MINISTRY OF FINANCE
OFFICE OF THE DIRECTOR-GENERAL
ECONOMICS AND RESEARCH DEPARTMENT

REVIEW OF ECCONOMIC DEVELOPMENTS, IMPLICATIONS OF THE FINANCIAL CRISIS, MACROEONOMIC FORECASTS AND PRINCIPLES OF ECONOMIC POLICY

APPENDIX TO THE NATIONAL BUDGET FOR 2009

Jerusalem

October 2009

Contents

Economic developments, the financial crisis and macroeconomic forecasts[1]

a. Introduction

The Israeli economy enjoyed high rates of growth during recent years. These were reflected by an improvement in the labor market, a rise in the standard of living, increased investment and the strengthening of the Israeli currency. This trend continued during the first eight months of 2008, albeit to a lesser extent. However, 2009 will be overshadowed by the global financial crisis. The crisis began in the second half of 2007 and intensified in September 2008. The crisis is still developing and the extent of its long-term impact on the real developments in the global and the Israeli economy is uncertain. We expect the ramifications of the crisis for Israel will be relatively moderate due to the different background conditions typical of the Israeli economy as compared to the USA and other countries:

- A different macroeconomic situation
- A bubble in the housing market did not develop in Israel.
- The ratio of finance to the value of properties provided in mortgages is low in Israel.
- The Israeli capital market has not reached the level of complexity of its American counterpart.
- The level of leverage in the Israeli economy is relatively low.

Moreover, Israel is well-prepared to face the global crisis and is in a good situation after five years of rapid growth, low unemployment and a responsible fiscal policy. In addition, the stability of the economy has strengthened considerably, and this will help to soften the impact of external shocks. The increased stability of the economy derived from the government's fiscal policy, which led to a reduction in the budget deficit and as a result, to a decrease in the ratio of the public debt to GDP in recent years.

Nevertheless, as a small and open economy Israel is likely to be affected by global developments. The global crisis is expected to impact the Israeli economy through a number of chanels: a reduced rate of growth in consumption (the wealth effect, because of a contraction in the public's asset portfolio), a

[1] The economic analysis and the forecasts are based on information published up to the end of September 2008.

slower increase in investment, a lower rate of export growth, and potential difficulties which companies could encounter in raising credit.

We estimate that growth will slow from a rate of over 5 percent a year during 2004-2007 to 4.2 percent in 2008. The growth forecast on which the 2009 budget is based amounts to 3.5 percent. However, as a result of global developments and their expected impact on Israel, this forecast is now at the upper end of the forecasting scale. Since the uncertainty deriving from the continued development of the global crisis is particularly high, at this stage we have refrained from making repeated adjustments in the forecast for 2009. The main impact of potentially lower growth is reduced tax revenue compared with its planned level and as a result, an increase in the budget deficit in excess of the target of 1.0 percent of GDP. Since a controlled growth in the deficit as a result of an economic slowdown is a type of automatic stabilizer that obviates the need for a drastic cut in government spending, its overall impact on the economy is positive. This is despite its negative implications in certain areas such as the need for increased government borrowing, which could push up the interest rate in the economy. The Ministry of Finance is closely monitoring current developments in the global economy and in Israel in order to maximize the economy's growth potential, and to maintain the credibility of the fiscal policy. Once the implications of the crisis for the Israeli economy become clear, growth and tax revenue forecasts will be updated accordingly.

In this review we will analyze the global financial crisis and its implications for Israel, we will describe economic developments in the first half of 2008 and in the third quarter and present the main elements of forecasts for 2009. We will also present the main elements of the fiscal policy and details of policy in the areas of wages, deficit finance and the capital market.

b. The global financial crisis and its implications for Israel

b.1 Description of the financial crisis

The financial crisis began in the USA in 2007 and has since spread throughout the world. The present crisis is regarded as the most serious in the USA since 1929, and certain European economies have been very badly affected. Although it is still unclear when the crisis will end, the process could be prolonged and involves:

- A decrease in asset prices to a stable level.
- A delevraging of the private sector.
- Recognition of the financial sector’s losses.
- A structural change in the financial system.

The contraction of private sector demand as a result of the credit crunch and the reduction in the public’s wealth will encumber the adjustment process, which is still far from complete.

The financial crisis began with the bursting of the real estate bubble in the USA in August 2007. During the years preceding the onset of the crisis, the number of high-risk (subprime) mortgage recipients in the USA increased. These borrowers received loans at high rates of finance reaching 100 percent and even more. In many cases, no examination was made of their economic position. The vibrant activity in the market led to a large and consistent increase in real estate prices over the years. Concurrently, the use of mortgage-backed bonds greatly increased. When it became clear that many borrowers were failing to meet their mortgage repayments, the bubble burst and real estate’ prices began to fall. The value of mortgage-backed bonds, which are affected by these prices, began to fall as well.

Many entities in the financial system in the USA and worldwide had invested large proportions of their total assets in the real estate market and in the MBS market. The sharp decrease in the prices of these assets led to an erosion in investors’ balance sheets. The fact that real estate prices are still falling (in the USA and in many parts of the world) and the uncertainty regarding the level at which they will stabilize are exacerbating the uncertainty in the financial system.

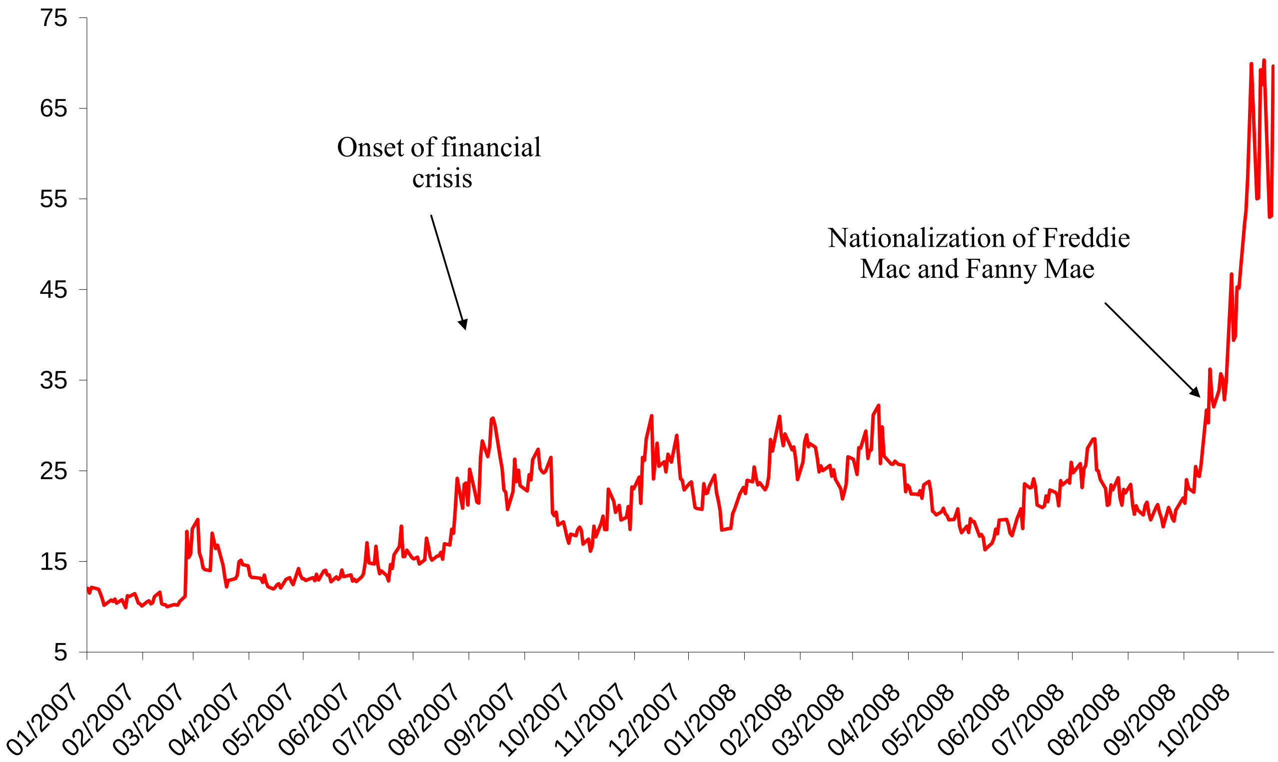
The erosion in financial entities’ capital limited their ability to offer credit (they were unable to adhere to the capital adequacy requirements)[2] and created a liquidity crisis that was translated into a credit crunch at the macro level.

---

[2] The erosion in their capital compelled financial institutions to increase the amount which they hold in order to adhere to the capital adequacy requirements, this at a time when it is very difficult to raise capital as a result of the prevailing uncertainty. Attempts were also made to raise capital by selling bonds. However this large-scale selling led to a further decrease in the value of the bonds and to a deterioration in the financial entities’ position.

In September 2008, the financial crisis worsened with the collapse of a number of major institutions in the capital market. The increased uncertainty that arose in the financial markets is reflected in the VIX index[3], which is also known as the Fear Index.

Development of the VIX Index, 2007-2008/9



b.2 Factors that led to the onset of the crisis

Economic policy in the USA

Liquidity surpluses arose in the American economy during recent years as a result of the balance-of-payments deficit and the budget deficit, and due to an expansionary monetary policy. The liquidity surpluses and low-cost credit led to a high volume of debts, created an incentive for the development of relatively high-yield complex financial instruments (see details below) and encouraged the leverage

---

[3] The index reflects investors' expectations regarding the extent of the volatility in the S&P 500 Index during the coming 30 days as expressed in options trading. A rise in the index reflects an increase in the level of risk inherent in the market.

of business activity in the USA (see details below). The complexity of the financial instruments in question made it difficult to accurately assess their risk and to properly price these assets. The lack of transparency may have been partly deliberate in order to help market these instruments.

For over a decade, the US government took measures to encourage the construction industry and to help the weak strata purchase housing by means of the Freddie Mac and Fanny Mae mortgage corporations. In this respect, in 1992 Congress pressured the mortgage corporations to increase the rate of their investment in borrowers from low socio-economic classes. In 1996 the HUD[4] presented a defined objective: 42 percent of the corporations' mortgage finance was to go to borrowers with an income lower than the median income. This objective was increased to 50 percent in 2000 and 52 percent in 2005. This was a wrong policy for several reasons. Firstly, it led to a distortion in the allocation of sources, contributed to the creation of a real estate bubble and exposed the government to credit risk. Moreover, the assistance was not recorded in a transparent manner in the budget accounts (it did not constitute a budgetary item).

To conclude, the liquidity surpluses, the availability of low-cost credit and government incentives (*inter alia* by granting various benefits to Freddie Mac and Fanny Mae)[5] contributed to the creation of the real estate bubble in the USA, which is a major factor behind the present crisis.

Regulatory failure

Regulation failed to adapt itself to the financial innovations and to the complexity of the financial system. Proposals to increase the supervision over Wall Street failed to gain support.

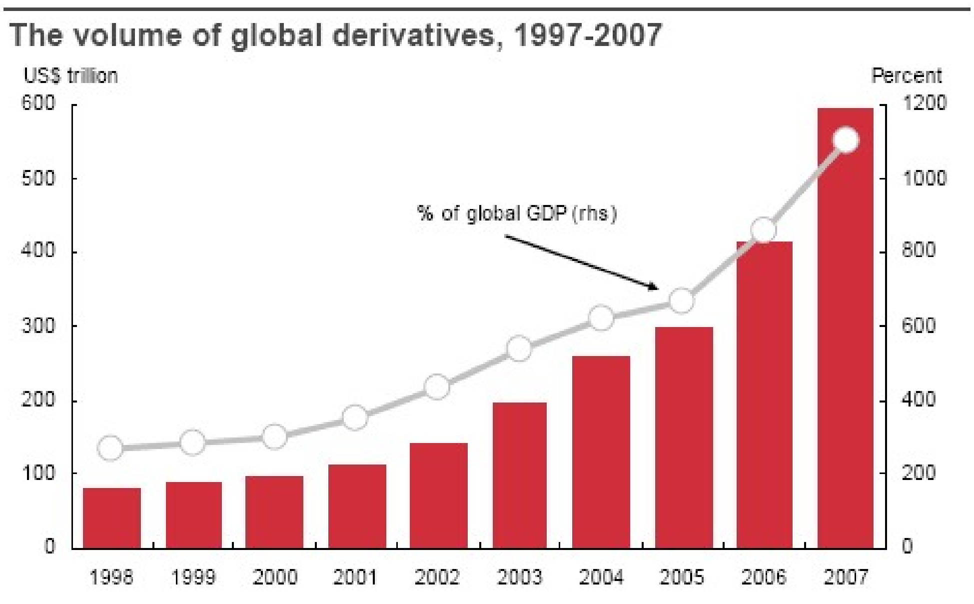
---

[4] The Department of Housing and Urban Development.

