
Average Maturity (in years)					
Tradable	6.6	5.9	6.3	8.0	9.1
Non-tradable	12.4	14.3	14.5	14.3	14.6
All	8.7	9.4	8.6	10.8	10.7

Source: Bank of Israel.

External Public Debt

Except as otherwise specified and for the purposes of presenting the statistical data in this report, public sector external debt means all debt of the public sector that is required to be paid in a currency other than the NIS, excluding any indebtedness originally issued within Israel or to an Israeli person or entity. On December 31, 2001, Israel had no external short-term floating rate indebtedness. The Government is the principal public sector borrower. In 2001, the public sector's share of Israel's gross external debt was 41.4%, a decrease of 1.2% since 2000, continuing a declining trend since 1994. The share of the Government's gross external debt of its total (external and internal) debt was 27.1% in 2001, compared to 26.7% in 2000 and 26.8% in 1999.

Total public sector external debt in 2001 was $27.6 billion, a decrease of $0.2 billion from the level of 2000, compared to an increase of $4.3 billion during the years 1994 to 1998. Total assets of the public sector in 2001 were $24.0 billion, a slight increase from $23.8 billion in 2000. In 1999, this level stabilized after a period from 1995 to 1998 that was characterized by a sharp increase, primarily as a result of increased foreign investments and other capital inflows. Consequently, during the period from 1995 to 1998, net public sector external debt decreased by $10.6 billion.

Israel's access to external funding has broadened increasingly over the past decade. From the mid-1980s to 1992, the major source of external net borrowings by the Government was State of Israel Bonds, the remainder coming from governments, international institutions, and foreign banks. State of Israel Bonds have been sold by the Government through the Development Corporation for Israel ("DCI"), Israel Bonds International ("IBI") and Canada-Israel Securities Limited ("CISL"). Sales of State of Israel Bonds have raised $21.4 billion since 1951. State of Israel Bonds are not freely transferable. The State of Israel Bonds have proven to be a reliable and important source of financing for the State, particularly under adverse circumstances, because many purchasers are individuals and institutions, including the Jewish community around the world, that have an interest in Israel. Israel expects to continue to issue State of Israel Bonds in the future.

By 1991, the annual amount raised by the Government through the sale of State of Israel Bonds reached an average of $1 billion per year. The outstanding balance of State of Israel Bonds of $9.7 billion on December 31, 2001 represented approximately 35% of Israel's total public sector external debt.

From 1993 through 1998, the largest source of external borrowings by the Government was the U.S. loan guarantee program. This program was enacted in 1992 for the stated purpose of supporting "Israel's extraordinary humanitarian effort to resettle and absorb immigrants into Israel from the republics of the former Soviet Union, Ethiopia and other countries." The U.S. loan guarantee program provided for the guarantee of up to $10 billion in principal amount of loans to Israel during U.S. government fiscal years 1993 through 1998. Under the program, the United States guaranteed all payments of principal and interest on guaranteed loans issued by Israel.

During 1998, Israel completed its borrowings under the U.S. loan guarantee program. Israel borrowed a total of $9.3 billion under this program, through the issuance of guaranteed notes having various terms, interest rates, and maturity. At the end of 2001, approximately $3.6 billion of the proceeds from these loans remained in the Government's account with the Bank of Israel to be applied to the budget over the next years. During 2001, Israel borrowed a total of approximately $1.5 billion abroad, of which approximately $1.1 billion was borrowed through State of Israel Bonds. In addition, Israel borrowed $225 million through a syndicated term loan facility from 19 banks and $162 million through a private placement denominated in Japanese yen.

The net external debt of the public sector, defined as the public sector external debt less foreign assets of the public sector, slightly decreased in 2000 as it had in 1999 and after a sharp decline in the period from 1994 to 1998. As a percentage of GDP, net public sector external debt as of December 31, 2000, was less than 4%, a decline from the level at the end of 1999 and down from the peak of 55% in 1985. Furthermore, the average maturity of the net external debt has lengthened in recent years and the cost of servicing such debt has also declined in both absolute and relative terms.

Approximately 93% of Israeli's public external debt is denominated in U.S. dollars, and approximately 4.4% is denominated in euros.