[5] Freddie Mac and Fanny Mae are secondary-market mortgage-providing corporations (that is, they are the mortgage banks' financiers) that lend or guarantee approximately half of the mortgages existing in the USA. Until they were nationalized in September 2008, the corporations were privately-owned and under Federal sponsorship. Federal sponsorship implied the granting of various benefits in the form of tax benefits and an alleviation of the capital requirements as a government measure for improving weak populations' accessibility to housing.

The increased usage of complex financial products

The mortgage-backed securities (MBS) market expanded greatly during recent years. These assets, which were regarded as safe and obtained a high credit rating by rating agencies, played an important role in the development of the crisis. The worldwide derivatives market also expanded greatly. In 2007 for example, the size of the derivatives market was nearly 12 times larger than the world gross product compared with less than 100 percent in 1998 (see diagram below). In addition, an extensive CDS[6] market developed, reaching $ 62 billion, several times larger than the bond market from which it is derived. Among other reasons, the collapse of AIG resulted from the fact that it was the leading issuer of this product.



Source: BIS, Nomura

High level of leverage

One of the reasons for the onset of the crisis is the national debt of the USA,[7] which rose from 163 percent of GDP during the 1980s to 346 percent in 2007. Two sectors are responsible for the large increase of leverage: households, whose debt rose from 50 percent of GDP in 1980 to 71 percent in 2000 and 100 percent in 2007, and the finance sector whose debt grew from 21 percent of GDP in

---

[6] Credit Default Swaps, which ensure bond holders against a fall in price.
[7] Debt including both the private and the public sector

1980 to 83 percent in 2000 and 116 percent in 2007. At a debt level such as this and in view of the apprehension regarding economic developments, borrowers are wary of granting credit. This could lead to a slowdown as a result of the size of the debt (as described by Irving Fisher in 1933 and as experienced by Japan in the 1990s). The problem therefore derives from a high level of debt, an erroneous perception of risk and the improper pricing of assets.

Problematic perception of risk

- The erroneous perception of risk in the assessment of financial instruments was also reflected by the excessive leverage in the mortgage market, where loans were granted at a liability-to-asset ratio of 100 percent and even more. The decrease in real estate prices led to a rapid erosion of the guarantees held by the lenders, even before taking into account the cost of foreclosing the assets.
- The credit rating agencies contributed to the development of the crisis by granting high ratings to complex assets (which retrospectively proved to be a very high-risk investment). With the onset of the crisis, the agencies were quick to reduce companies' ratings and thereby exacerbated the crisis. The rating agencies have been accused of a structured conflict of interests because of the way in which they are remunerated for the assessments which they make (they were remunerated by the entities which they rated) and of using models that failed to predict what came to be. Moreover, the rating of financial institutions was based on the value of those institutions' bonds as determined in the market, and not on an examination and analysis of their balance sheets.
- Many investors, including institutional investors, relied on credit rating rather than on an independent risk assessment.
- A moral hazard arose in the financial markets when financial institutions managers were highly remunerated for short-term success but were only moderately penalized for their failures. This provided an incentive for managers to engage in a "yield race" in the markets, a situation in which the investment risk had become of secondary importance.

- "Stability leads to instability"[8] – a prolonged period of rapid growth, low inflation, a low interest rate and macroeconomic stability induced complacency and an increased apatite for risk.

b.3 Implications of the crisis

Financial entities' difficulty in raising liquidity and credit as a result of the crisis

The fall in the value of mortgage-backed bonds and the reductions in these bonds' credit rating led to the creation of a "lemon market"[9]. Before the crisis, the bonds obtained a high rating (sometimes even AAA), provided a stable yield and were highly tradable. The crisis in the mortgage market largly reduced the tradability of these bonds' because of the difficulty in assessing the value of the mortgages underlying the bonds. As a result, a market was created in which sellers had better information on the quality of the bonds than buyers, who take this into account and assume that the bonds offered for sale are the worst. These assets became non-liquid as a result of the information gap, thereby making it difficult for organizations in financial distress to raise liquidity.

A phenomenon of asymmetry in information exists at the level of the financial sector as well: An organization wishing to raise credit is suspected of being in financial distress and therefore has difficulty in raising the credit required. This phenomenon has macroeconomic implications. Financial institutions' difficulty in raising liquidity reduces the availability of credit (see the large rise in the yield spread in the graph below).

The US government's program (see below) does not completely solve the problem of information asymmetry. Even after the government purchases part of the problematic assets, buyers in the private market will still suspect that the assets offered for sale are of low quality. The information problem regarding the quality of MBS will remain because the difficulty of assessing the value of the underlying assets will also continue.

---

[8] See Hyman Minsky, *Stabilizing an Unstable Economy*.

[9] Called after George Akerlofs well-known article from 1970 in QJE, *The Market for Lemons: Quality, Uncertainty in the Market Mechanism*. This article discusses the asymmetrical information that occurs in cases where the seller knows more about the product than the buyer.

The TED Spread, the spread between the inter-bank and US treasuries interest rate 2006/10-2008/10 (in percentage points)

SOURCE: Bloomberg.

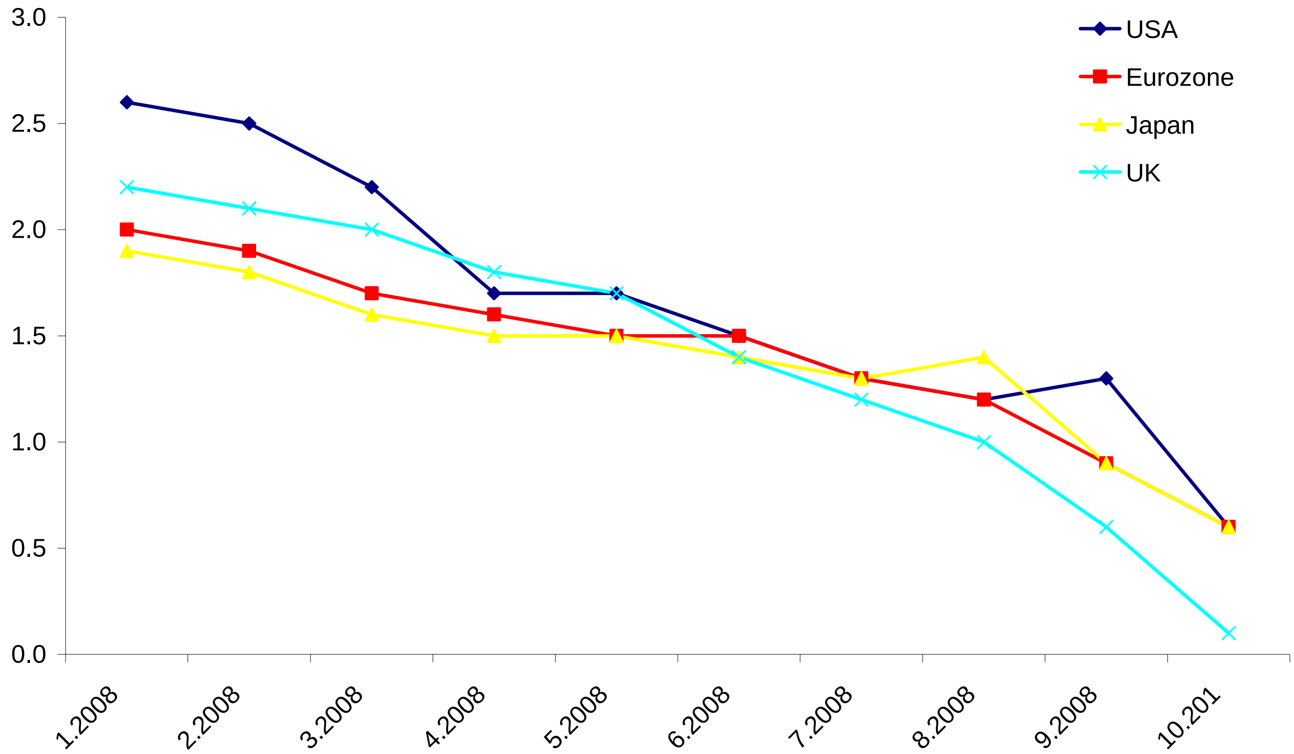
Macroeconomic effects in the USA and worldwide

Following several years of high GDP growth rates worldwide, a slower pace of growth was recorded in the first two quarters of 2008. The worsening of the crisis in September 2008 suggests that the slowdown will become more intense and that a number of countries, mainly in Europe, will enter into a recession.

The resulting credit crunch is making it difficult for businesses to obtain credit, and is leading to a decline in business sector GDP. The credit crunch is also making it difficult for individuals to obtain loans for the purchase of apartments and vehicles, and is thereby reducing private consumption. The losses posted in equity markets worldwide are also reducing private consumption by means of the wealth effect – the contraction of the public's asset portfolios.

The impact of the financial crisis on non-financial activity is reflected by growth forecasts for 2009[10], which predict a significant slowdown. During recent months, growth forecasts have been downward adjusted consistently as the extent of the crisis became increasingly apparent.

Development of global growth forecasts for 2009



* According to the consensus forecast published by the Economist.

Improper allocation of resources

Joseph Stiglitz, winner of the Nobel Prize for Economics, has published a number of analyses that attempt to identify the sources of the financial crisis. His analysis focuses on the allocation of sources in the American economy. Stiglitz personified the financial sector as the “brain” of the economy that is responsible for the allocation of sources and the management of risks. The competition in the American financial system led to the development of complex and only partially transparent financial products. The combination of these products and a system that rewards excessive risk-taking

[10] According to the consensus forecast published by the Economist.

transformed the American capital market into a casino in which investment managers' gamble with other people’s money. Stiglitz estimates that the cumulative damage to the American economy resulting from extensive resources being directed to the granting of mortgages to individuals who failed to meet the repayments, instead of their being directed to productive businesses, amounts to a loss of GDP of $1.5 trillion.

Further activity required.

Significant changes in financial institutions’ activity are necessary in the following areas:

- Risk management.
- Remuneration of employees and managers.
- A risk transfer model (securitization of assets and their sale to another entity).
- Supervisory methods. In systems lacking supervision, crises are inevitable although their timing is unknown.
- Limiting the liability-to-asset ratio in mortgage loans.

b.4 How the authorities are coping with the crisis

In the initial stages, the authorities in the USA and Europe coped with the crisis in two main ways: by injecting liquidity into the markets, and by means of direct involvement in order to rescue financial institutions in distress.

When the crisis intensified in September 2008, the authorities’ became far more involved in the financial markets. At the beginning of September, the two largest mortgage corporations in the USA, Freddie Mac and Fanny Mae, were nationalized. A few days later, Lehman Brothers, the fourth largest investment bank in the USA, declared bankruptcy after the authorities in the USA had refused to provide guarantees for potential buyers. On the following day, the government nationalized the AIG insurance company, which until recently was the largest insurance company in the world. At the end of September, Washington Mutual, the largest loans and savings bank in the USA, was also nationalized after encountering serious liquidity difficulties. Immediately afterwards, the bank's activity was sold to JP Morgan. Also at the end of September, five major banks in Europe were rescued by means of nationalization or cash injection after having suffered acute liquidity problems.

The US government's action in response to the events of September 2008 is of major economically historical significance, and will re-shape the American capital market. The government's takeover of Freddie Mac, Fanny Mae, AIG and Washington Mutual constitutes a deviation from the principle of limited government intervention that guided economic policy in the USA for many years.

In an attempt to end the uncertainty in the capital markets and under pressure from the Treasury Department and the Fed, an agreement was reached on a **financial sector stabilization program**. The program includes:

- The establishment of a fund that will manage $ 700 billion and which will purchase problematic securities (mainly MBS, as well as other securities). In the initial stage, the fund will receive $ 250 billion. At the next stage, the fund will receive, with Congressional approval, another $ 100 billion. At the last stage, $ 350 billion will be transferred to the fund, subject to additional approval from Congress.
- $ 250 billion of the fund's budget will be used for buying the banks' shares. Half of that amount ($ 125 billion) will be transferred to the nine largest banks in the USA. In return, the government will receive preferred stock that will guarantee a dividend of 5 percent in the first five years and 9 percent in the subsequent years. The government will not receive managerial rights at the banks. Every bank that wishes to accede to the government's offer will have to agree to adhere to restrictions on its managers' remuneration.
- The fund will receive preferred stock from the institutions that were provided with assistance, so that the taxpayers will be able to benefit from a rebound.
- Part of the money will be designated for encouraging those holding problematic bonds to keep them by providing insurance for the problematic assets.
- Imposing restrictions on managers' severance payments at institutions that received assistance from the fund.
- A change in the terms of problematic mortgages, enabling borrowers to maintain their monthly repayments. This is intended as assistance for home-owners.

- Providing numerous tax benefits in order to obtain support in Congress. The benefits are granted *inter alia* for those who have suffered as the result of natural disasters and for the production of renewable sources of energy. The amount of the tax benefits is estimated at $ 100-150 billion.
- Increasing the ceiling for Fed deposit insurance at commercial banks from $ 100 thousand per deposit to $ 250 thousand.

The government program was met with criticism on both sides of the political spectrum in the USA. Most of the criticism came from Republican representatives, who objected to increased government involvement in the economy. Criticism was also voiced regarding the lack of social justice in the program – assistance to corporate giants, which created the crisis, at the expense of the taxpayers who were hit twice due to no fault of their own: first from the economic crisis and second, as a result of the cost of rescuing the financial institutions, which was imposed on them.

The government was also criticized for its action during the financial crisis due to the creation of moral hazard. The phenomenon is expressed by the fact that other organizations (especially large organizations) will, in the future, tend to take risks in the belief that even if the risks lead to negative results and the danger of bankruptcy, the government will intervene and prevent them from becoming insolvent. This could lead to an increase in the risk level of financial institutions' assets, and pose the threat of an even more serious crisis in the future. These processes have potential implications for other sectors as well. Leaders of the automobile industry in the USA recently asked for government intervention in order to assist companies in distress.

b.5 Implications for Israel

Most of the deficiencies that led to the development of the financial crisis do not exist in Israel:

- A different macroeconomic situation. During recent years Israel has enjoyed a balance-of-payments surplus and a low fiscal deficit.
- A bubble in the housing market did not develop in Israel. The stock of apartments for sale in 2008 amounts to a low level of 9,500 units compared with an average of 13,000 units during the years 2004-2007.

- The liability-to-asset ratio in mortgages in Israel does not exceed 90 percent (except in special cases), and is usually closer to 60-70 percent.
- The Israeli capital market has not reached the level of complexity of its American counterpart. Trading in structured products in Israel is marginal compared with the USA. As a result, CDS instruments do not exist in the financial market in Israel and an MBS market does not exist either. Although Israeli institutions have invested in MBS, CDS and similar derivatives, such investments have not been on a large scale.
- The availability of credit in the Israeli capital market is much lower than in the USA. As a result, the level of leverage in the Israeli economy is lower than in the USA.

Moreover, Israel is well positioned to face the global crisis after five years of rapid growth: The economy is diversified, with low unemployment rates and a responsible fiscal policy. Nevertheless, as a small and open economy, Israel will be affected by the ramifications of the crisis in global markets, with the following results:

- A decrease in the public's wealth due to the continued losses in the equities markets.
- Weaker exports due to the increasing extent of the global crisis.
- Growing difficulties in raising credit at the banks and in the capital markets. Companies with high leverage such as real estate companies could be hard hit as a result.

In addition, some of the changes that are expected in worldwide regulation are relevant to Israel as well:

- The largest Israeli rating agencies are branches of leading agencies from the USA, and are likely to be affected by regulatory changes in the USA.
- In the area of regulation, the recommendations issued by such organizations as the IMF and the FSF as a result of the crisis are *inter alia* as follows:
  - To examine the models on which the rating agencies base their assessments of banks and other financial institutions.
  - To prevent situations of conflicts of interest with respect to the rating agencies, and to prevent investors' excessive reliance on credit rating.

- To promote increased cooperation between the regulatory authorities (within the country and at the international level as well).
- To initiate a re-division of authorities between the regulatory authorities (according to the type of activity rather than the type of body supervised).
- To strengthen supervision by enhancing the regulator's resources and degree of specialization.
- To increase regulation with respect to a number of bodies such as mortgage banks and hedge funds.

When the recommendations are compiled more precisely, it will be necessary to examine the manner in which they are applied in Israel.

c. Economic developments in the first half of 2008

c.1 GDP and business sector GDP

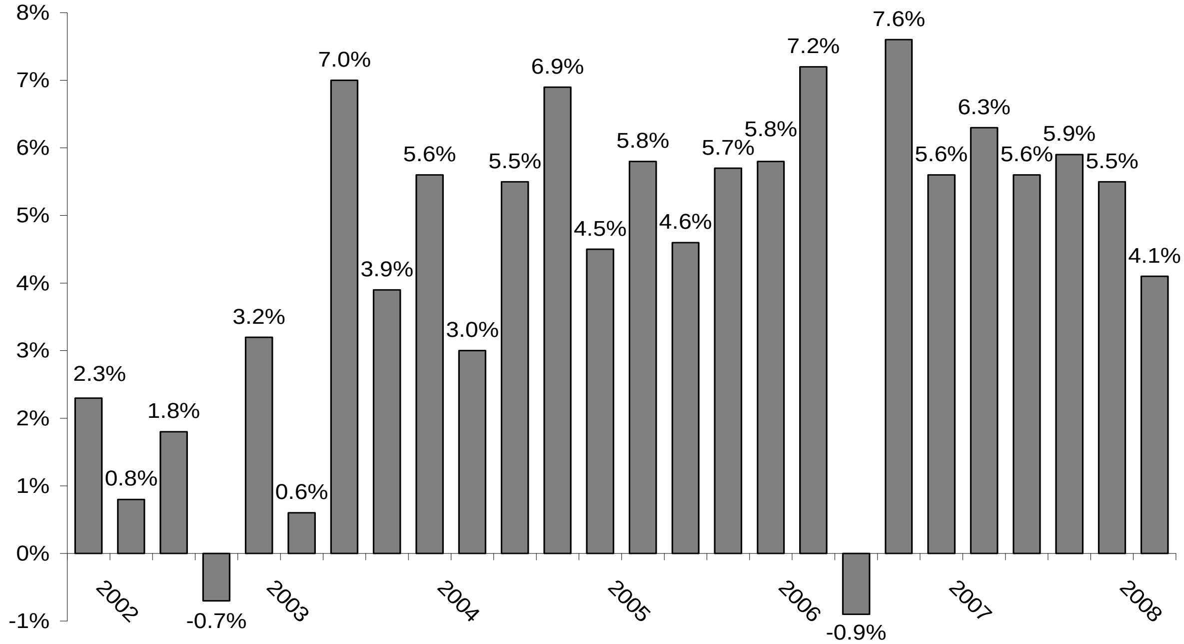
The rapid growth in GDP continued in the first quarter of 2008, but a slower pace of growth was recorded in the second quarter.[11] Business sector GDP rose by 5.2 percent[12] in the first half of 2008 (5.5 percent in the first quarter and 4.1 percent in the second quarter) following an increase of 5.8 percent in the second half of 2007.

[11] This review presents Central Bureau of Statistics data updated to October 22, 2008.

[12] All the data presented is annualized and compared with the previous period unless otherwise stated.

GDP growth

(quarterly rates of change, annualized)



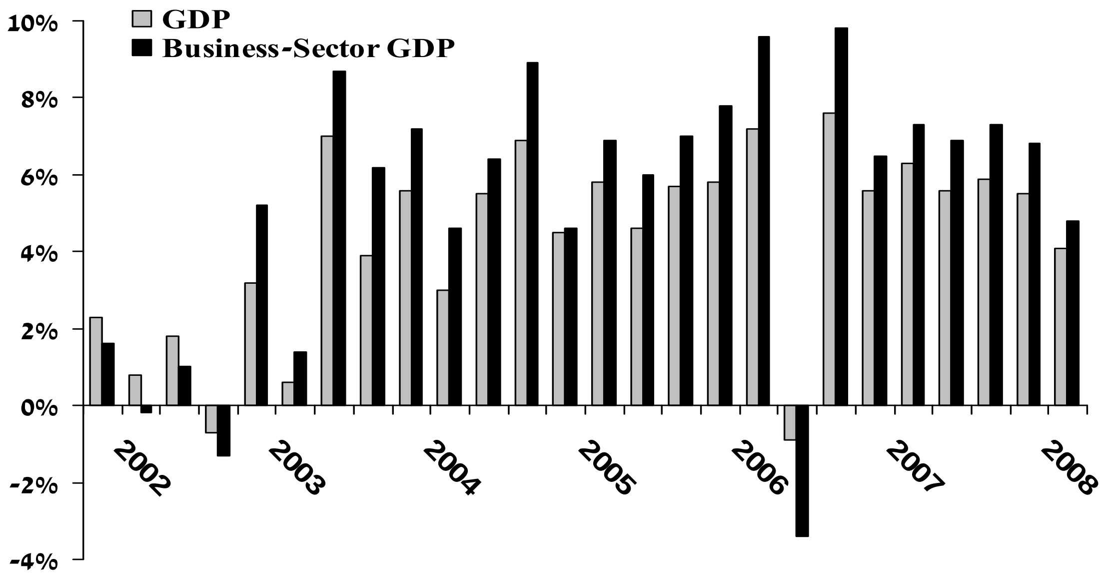
SOURCE: Central Bureau of Statistics.

The growth recorded in the second quarter of 2008 mainly derived from an increase in gross domestic investment. The per capita GDP growth rate in the first half of 2008 amounted to 3.4 percent, similar to the average for the years 2003-2007.

Business sector GDP rose by 6.4 percent in the first half of 2008 compared with the 7.1 percent in the previous six-month period. Business sector GDP increased by 6.8 percent in the first quarter and by 4.8 percent in the second quarter. The growth of recent years encompassed the majority of GDP components, with business sector GDP expanding more rapidly than the economy as a whole. This trend continued during the first half of the year.

Growth of the GDP & the Business-Sector GDP, 2002-2008

(Quarter-on-Quarter at Annual Rate)



SOURCE: Central Bureau of Statistics.

c.2 Main developments in GDP components

Private consumption

Private consumption expanded by 4.5 percent in the first half of 2008 after increasing by 5.7 percent in the previous half. This expansion implies a 2.7 percent growth in per capita private consumption. Expenditure on private consumption reflects a large increase in spending on consumer durables and especially private cars (due *inter alia* to a change in taxation,[13] in the value groups and in the recording of the model year). Most of the increase occurred in the first quarter of 2008 – 8.8 percent – which was partly offset in the second quarter when an annualized decrease of 2.7 percent was recorded.

Developments in private consumption were affected by the continuation of the tax reform for individuals, the price increase, the change in real wages (a year-on-year increase of 0.7 percent in the first half of 2008) and the decrease in the value of the public's asset portfolio. The decrease in the

[13] The purchase tax on vehicles was cut from 84 percent in 2007 to 78 percent at the beginning of 2008.

value of the asset portfolio during recent months could lead to a slower pace of private consumption growth in 2009.

Public consumption

Public consumption rose by 0.5 percent in the first half of 2008, reflecting a 3.0 percent increase in civilian consumption and a 4.9 percent decrease in defense consumption. Most of the increase in public consumption occurred in the first quarter of 2008 due to large-scale defense imports (The increase is likely to be offset later in the year). In the second quarter, public consumption fell by 3.3 percent annualized.

Investment and foreign investment

Investment in fixed assets expanded by a moderate 1.8 percent in the first half of the year following an increase of 23.1 percent in the second half of 2007. Concurrently, gross domestic investment dropped by 1.5 percent, reflecting a decrease in stocks. Investment in machinery, equipment and transportation vehicles rose by 4.2 percent (investment in vehicles rose by a higher rate), while investment in construction remained slack and fell by 3.7 percent. The volume of investment is directly affected by the increased uncertainty resulting from the global financial crisis.

Foreign investment (direct investment in Israeli enterprises, portfolio investment and other investment) amounted to $10.0 billion annualized in the second half of 2008, of which $7.4 billion was direct investment. Foreign investment, especially direct investment, has been high in the past two years.[14]

Exports

Exports rose by 9.4 percent in the first half of 2008 following an increase of 11.3 percent in the previous half and 9.3 percent year-on-year.