Table No. 32 Outstanding Public Sector External Debt

	Balance at Year End			
	1998	**1999**	**2000**	**2001**
	(in millions of dollars)			
Public sector external debt				
Foreign governments and international institutions	3,853	3,425	3,098	2,806
Negotiable bonds guaranteed by the US government[1]	13,821	13,284	13,006	12,749
Negotiable bonds – unguaranteed	1,048	1,595	1,736	1,392
Thereof: in Israel	217	211	179	121
State of Israel bonds[2]	8,186	8,755	9,311	9,683
Foreign banks	508	374	309	450
Total	27,417	27,433	27,460	27,081
Total public sector external assets	23,183	23,389	23,969	23,953
Net public sector external debt	4,234	4,044	3,491	3,128

(1) Includes interest accrued on zero coupon bonds.

(2) Includes interest accrued on savings and zero coupon bonds.

Source: Accountant general of the Ministry of Finance and Bank of Israel.

Israel's major sources of external financing have been low-cost, long-term debt from other sovereigns or backed by guarantees of other sovereigns, and State of Israel Bonds. Consequently, the majority of Israel's outstanding public sector external debt was issued at favorable interest rates with a maturity of 10 years and more.

Table No. 33 Forward Amortization (Principal) Payments of Public Sector External Debt

	Outstanding Amounts as of December 31, 2001	2002	2003	2004	2005	2006	2006 and Thereafter(2)
	(Principal in millions of dollars)(1)						
US Government	1,978	195	196	197	199	182	1,009
Other foreign governments and international institutions	829	55	49	47	41	35	602
Negotiable bonds guaranteed by the US government(2)	12,749	735	1,234	996	792	537	8,456
Negotiable bonds – unguaranteed	1,393	48	—	—	163	325	857
State of Israel bonds(3)	9,683	1,007	1,189	1,311	1,022	1,110	4,045
Foreign banks	450	95	92	6	5	230	22
Total	27,082	2,136	2,760	2,557	2,222	2,418	14,990

(1) Scheduled non-dollar repayments were calculated using Bank of Israel representative rates as of balance date.

(2) Includes interest accrued on zero coupon bonds.

(3) Includes interest accrued on savings and zero coupon bonds.

Source: Bank of Israel.

Government Guarantees

In certain cases, the State may issue financial guarantees of third-party obligations if the Government determines that the issuance of such guarantees is in the best interest of the State. These guarantees are generally made on a secured basis and require the payment of a fee to the State. Each guarantee or guarantee program must be specifically approved in advance by the Finance Committee of the Knesset, and the aggregate obligations under such guarantees (not including guarantees set forth under category (iii) below) issued during each budget year may not exceed 10% of the total budget expenditures of the same year. Government guarantees fall into three general categories: (i) guarantees to support economic activities, including encouragement of capital investment, small business activity, and investment in publicly traded venture capital funds pursuant to the Government's publicly announced policy of encouraging development of the private sector; (ii) special guarantees to support Government-controlled entities, particularly those in the defense sector, or to support other enterprises or activities on a case-by-case basis; and (iii) guarantees given to support foreign trade made through Israel Foreign Trade Risks Insurance Company ("IFTRIC"), a Government-controlled company that provides import and export guarantees, guarantees of the capital of IFTRIC, guarantees against foreign political risks on a transaction-by-transaction basis, and direct guarantees for certain large individual transactions, particularly those involving military equipment. These guarantees, fees, and other receipts associated with them are included in the national accounts but, other than some of the guarantees listed in clause (i), are not part of the Government's annual budget.

After the events of September 11, 2001, aviation insurers worldwide gave notice of terminating war liability coverage for third-party bodily injury or property damage.

In order to allow the Israeli aviation companies to continue flying, the State of Israel issued a state guarantee to Inbal Insurance Company Ltd. (a fully government owned insurance company) (Inbal) that enabled it to insure Israeli aviation companies for war liability coverage for third-party bodily injury or property damage.

The total amount of the guarantee to Inbal as of December 31, 2001 is $3.84 billion.

As of December 31, 2001, there were approximately $6.9 billion of Government guarantees outstanding.

The following table sets forth the outstanding Government guarantees of third-party indebtedness by category.