[14] Foreign investment totaled $ 14.4 billion in 2007 and $ 17.8 billion in 2006 (excluding the Teva/Ivax transaction). Direct investment amounted to $ 9.7 billion in 2007 and $ 14.3 billion in 2006.

Exports of goods (in dollar terms, excluding diamonds, ships and planes) to the countries of the European Union rose by 18.1 percent in the first eight months of the year following an increase of 21.1 percent in 2007. Exports to the USA grew by 22.2 percent following a relatively small increase of 4.5 percent in 2007. Exports to other countries expanded by 23.1 percent. During that period, high-tech industrial exports rose by 18.9 percent and low tech industries exports increased by 28.8 percent (the sharp growth in exports by the low tech industries is attributed to the large increases in raw material prices).

Imports

Imports rose by 4.4 percent in the first half of 2008, with imports excluding defense imports, ships, planes and diamonds expanding by 7.3 percent. Accounting for the increase were a 9.7 percent growth in service imports and a moderate 0.8 percent rise in imports of civilian goods (following a 17.8 percent expansion in the previous quarter).

During the first eight months of 2008, compared with the average for 2007, imports of goods (in dollar terms, excluding diamonds, ships and planes) rose by 12.8 percent from the countries of the European Union, 11.4 percent from the USA and 34.6 percent from the rest of the world.

Imports of consumer goods (in dollar terms) expanded by 20.3 percent during the first eight months of the year, while imports of capital goods and raw materials rose by 16.5 percent (in dollar terms).

c.3 Other macroeconomic developments

The budget deficit/surplus

The budget surplus (excluding credit extensions) amounted to NIS 2.1 billion in the first nine months of 2008 compared with NIS 7.8 billion in the same period last year.

Year-to-date government spending totaled NIS 135.8 billion compared with NIS 129.6 billion year-on-year, a nominal increase of 4.8 percent, similar to the 4.1 percent nominal increase planned in the 2008 budget compared with 2007.

Tax revenue (excluding defense import VAT) totaled NIS 143.4 billion in that period, an amount equivalent to 75 percent of the tax revenue forecast for the year in the original budget plan. This represents a nominal decrease of 1.6 percent compared with the same period of 2007, when tax revenue till September totaled NIS 145.8 billion. The reduction reflects a nominal decrease of 9.1 percent in the collection of direct taxes. It should be noted that numerous legislative changes were applied between 2007 and 2008, which reduced the collection of direct taxes. However, indirect tax receipts increased by 8.3 percent in nominal terms.

The budget deficit for 2008 is expected to adhere to the upper limit of 1.6 percent of GDP prescribed in the budget plan.

Balance of payments

The balance-of-payments current account has been in surplus during recent years, peaking at 5.6 percent of GDP in 2006. In 2007 the current account surplus fell to 2.8 percent of GDP and contracted further to 1.9 percent in the last four quarters (2007 third quarter until 2008 second quarter).

The current account surplus amounted to $ 2.1 billion in the first half of 2008, compared with $ 1.4 billion in the second half of 2007 and $ 1.2 billion in the first half of 2007[15].

The current account surplus in the first half of 2008 was comprised of:

- A $ 1.7 billion deficit in the goods and services account compared with a deficit of $2.4 billion in the second half of 2007. The deficit in the goods account amounted to $ 4.0 billion and the surplus in the services account reached $ 2.3 billion. The reduced deficit in the goods and services accounts derived from the increased surplus in the services account resulting from the sale of start-up companies to foreign residents.[16]

[15] The current account surplus amounted to $ 1.2 billion in the first quarter of 2008 and approximately $ 1 billion in the second quarter of 2008.
[16] Sales of start-up companies are recorded as service exports in the balance of payments.

- A net deficit of $ 561 million in the income account compared with break-even in the second half of 2007. The increased income account deficit reflects Israeli residents' reduced income on investments abroad resulting largely from the losses posted in worldwide equities markets.
- A net surplus of $ 4.4 billion in the current transfers account compared with a surplus of $ 3.8 billion in the second half of 2007.

The finance account is a mirror image of the current account, and is mainly comprised of foreign residents' investments in the Israeli economy minus Israeli residents' investments abroad.

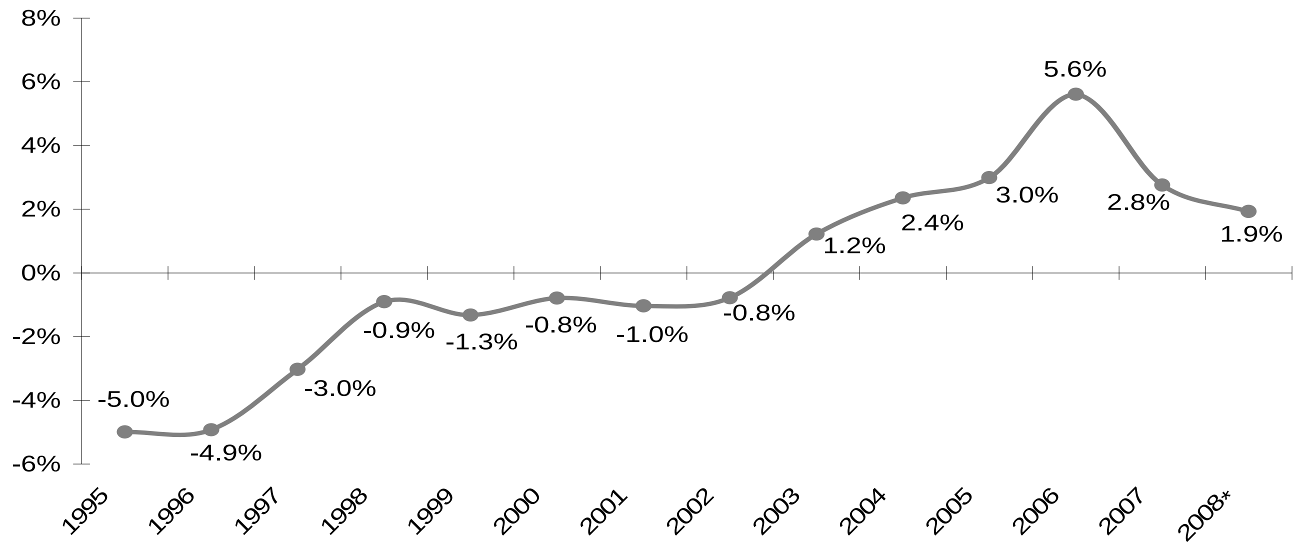
The capital account was notable for the following during the first half of 2008:

- Foreign residents' direct investments in Israel totaled $ 7.3 billion annualized. Israelis' direct investment abroad totaled $ 6.1 billion annualized.
- Foreign residents' portfolio investments in Israel totaled $ 2.0 billion annualized. Israeli residents' investment in marketable securities abroad remained unchanged compared with $ 4.0 billion in 2007.

The strength of the shekel resulted from the balance-of-payments surplus, the relatively high volume of foreign investment and the decrease in Israelis' investments abroad (principally portfolio investments).

Balance-of-payments current account

(as percentage of GDP)



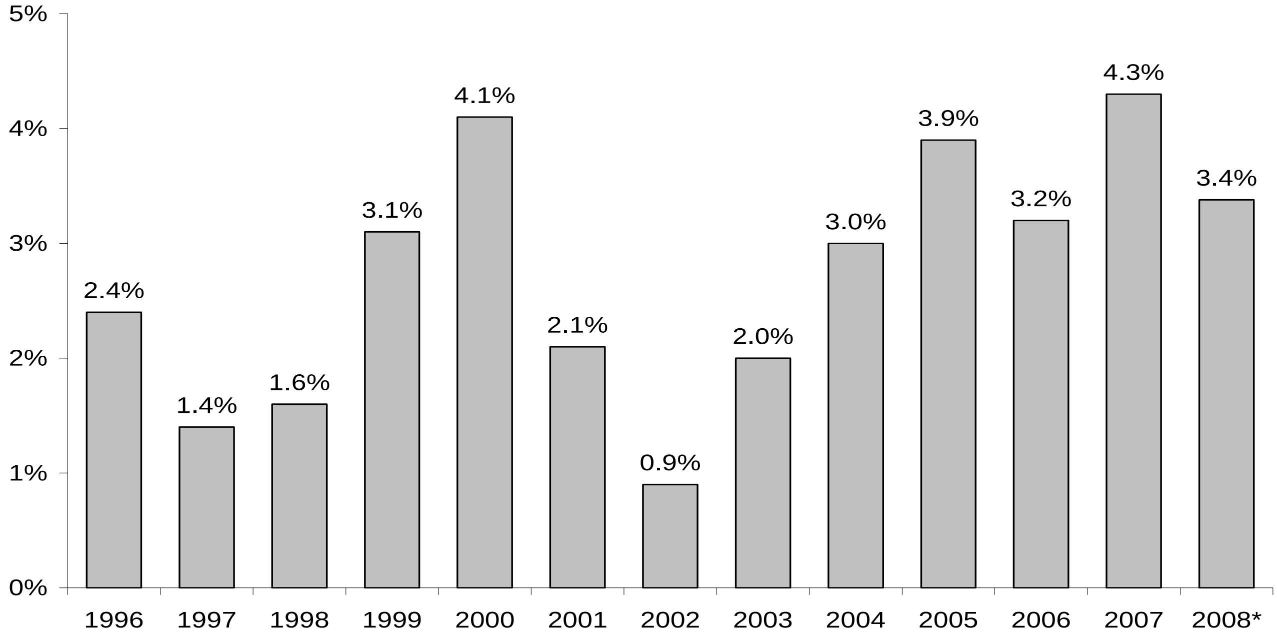
* 2007 Q3 to 2008 Q2.

SOURCE: Central Bureau of Statistics, Calculations by the Economics and Research Department

The labor market

The improvement in the labor market continued during the first half of 2008. In the past year (2008 second quarter compared with 2007 second quarter) the number of employed persons increased by 3.4 percent, reaching 2.77 million employed persons compared with 2.68 million employed persons in the first half of 2007. The growth in employment was centered among full-time payrolls, while the number of part-time payrolls decreased.

Development in the number of employed persons in Israel



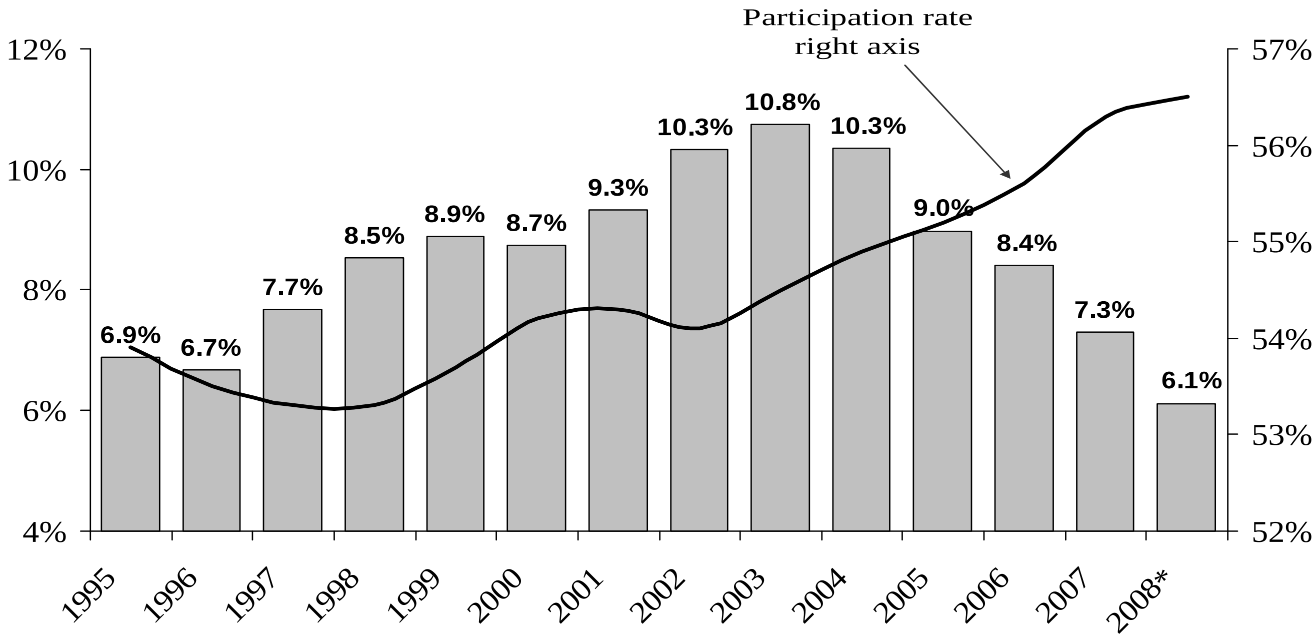
* 2007 Q3 to 2008 Q2.

SOURCE: Central Bureau of Statistics man power survey from different years, Calculations by the Economics and Research Department

.

A persistent increase in the labor force participation rate was recorded during recent years, from 54.1 percent in 2002 to 56.3 percent in 2007 and 56.4 percent in the second quarter of 2008. The rise in the participation rate resulted from such factors as the rapid growth in the economy (which increases the demand for workers), postponement of the retirement age, the policy of moving from allowances to labor, and a long-term process of improvement in the working age population's level of education (young people entering the labor market are more educated than the population retiring from the labor market).

The Unemployment Rate and the Participation Rate



*First half of 2008.

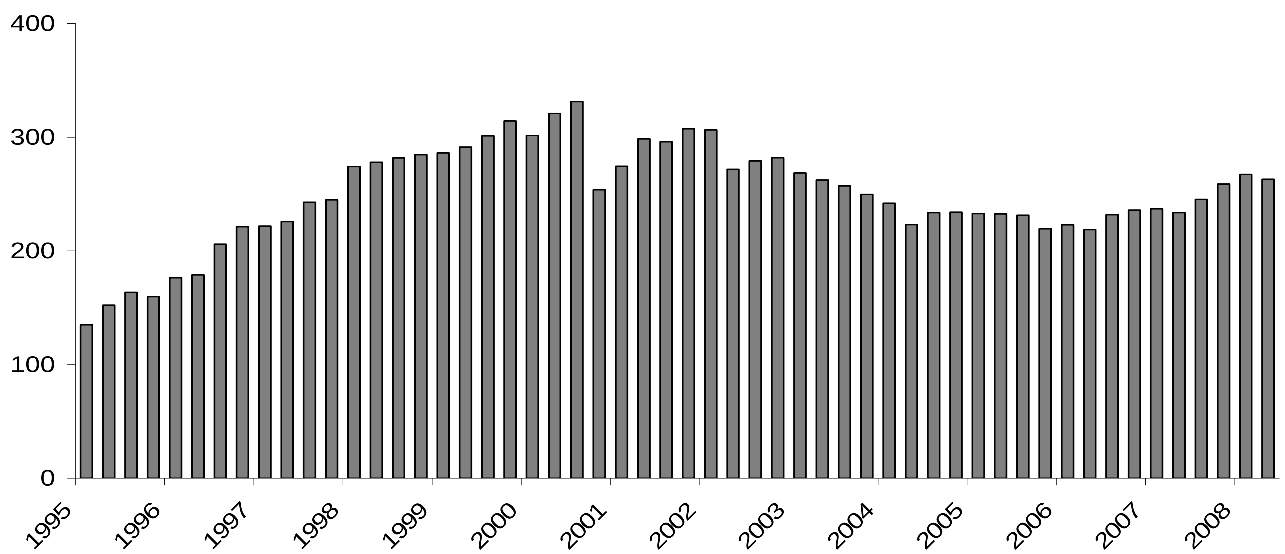
SOURCE: Central Bureau of Statistics man power survey from different years, Calculations by the Economics and Research Department

The unemployment rate continued to decline during the first half of 2008 and amounted to 6.1 percent (5.9 percent in the second quarter). This is the lowest level recorded since the mid-1990s. The combined process of a decrease in the unemployment rate and an increase in the participation rate derived from the fact that the growth in the number of employed persons during recent years exceeded the expansion in the working-age population, which resulted from the rapid growth in the economy leading to a large rise in demand for workers.

The number of foreign workers (and Palestinian workers) rose during the past year after falling during the years 2002-2004 and remaining stable until mid-2007. The decrease in the number of foreign workers from the beginning of 2002 until 2004 reflected the successful implementation of the government's policy of reducing the number of foreign workers in order to increase the number of Israeli employed persons and to improve the wages of Israelis employed in similar sectors. The changing trend during the past year resulted from the fact that while the number of foreign workers in industry and construction is still declining, the extensive employment of foreign workers in the agricultural industry is continuing.

Foreign workers in the economy, 1990-2008

(thousand)

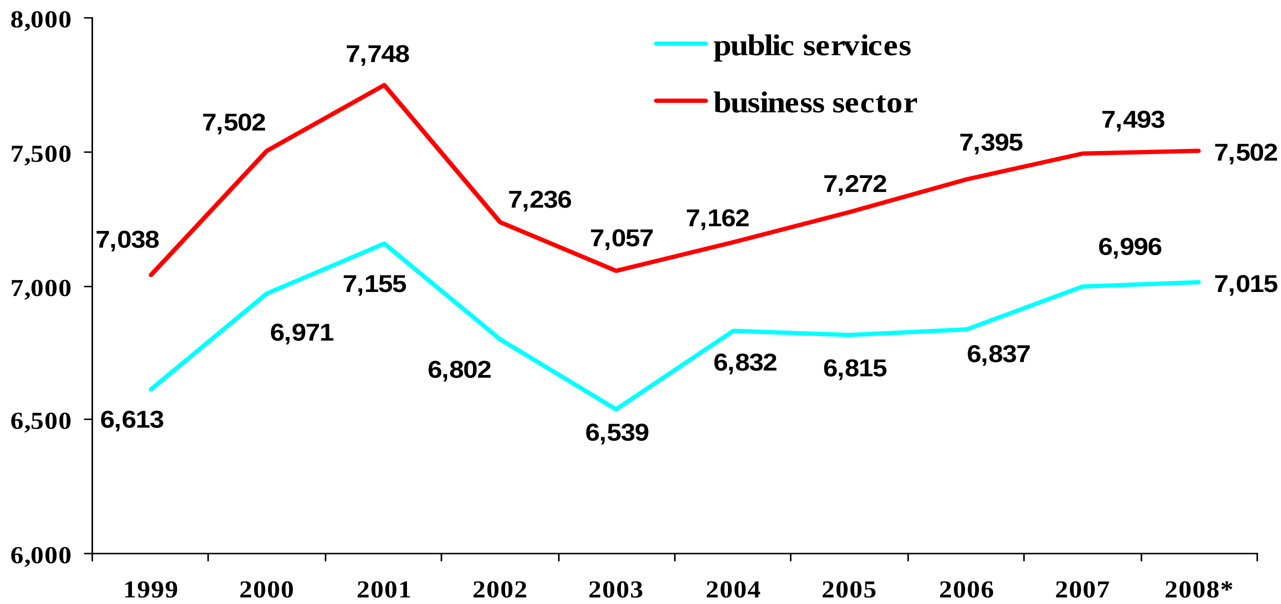


SOURCE: Central Bureau of Statistics.

The average real wage in the economy rose by 0.7 percent in the first half of 2008 year-on-year (the nominal wage rose by 5.0 percent in that period but was eroded by inflation).

Real Wages, 1999-2008,

Jan. 2004 prices, CPI-adjusted



* First half of 2008.

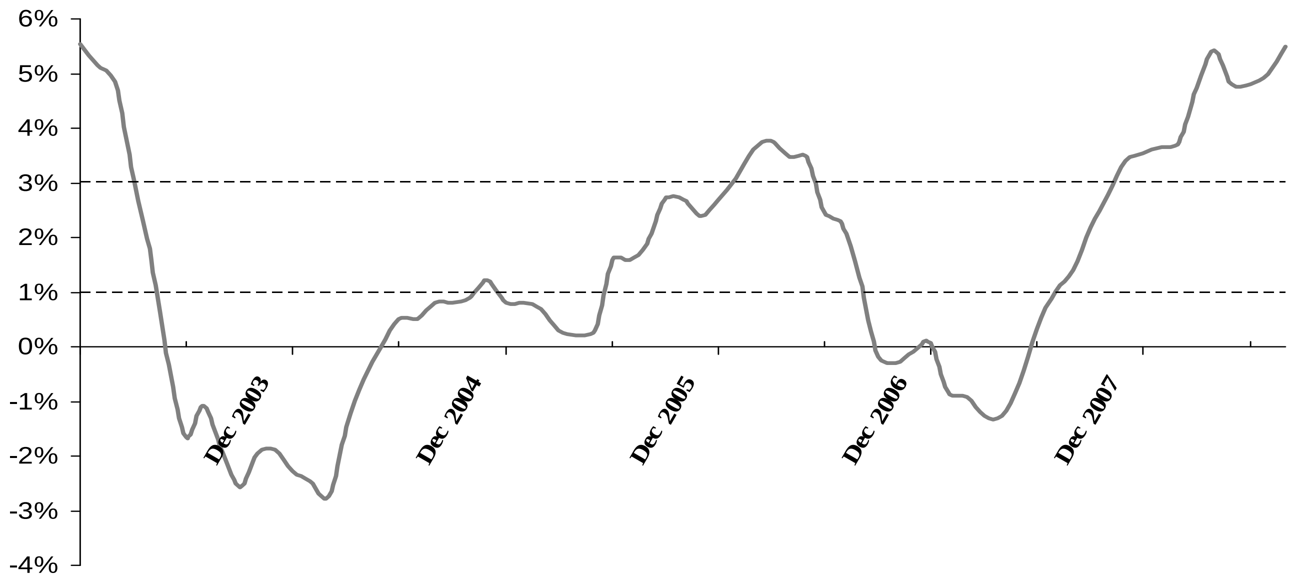
SOURCE: Bank of Israel.

Inflation and monetary policy

The consumer price index rose by 3.4 percent in 2007 (the index excluding housing went up by 3.9 percent). During the last 12 months (up to September 2008), the price index rose by the high rate of 5.5 percent (5.8 percent excluding housing) – considerably higher than the inflation target of 1-3 percent. Much of the rise in the index derived from the worldwide increase in energy and food prices. However, the upturn in inflation derived from local factors as well, including housing prices, which rose rapidly during recent months. This increase can be partly attributed to the erosion in housing prices (compared with the other components of the CPI) in the previous year resulting from their indexation to the dollar. The rapid strengthening of the shekel against the dollar from the beginning of 2007 greatly decreased this form of indexation (as well as the indexation of additional services). This process is positive in the long term because it reduces shocks in the economy by limiting the impact of volatility in exchange rate adjustments on inflation.

The rapid upturn in prices of raw materials and foods reversed in recent months. This process is expected to weaken the external inflationary pressures on the Israeli economy.

The 12–month Rate of Change in the CPI and Annual Inflation Targets



SOURCE: Central Bureau of Statistics, Calculations by the Economics and Research Department

Monetary policy during the past year was affected by two developments. The first development was the large rise in inflation, above the upper limit of the targeted range. The other development was the global financial crisis and fears of a global slowdown. At the end of 2007, the Bank of Israel's nominal interest rate amounted to 4.0 percent. At the beginning of 2008, the rate was increased by 0.25 percentage point but in March the Bank of Israel resumed its reduction of the interest rate, which reached 3.25 percent in May. Concurrent with the intervention in the foreign currency market and the decision to increase the foreign exchange reserves, the interest rate was cut as a result of the major strengthening of the shekel against the majority of principal currencies at the beginning of 2008, and due to concern that exports would be adversely affected by this development. Another reason for the interest rate cut was concern over the global slowdown and the expectation of further rate cuts in the USA. The high price indexes recorded from the beginning of 2008 and the importance of bringing down inflation expectations to within the targeted range, prompted the Bank of Israel to raise the interest rate by 0.25 percentage points in every month from June (1.0 percent cumulative to 4.25 percent for September). At an unscheduled decision in October, a decision was taken to cut the interest rate by 0.5 percentage point to a level of 3.75 percent, mainly due to the growing intensity of the global financial crisis and in view of the expectations of lower inflation and lower growth.

d. Initial economic development in the third quarter of 2008

Following the rapid growth recorded in the first quarter of 2008 and the slower growth in the second quarter, the majority of third-quarter indicators show a continuation of growth, albeit at a slower pace.

During the months July-September prices rose by 2.0 percent compared with the second quarter and by 5.5 percent compared with the third quarter of 2007. In September, however, the price index remained unchanged.

The worsening financial crisis in the USA and in Europe, the increased cost of credit for businesses and indicators showing a decline in non-financial activity are likely to become apparent and exert an effect mainly in the fourth quarter of the year in Israel.