Table No. 34 Government Guarantees by Category

(as of December 31, 2001)

Support of Economic Activities		**Guarantees of Indebtedness**		**Guarantees for International Trade**	
		(in thousands of NIS)			
Guarantee Programs		**State-Owned Enterprises**		**IFTRIC**	
IEC Corporation	8,217,238.4	Israel Aircraft Industries	2,221,834.0	Foreign Trade Insurance	888,412.2
Small Business Funds[1]	90,539.5	Israel Military Industries	116,653.0		
Capital Investment Law	117,481.7				
Development Bank Loans	38,491.7				
Subtotal	8,463,751.3	Subtotal	2,338,487.0	Subtotal	899,811.3
Case-by-Case Guarantees		**Case-by-Case Guarantees**		**Case-by-Case Guarantees**	
Absorption and Construction	305,802.8	Miscellaneous	7,652.6	IEC Corporation	1,068,739.3
Education and health	1,198.7			EL AL Israel Airlines	453,730.8
Other industries	128,333.6			Inbal Insurance Company Ltd	16,957.440.0
Subtotal	435,335.1	Subtotal	7,652.6	Subtotal	18,479,910.1
Total	8,899,086.4	Total	2,346,139.6	Total	19,379,721.4

(1) Until 2001, the figures did not include realized guarantees. Since 2001, figures include both realized and unrealized guarantees.
Source: Ministry of Finance.

DEBT RECORD

Israel has never defaulted in the payment of principal or interest on any of its internal or external indebtedness.

SUBSCRIPTION AND SALE

The Dealers have in an Amendment and Restatement Agreement (Programme Agreement) dated September 5, 2002 (such agreement as further amended and restated or supplemented from time to time, the "Programme Agreement") agreed with the Issuer a basis upon which they or any of them may from time to time agree to purchase Notes. Any such agreement will extend to those matters stated under "Form of the Notes" and "Terms and Conditions of the Notes" above. In the Programme Agreement, the Issuer has agreed to reimburse the Dealers for certain of their expenses in connection with the establishment of the Programme and the issue of Notes under the Programme.

United States

The Notes have not been and will not be registered under the Securities Act and are subject to U.S. tax law requirements. Subject to certain exceptions, Notes may not be offered, sold or delivered within the United States or to U.S. persons. Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will not offer, sell or deliver any Notes within the United States or to U.S. persons except as permitted by the Programme Agreement.

In addition, until 40 days after the commencement of the offering, an offer or sale of Notes within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act.

The Notes are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code and regulations thereunder.

Each issue of Indexed Notes and Dual Currency Notes shall be subject to such additional U.S. selling restrictions as the Issuer and the relevant Dealer or Dealers shall agree as a term of the issue and purchase of such Notes, which additional selling restrictions shall be set out in the applicable Pricing Supplement. Each relevant Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will offer, sell or deliver such Notes only in compliance with such additional U.S. selling restrictions.

United Kingdom

Each Dealer has represented and agreed and each further Dealer appointed under the Programme will be required to represent and agree that:

(i) in relation to any Notes which have a maturity of less than one year, (a) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (b) it has not offered or sold and will not offer or sell any Notes other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses where the issue of the Notes would otherwise constitute a contravention of Section 19 of the FSMA by the Issuer;

(ii) it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which section 21(1) of the FSMA does not apply to the Issuer; and

(iii) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to such Notes in, from or otherwise involving the United Kingdom.

The Netherlands

Each Dealer has represented and agreed (and each further Dealer appointed under the Programme will be required to represent and agree) that it has not, directly or indirectly, offered or sold and will not, directly or indirectly, offer or sell in The Netherlands any Notes with a denomination less than euro 50,000 (or its foreign currency equivalent) other than to persons who trade or invest in securities in the conduct of a profession or business (which include banks, stockbrokers, insurance companies, pension funds, other institutional investors and finance companies and treasury departments of large enterprises) unless one of the other exemptions from or exceptions to the prohibitions contained in article 3 of the Dutch Securities Transactions Supervision Act 1995 (*Wet toezicht effectenverkeer 1995*) is applicable and the conditions attached to such exemption or exception are complied with.

Japan

Each Dealer has acknowledged that the Notes have not been and will not be registered under the Securities and Exchange Law of Japan and, accordingly, each Dealer has undertaken and each further Dealer appointed under the Programme will be required to undertake that it will not offer or sell any Notes, directly or indirectly, in Japan or to, or for the benefit of, any Japanese Person or to others for re-offering or resale, directly or indirectly, in Japan or to any Japanese Person except under circumstances which will result in compliance with all applicable laws, regulations and guidelines promulgated by the relevant Japanese governmental and regulatory authorities and in effect at the relevant time. For the purposes of this paragraph, "Japanese Person" shall mean any person resident in Japan, including any corporation or other entity organised under the laws of Japan.

Germany

Each Dealer has confirmed that it is aware of the fact that no German selling prospectus (*Verkaufsprospekt*) has been or will be published in respect of the Programme and that it will comply with the Securities Selling Prospectus Act (the "Act") of the Federal Republic of Germany (*Wertpapier-Verkaufsprospektgesetz*). In particular each Dealer has undertaken and each further Dealer appointed under the Programme will be required to undertake not to engage in public offerings (*öffentliches Anbieten*) or other selling activities in the Federal Republic of Germany with respect to any Notes issued under the Programme otherwise than in accordance with the Act and any other legislation replacing or supplementing the Act and all other applicable laws and regulations.

General

Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Notes or possesses or distributes this Offering Circular and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and neither the Issuer nor any other Dealer shall have any responsibility therefor.

Neither the Issuer nor any of the Dealers represents that Notes may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale.

With regard to each Tranche, the relevant Dealer will be required to comply with such other additional restrictions as the Issuer and the relevant Dealer shall agree and as shall be set out in the applicable Pricing Supplement.

GENERAL INFORMATION

Authorisation

The establishment of the Programme and the issue of Notes thereunder have been duly determined by the Government of the State of Israel on behalf of the State of Israel acting through officials of the Ministry of Finance authorised under the State Property Law 5711/1951 of the State of Israel.

Taxation

By virtue of the Income Tax Order of January 15, 1991 interest paid on the Notes to non-residents of Israel as well as capital gains made by them on a sale of Notes will not be subject to Israeli taxation, whether by withholding or otherwise.

Listing of Notes on the Official List of the UK Listing Authority

The listing of Notes on the Official List of the UK Listing Authority will be expressed as a percentage of their nominal amount (excluding accrued interest). It is expected that each Tranche of Notes which is to be admitted to listing on the Official List of the UK Listing Authority and to trading on the London Stock Exchange will be admitted separately as and when issued, subject only to the issue of a temporary global Note initially representing the Notes of such Tranche. The listing of the Programme in respect of Notes issued during the period of 12 months from the date of this Offering Circular is expected to be granted on or about September 9, 2002.

Documents Available

So long as Notes are capable of being issued under the Programme and/or remain outstanding, copies of the following documents will, when published, be available from the office of the Issuer referred to at the back of this Offering Circular and from the specified office of the Agent in London:

(i) the Programme Agreement, the Agency Agreement, the forms of the Temporary Global Notes, the Permanent Global Notes, the Definitive Notes, the Receipts, the Coupons, the Talons and the Deed of Covenant;

(ii) a copy of this Offering Circular;

(iii) any future offering circulars, prospectuses, information memoranda and supplements including Pricing Supplements (save that a Pricing Supplement relating to an unlisted Note will only be available for inspection by a holder of such Note and such holder must produce evidence satisfactory to the Agent, as to the identity of such holder) to this Offering Circular and any other documents incorporated herein or therein by reference; and

(iv) in the case of each issue of listed Notes subscribed pursuant to a subscription agreement, the subscription agreement (or equivalent document).

Clearing Systems

The Notes have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The appropriate Common Code and ISIN for each Tranche allocated by Euroclear and Clearstream, Luxembourg will be specified in the relevant Pricing Supplement. If the Notes are to clear through an additional or alternative clearing system the appropriate information will be specified in the relevant Pricing Supplement. Transactions will normally be effected for settlement not earlier than three business days after the date of the transaction.

Proposed European Directive on the Taxation of Savings

On 13 December 2001 the European Commission published a proposal for a new directive regarding the taxation of savings income. Subject to a number of important conditions being met, it is proposed that Member States will be required to provide to the tax authorities of another Member State details of payments of interest or other similar income paid by a person within its jurisdiction to an individual resident in that other Member State, subject to the right of certain Member States to opt instead for a withholding system for a transitional period in relation to such payments. The proposals are not yet final and they may be subject to further amendment and/or clarification.

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