Set out below are positive and negative indicators for the third quarter of 2008. All the data represent the average figures available for the third quarter compared with the average for the second quarter, seasonally adjusted, unless otherwise stated.

Positive indicators:

- A moderate but positive increase of 0.6 percent in industrial production[17]. Most of the increase was recorded in production by medium-high technology industries, which expanded by 2.3 percent.
- Exports of goods[18] excluding ships, planes and diamonds rose by 7.9 percent in dollar terms (July-August data).

[17] The average was calculated on the basis of data for July only.

[18] The export and import data detailed in the positive and negative indicators are in dollar terms.

- The revenue of the commerce and services industries increased by 1.8 percent (July data), after decreasing by 0.9 percent in the second quarter.
- The retail chains' sales rose by 2.3 percent (July-August data) after falling by 0.6 percent in the second quarter.
- Imports of raw materials excluding diamonds and energy expanded by 6.6 percent (July-August data).
- Imports of consumer goods rose by 4.6 percent (July-August data).
- The shekel depreciated by 2.1 percent against the dollar.
- Oil prices in world commodities markets fell by 4.8 percent, thereby alleviating inflationary pressures and reducing production costs.

Negative indicators:

- The Tel Aviv 100 Index fell by 10.6 percent. Stock market Indexes fell worldwide as well.
- The global financial crisis became more intense in September 2008.
- A 3.1 percent decrease (July-August data) was recorded in indirect tax receipts (seasonally adjusted at fixed prices).
- A decrease of 6.1 percent (July-August data) was recorded in direct tax receipts (seasonally adjusted at fixed prices)[19].
- A 2.0 percent rise in the consumer price index during the months July-September (During the 12 months ending in September, the index went up by 5.5 percent).
- A 2.4 percent decrease in service exports (July-August data)[20].
- A 2.6 percent decrease in imports of capital goods (excluding ships and planes).
- A 1.8 percent appreciation of the shekel against the euro.
- A 9.6 percent decrease in tourist arrivals by air.

[19] The comparison of direct tax receipts between the third quarter and the second quarter is significant because no legislative changes in direct taxation were implemented during the calendar year.

[20] Service export data are affected by the Bank of Israel's Composite Index, and do not represent the total service exports appearing in the national accounts.

e. Macroeconomic estimates for 2008 and assessments for 2009

General

Data for the first half of 2008 and the months July-September 2008 point to a slowdown in the trend of rapid growth recorded in previous years. We estimate that the global slowdown and the high level of uncertainty in the markets will adversely affect export and investment growth rates for the rest of the year. Due to the slower pace of growth in recent months and global economic uncertainty, growth in 2008 will amount to 4.2 percent.

The growth rate forecast for 2008 is 4.2 percent. Although this is a slower rate of growth than in previous years, it is higher than Israel's average growth rates in the last decade, and higher than the growth rates in the majority of developed countries.

e.1 Main assumptions behind the growth forecast for 2008 and 2009

The short-term growth rate in the economy is dependent on a number of factors that will affect demand for domestic uses and for exports. The main factors are:

- The global financial crisis and its implications (see section b).
- The global growth rate and its composition. According to the consensus forecasts, the growth rates currently forecast for 2008 are 1.6 percent in the USA and 1.2 percent in the eurozone. The growth rates expected for 2009 are 0.6 percent in the USA and 0.6 percent in the eurozone. The developed countries' growth rate, weighted according to their proportion in Israeli exports, will fall from 1.6 percent in 2008 to 0.8 percent in 2009. During recent months, these growth rates were downward adjusted persistently (see graph in section b).
- The extent of monetary restraint. As a result of the high inflation in the past year, the Bank of Israel raised the nominal interest rate in recent months. We estimate that inflation will converge to within its targeted range during the second half of 2009.
- Management of a responsible fiscal policy. One of the key assumptions is that the government will maintain an economic policy of adherence to expenditure and deficit targets.
- The security situation. The main working assumption is that no major deterioration in the security situation will occur during 2008 and 2009.

e.2 Main elements of the forecasts for 2008

Inflation

A deviation from the upper limit of the inflation target. The consumer price indexes in the first half of the year were heavily affected by the increases in world prices for raw materials and food. An increase in local prices such as housing (whose price decreased in the previous year relative to the other index components as a result of indexation to the dollar) was also apparent in recent months. We estimate that inflation during 2008 (December 2008 compared with December 2007) will amount to 4.9 percent, and that annual inflation will average 4.8 percent.

The participation rate

Moderate increase in the participation rate. The participation rate is expected to rise from an average of 56.3 percent in 2007 to 56.6 percent in 2008 as a result of the action taken by the government to increase the participation rate in the labor force, and also due to the postponement of the retirement age and the change in the composition of the working-age population. (The young population entering the labor market is more educated than the elderly population who is retiring from the labor market).

Employment

The growth in employment will continue. Employment will increase by 4.1 percent, while the unemployment rate will average 6.0 percent.

The public debt

The ratio of the public debt to GDP will continue to fall. The debt-GDP ratio is expected to fall from 79.8 percent at the end of 2007 to 78.5 percent at the end of 2008. Despite the decrease, the debt-GDP ratio in Israel is still significantly higher than in the majority of developed countries. The debt-GDP ratio in the OECD countries averaged 58.1 percent in 2007.

Private consumption

Private consumption is expected to grow by 4.3 percent in 2008 due to the continuation of the tax reform, the increase in the number of employed persons, the fall in unemployment and the moderate increase in real wages. The decrease in the value of the public's asset portfolio during 2008 will adversely affect consumption.

Public consumption

Public consumption is expected to grow by 2.3 percent in 2008. This increase takes into account the legally prescribed 1.7 percent growth in expenditure.

Investment in fixed assets

Investment in fixed assets is expected to increase by 5.5 percent. This increase is smaller than the increase in investment in fixed assets in the years 2006-2007, mainly due to expectations of a global slowdown and the high level of uncertainty in the market resulting from the financial crisis.

Exports

Exports of goods and services will expand by 4.9 percent (6.9 percent excluding diamonds). This is less than the 8.5 percent export growth recorded in 2007 due to the global slowdown and the appreciation of the real exchange rate.

Imports

Imports of goods and services are expected to rise by 4.0 percent. The rise is Affected by the strengthening of the shekel and the change in vehicle taxation.

e.3 Assessment for 2009

The growth forecast on which the 2009 budget is based amounts to 3.5 percent. As the result of global developments, this rate of growth is now at the upper limit of the forecast range. Since the level of uncertainty resulting from the continued development of the global crisis is particularly high, at this stage we have decided not to make repeated updates in the forecasts for 2009. The Finance Ministry is continuing to closely monitor current developments in the global and Israeli economy in order to maximize the economy's growth potential and to maintain the credibility of the fiscal policy. Once the implications of the crisis for the Israeli economy become clear, updates will be made in the growth forecast and the tax revenue forecast.

The reasons for the lower growth assessment for 2009 compared with 2008 are:

- The global financial crisis and its implications (see section b).
- A slower rate of export growth due to the delayed effects of the real appreciation of the shekel and the global slowdown.
- A decrease in the GDP gap and the resulting increase in supply restrictions. The decrease in the GDP gap is reflected by lower unemployment rates compared with previous years and by much higher fixed asset investment during the years 2006-2007.
- The high inflation in the past year adversely affected the increase in real wages and private consumption as a result. Private consumption could also be adversely affected by the decrease in the value of the public's assets portfolio resulting from the global financial crisis.
- The uncertainty in the markets is adversely affecting investments.
- End effects: These derive from the slower pace of growth in the second half of 2008. If activity in the third and fourth quarters proves to be relatively weak, this will affect the average rate of growth in 2009.

Growth in 2009 is dependent on the application of a responsible and resolute economic policy that will make an impact via a number of channels:

- **A moderate increase in government spending** in accordance with the expenditure limit will make it possible to further reduce the tax rates on individuals and companies (thereby increasing disposable income and private consumption), as well as a continued reduction in the public debt as a percentage of GDP, which will help to consolidate stability and growth in the economy.

- **A stable fiscal policy supportive of price stability**, an expansionary monetary policy and a decrease in the economy’s risk premium.
- **Continued investment in utilities, education, R&D and national projects** will form a basis for the economy’s continued business development.
- **Application of an active policy in the labor market** will permit a further reduction in unemployment, an increase in the participation rate and a rise in the standard of living of the weak strata.
- **Increasing the efficiency of the public sector in order to assure a high level of products and services for the citizen.**
- **Structural changes in the economy's different sectors, which will lead to greater competition and growth in productivity.**
- **Enhancing and increasing the efficiency of the regulatory system.**

Table 1. Real GDP growth rates and GDP components, 2004-2008

	2004	2005	2006	2007	2008
	Actual	Actual	Actual	Actual	**Estimate**
Real growth rates (in percentage)					
Gross domestic product	5.0	5.1	5.2	5.4	4.2
Private consumption	5.4	3.7	4.0	6.9	4.3
Of which: By Israeli households	5.5	4.1	3.7	6.9	4.2
Public consumption	-1.9	1.9	2.7	2.9	2.3
Gross investment	3.1	12.7	6.5	12.0	5.2
Of which: Investment in fixed assets	0.9	3.0	9.9	15.3	5.5
Of which: Investment in fixed assets excluding housing construction	1.9	4.1	12.8	18.7	6.3
Exports	17.5	4.2	6.1	8.5	4.9
Exports excluding diamonds	19.4	6.7	10.3	9.5	6.9
Exports of goods	16.0	3.1	5.5	9.0	4.5
I ndustrial exports excluding diamonds	17.9	6.3	12.4	10.2	8.2
Exports of services	20.7	6.6	7.4	7.5	5.8
Imports	11.8	3.3	3.6	11.7	4.0
Imports of goods	11.2	2.8	3.1	10.3	3.7
Imports of services	14.2	6.0	5.0	16.4	4.9
Business sector GDP	6.8	6.1	6.4	6.2	4.8
Per capita GDP	3.2	3.3	3.3	3.5	2.4

Table 2. Price indexes and the labor market, 2004-2008

	2004	2005	2006	2007	**2008**
	Actual	Actual	Actual	Actual	**Estimate**
Consumer price index					
Index (2006=100)	96.7	97.9	100.0	100.5	105.3
Change (annual average vs. annual average)	-0.4	1.3	2.1	0.5	4.8
Change (December vs. December in percentage)	1.2	2.4	-0.1	3.4	4.9
Wages					
Average wage at current prices	7,051	7,220	7,468	7,630	8,052
Annual change in current prices (in percent)	2.1	2.4	3.4	2.2	5.5
Annual change in fixed prices (in percent)	2.5	1.0	1.3	1.6	0.6
Employed persons					
Number of employed persons (thousand)	2,634	2,723	2,801	2,926	3,046
Annual change (in percentage)	1.7	3.4	2.8	4.4	4.1
Israeli employed persons					
Number of employed persons (thousand)	2,401	2,494	2,574	2,682	2,781
Annual change (in percentage)	3.0	3.9	3.2	4.2	3.7
Non-Israeli employed persons					
Number of employed persons (thousand)	233	229	227	244	265
Annual change (in percentage)	-10.1	-1.8	-0.7	7.2	8.7
Unemployed persons					
Unemployed (thousand)	278	246	236	212	179
Unemployment rate	10.4	9.0	8.4	7.3	6.0
Participation rate (in percentage)	54.9	55.2	55.6	56.3	56.6

Table 3. Real GDP and nominal GDP

	2004	2005	2006	2007	**2008**
	Actual	Actual	Actual	Actual	**Estimate**
GDP at fixed prices (2005 prices)	568.6	597.8	628.7	662.5	690.3
Rate of change in real GDP (in percentage)	5.0	5.1	5.2	5.4	4.2
GDP at current prices (NIS million)	563.7	597.8	640.8	673.5	713.4
Rate of change in nominal GDP (in percentage)	5.0	6.0	7.2	5.1	5.9

Principles of economic policy for 2009

a. Fiscal policy

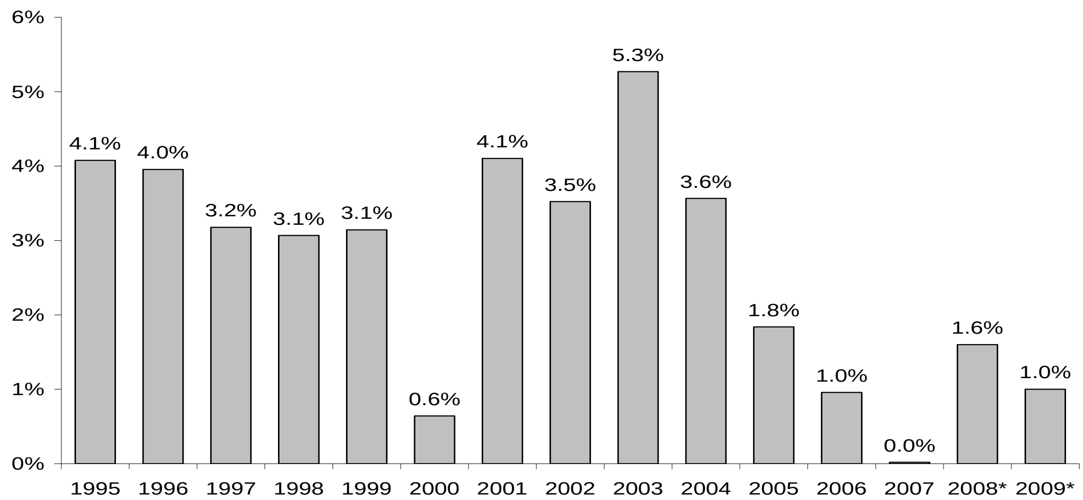
The economic policy proposed in the draft budget and the Arrangements Law for 2009 is a direct continuation of budgetary policy from previous years. The policy objective is to fully exhaust the economy's growth potential while reducing the economic gaps among the population. This policy will be applied on the basis of two main principles: Firstly, the economy's growth potential will be fully exploited by maintaining a responsible fiscal policy that will make it possible to reduce the tax burden and increase economic stability by means of a continued reduction in the debt-GDP ratio. Concurrently, reforms aimed at increasing efficiency in the economy will continue to be applied. The second principle, reducing economic gaps, will be implemented by applying the Socio-Economic Agenda and the Program for the Encouragement of the Periphery as short and medium-term measures, and by applying the reform in the education system as a means for reducing the gaps (and increasing growth) in the long term.

a.1 Government expenditure and the budget deficit

The draft budget for 2009 is based on two fiscal rules: a 1.7 percent real increase in the budget framework (net, including lending) and a budget deficit ceiling of 1.0 percent. The draft budget maintains the policy of preserving the budget framework and consistently reducing the budget deficit ceiling. The decrease in the budget deficit during recent years increased the stability of fiscal policy and its credibility, and made it possible to reduce the government (and public) debt. It should be noted that the budget deficit recorded during the years 2005-2006 and the break-even recorded in the budget in 2007 resulted from the rapid growth in the economy, which pushed up tax revenue in excess of the originally forecast level.

Budget deficit, 1995-2009

(as a percentage of GDP)



* Deficit ceiling in 2008 budget and draft budget for 2009.

SOURCE: Economics and Research Department calculations from data issued by the Accountant-General and the Central Bureau of Statistics.

a.2 Fiscal rule

Background

The present fiscal policy is managed, as mentioned, on the basis of two fiscal rules: limiting the real increase in the expenditure framework (the net framework including lending) to 1.7 percent and prescribing a budget deficit ceiling of 1.0 percent. These rules were determined in the Law for the Reduction of the Deficit and Limitation of Budgetary Expenditure. This law was first enacted in 1992, and in the initial years only governed the level of the deficit. As a result of the deep recession and large deficit recorded in the years 2001-2003, a decision was taken to add to the deficit restriction a rule limiting the growth in the expenditure framework. As a result, the growth in spending was restricted to 1.0 percent in 2005 and 2006 and 1.7 percent from 2007 (similar to the rate of increase in the population, meaning that the real per capita expenditure remains constant). The addition of the expenditure restriction enhances the credibility of fiscal objectives. This is because it supplements the deficit restriction, and reduces the reliance on growth and tax revenue forecasts, which tend to be highly volatile, as apparent when the economy slid into recession in 2002 and during recent years when growth (and tax revenue as a result) was higher than forecast.

Israel is by no means unique in determining fiscal rules. During recent years many countries have adopted fiscal rules that vary from country to country according to their nature and specific requirements. Accordingly, in certain countries the rules relate to the entire public sector while in other countries, they relate only to the central government deficit. Some of the rules are focused on the size of the deficit, some on the size of the debt and some on other factors. In addition, certain countries determine rules for the range of a year, while in others the rules are adopted on a multi-year basis or for the length of the business cycle.

- **Why are fiscal rules necessary?**

Fiscal rules have a number of important advantages:

- The creation of budgetary anchors that prevent a deviation from the budget and the development of inflationary pressures as a result.
- Enhancing the stability and credibility of economic policy vis-à-vis the business sector and foreign entities.
- Increasing the transparency of the budget.
- Supporting increased public sector efficiency.

However, the determination of rules limits the ability to manage an anti-cyclical policy, and could lead to the postponement of expenditures and thereby reduces the flexibility of the budgetary activity.

- **Guidelines for the rule**

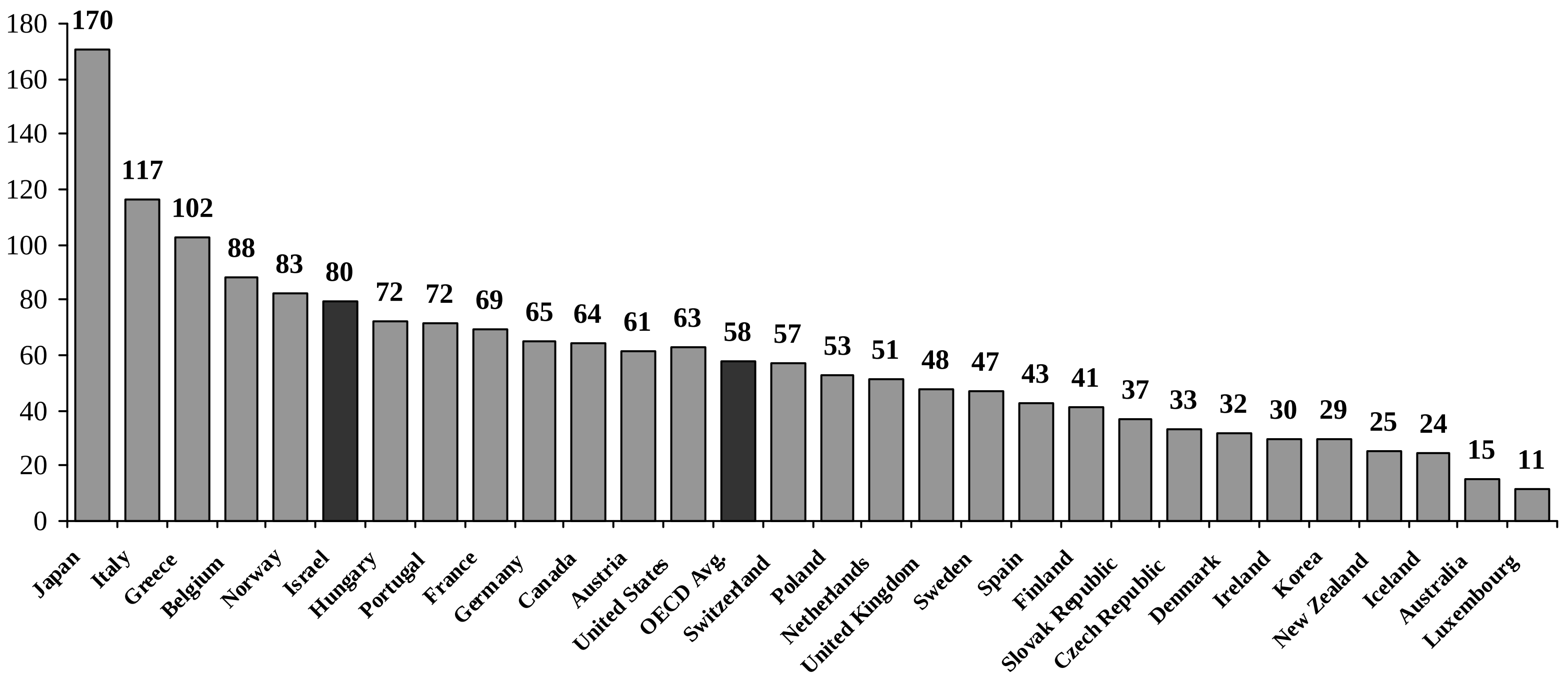
The appropriate fiscal rules for Israel in the medium term have been discussed extensively during the past year. Representatives of the Ministry of Finance, the Bank of Israel and the National Economic Council participated in these discussions. Various proposals for a new fiscal rule were raised at the discussions. Common to all of the proposals was that the main objective for the rule to be determined is that it should lead to a further reduction in the public debt and in the debt-GDP ratio to levels similar to the average in the OECD countries. Despite the rapid decrease in the debt-GDP ratio during recent years, it is still significantly higher than the average for the OECD member countries.

Based on the principles that have been presented, the fiscal rule will be built around two components:

- The first component, budgetary expenditure, will increase as the debt-GDP ratio decreases – The reduction in the debt-GDP ratio below a certain level will permit a larger real increase in the budget.
- The second component, the budget deficit ceiling, will not exceed 1.0 percent.

Gross public debt – international comparison, 2007

(as a percentage of GDP)



* OECD average is a simple average of the OECD countries appearing in the diagram.

SOURCE: Economics and Research Department calculations from data issued by the Accountant-General, the Bank of Israel, the Central Bureau of Statistics and the OECD.

An emphasis has been placed on reducing the debt-GDP ratio for several reasons:

– A decrease in the ratio increases the economy's resilience in the face of external shocks and increases its flexibility in a crisis situation.

– The geopolitical situation in Israel: The defense component in Israel's budget is significantly bigger than that of other developed countries. This component is expected to remain big in the future under any potential scenario (whether a continuation of the existing situation, a deterioration or an improvement).

– Aging of the population – This component is the main reason for reducing the debt in the majority of developed countries because its implications for social and health expenditures are considerable as a result of the growth in the elderly population compared with the population in the labor market. In Israel the situation is better than in other countries because the proportion of the elderly population is not expected to increase to a major extent during the coming decade. Thereafter however, a process similar to that occurring in other developed countries is expected. Reducing the debt in the medium term is therefore of major importance. It should be noted that maintaining a high level of debt transfers the burden to the coming generations.
– Reducing the debt brings down interest expenses and the cost of financing the debt, thereby freeing budgetary sources for other requirements without the need to expand the overall framework.

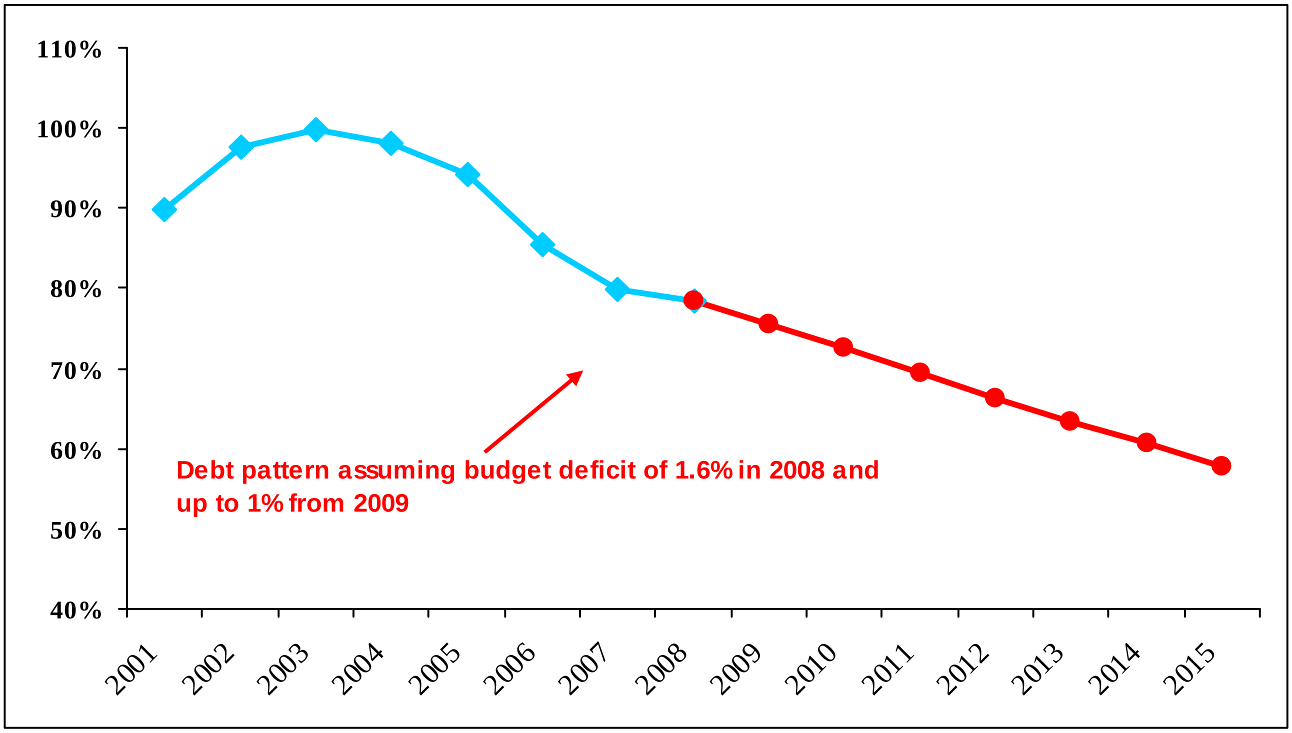
Apart from the main objective of reducing the debt-GDP ratio (to a level of 58 percent in 2015, similar to this year's average for the OECD countries, and an interim target of 70 percent in 2011) we were guided by a number of other principles when determining the proposed rule:

– The rule needs to be as simple and transparent as possible.
– The rule will maintain the credibility of fiscal policy by keeping within the budgetary framework and by providing a solution for medium-term budgetary needs.
– The rule will obviate the need for frequent changes, deviations (such as non-recurring increments) and for adopting solutions that bypass the budget.
– The rule will be based on actual economic developments, and will prevent the use of forecasts as much as possible.
– The rule will not create a pro-cyclical policy – increasing expenditures in a growth period and reducing expenditures in a period of slowdown – a process that leads to increased volatility.

A simulation based on the fiscal rule and assuming growth of 3.5 percent a year from 2009, a budget deficit of up to 1.0 percent from 2009 and annual inflation of 2.0 percent from 2010 shows that from 2015, the debt-GDP ratio will amount to 58 percent as targeted.

The public debt as a percentage of GDP

Simulation assumptions: GDP growth rate of 4.2 percent in 2008 and 3.5 percent in the years 2009-2015, inflation of 4.9 percent in 2008, 3.2 percent in 2009 and 2.0 percent from 2010.



a.3 Reducing Social Economic gaps

A second major component of budgetary policy for 2009 is the reduction of the economic gaps in the Israeli society while maintaining a growth-oriented policy. This policy will be based on short, medium and long-term measures, and will include various tools that have been formulated in the Socio-Economic Agenda and the Program for the Encouragement of the Periphery. In addition, significant budgets will be added for the purpose of applying the reform in the education system.

- **The Socio-Economic Agenda**

The government adopted the Socio-Economic Agenda in 2007. Following the adoption of the Agenda, an inter-ministerial committee headed by the Director-General of the Ministry of Finance was established. The committee set up various working groups with participants from different entities. These working groups are engaged in defining targets for improving the socio-economic situation, creating the tools for encouraging employment, monitoring the application of the tools and the manner in which their efficiency is measured, and a working group devoted to the matter of foreign workers. The Socio-Economic Agenda is focused on an improvement in the situation of the weak strata by increasing employment and wages and reducing poverty. As a result of the committee's activity, the government adopted two objectives for medium-term socio-economic policy: The first is an employment objective – increasing the employment rate among the 25-64 age group from 69.1 percent to 71.7 percent by 2010. The second objective is that of reducing poverty – the income of the lowest quintile will increase by 10 percent more than the per capita GDP growth rate in the years 2008-2010, while the proportion of income from labor to the lowest quintile's income will increase from 43 percent to 45 percent.

- **Ways of attaining the agenda's objectives**

Poverty in Israel is distributed in a non-uniform manner among the population. The ultra-orthodox sector and the minorities sector together account for a quarter of the entire population but contain over half of all of its poor families. The low labor force participation rate among ultra-orthodox men and Arab women is the main reason for this, and necessitates a focused treatment for these sectors. Accordingly, a number of actions are planned. These include a decision to encourage vocational training for occupations for which there is a demand in the labor market. This decision was already reflected in the budget for 2008, in which NIS 15 million were allocated for training male engineers and technicians in the ultra-orthodox sector. In addition, an authority was established for the purpose of promoting economic development in the minorities sector. The initial budget for the authority amounted to NIS 50 million in 2008. The objective of the authority is to fully exploit the economic potential of the minorities' population by encouraging productive and business activity within the sector.

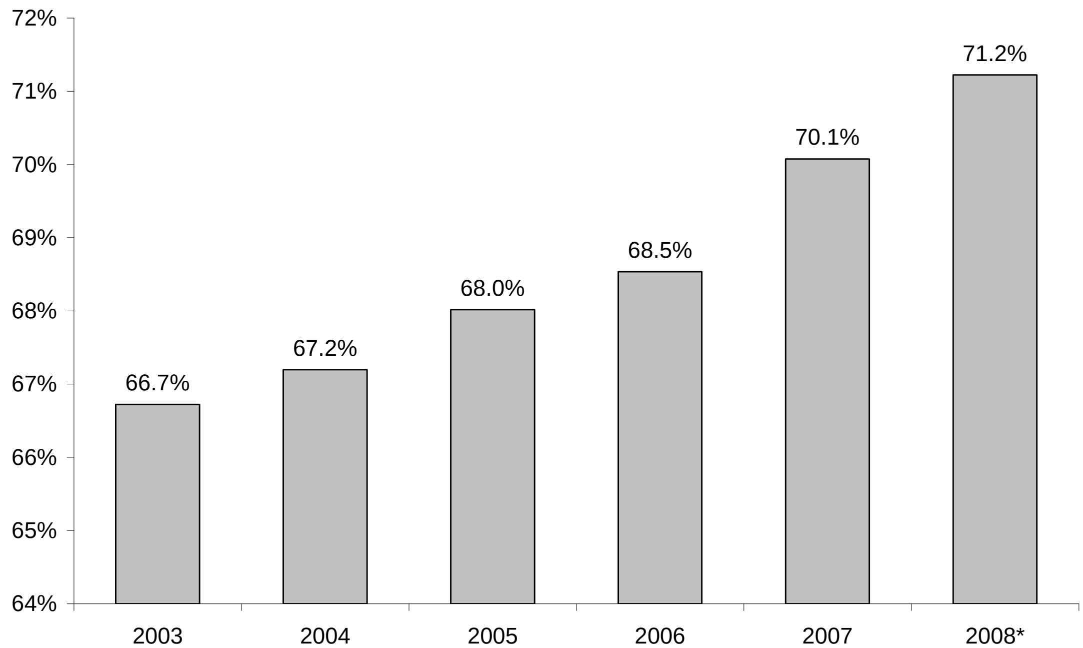
There is a need to endow a wide range of skills to the unemployed. Measures for encouraging the employment of the unemployed and groups that have remained outside of the labor market for an extended period of time will include an improvement in the *Mehalev* (Wisconsin) program, which is aimed at integrating income maintenance recipients in the labor market and preparing for the application of this program nationwide. In addition, the range of assistance provided by means of day-care centers has been extended, a measure that supports the employment of women and increases the disposable income of the populations that are able to use these centers. The 2009 budget will include increased subsidization of day/half-day care centers for the children of working women. Measures for promoting employment also include the *Laron* program for integrating disabled persons in the labor market, and the *Tevet* program, which is intended to examine tools for promoting employment among special population groups. Another NIS 55 million has been allocated in the 2009 budget for vocational training for the purpose of replacing foreign workers.

Earned income tax credit (EITC – that is, negative income tax) is an additional means for reducing poverty among working families and raising the labor force participation rate by increasing the remuneration for labor to low income-earners. The program provides a solution for the problem that has arisen as a result of the various forms of support granted to the unemployed and the needy concurrent with the low wages offered to them, which have made entry into the cycle of employment an unattractive proposition. A detailed program for applying EITC in Israel has already been compiled, and began to operate in recent months. The program will be applied in stages, initially in regions where the *Mehalev* program is operated. By 2010, the program will be extended to cover the entire country. A quarter of a million households will be eligible for the benefit once the program is applied nationwide.

Apart from the previously mentioned activities, the Agenda is concerned with the possibility of making the system of allowances a more efficient and focused, and with expanding the social services. The system of allowances needs to become more efficient because the effectiveness of some of them is doubtful, in the sense that their contribution to the population in most need of assistance is low relative to their cost. Accordingly, it is proposed in the agenda to examine the implementation of focused allowances for the needy elderly population.

As stated, one of the agenda's objectives is to increase the rate of employment among the 25-64 age group to 71.7 percent in 2010. As a result of the substantial improvement in the labor market during recent years, the employment rate reached 71.2 percent in the second quarter of 2008.

Employment rate in 25-64 age group



* 2008 Q2, seasonally adjusted.

SOURCE: Central Bureau of Statistics man power survey from different years, Calculations by the Economics and Research Department

Government wage and Personal policy [21]

On May 22 2003 a collective agreement for encouraging growth in the economy was signed by the government and other public service employers, and the New Histadrut for the period from July 1 2003 to June 30 2005. The agreement related to a temporary reduction in wages, postponement of the date for updating the cost-of-living increment, and postponement of the date for payment of vacation allowance and the seniority bonus. Following the agreement, it was stipulated in the law that the reduction and postponement of these payments will also apply to employees who are not represented by the New Histadrut and other entities in the public service that were part of the agreement. The budgetary saving deriving from the implementation of the agreement reached NIS 2 billion a year in those years.

On December 12 2004 an additional agreement was signed with the New Histadrut, specifying that the wage reduction would end as scheduled and that the payment of vacation allowance for 2004 would be brought forward to salary payments for December 2004 (instead of the beginning of 2005). In the civil service, the second date for payment of the cost-of-living increment for 2002 was postponed to June 2006, in accordance with the agreement for the encouragement of growth and the agreement of December 12, 2004. The wage reductions specified in the collective agreement signed with the Histadrut Labor Federation ended in July 2005.

The salaries of senior officials which were indexed to the average wage were updated in January 2006 for the first time since 2001. The basic salary of senior officials which is indexed to the salary of deputy ministers was fully adjusted to the rise in the index during the years 2001-2006.

In June 2006 public sector employees were paid the second part of the cost-of-living increment for 2002, at the rate of 2.1 percent of the salary exceeding the minimum wage. No limit was placed on the payment of the cost-of-living increment for employees at grades represented by the Histadrut. Other employees were limited to a ceiling of NIS 7,856.

In April 2006 the legal minimum wage was adjusted in accordance with the increase in the average wage in the economy to NIS 3,456.58 a month. Under the agreement for the establishment of a

[21] This section was prepared by the Wages and labor Agreements Department.

coalition government, the minimum wage was adjusted to NIS 3,585.18 a month in July 2006, NIS 3,710.18 a month in April 2007, and to NIS 3,850.18 a month in July 2008.

An arbitration process is currently being conducted prior to the signing of a collective wage agreement between employers in the health sector (the government, Clalit Health Services and Hadassah) and the Israel Medical Federation (an employees' organization representing the doctors). This is an alternative mechanism for resolving disputes between the parties involved by means of compulsory arbitration, if the parties fail to reach an agreement in the course of normal negotiation.

The government specified a number of requirements in the course of the arbitration. The principal requirement is that doctors should "clock-in" for work. Doctors are the only government employees who do not clock-in and merely report manually every month.

An arbitration ruling concerning the erosion of the salary of teachers for the years 1999-2001 was issued in May 2007. The arbitration ruling prescribed a 4.75 percent increase in the wages of teachers with effect from January 2007, as well as non-recurring compensation for those years for pensioners who are insured in an accrual pension.

On September 10 2007 a collective agreement was signed for the initial application of the reform in the education system, at elementary schools and in junior high school grades (for teachers who are represented by the Teachers Federation only), following the signing of the declaration of principles on May 16 2007 between the State of Israel and the Teachers Federation. The reform measures to be applied in elementary schools, junior high school grades and special education schools were agreed recently. Under the reform, the teachers will be entitled to an average salary increment of 26 percent. In addition, requirements were stipulated whereby students are to be taught in smaller groups and teachers are to remain at school for such purposes as teaching-support work and staff meetings. 313 schools moved to employment in accordance with the conditions of the reform in the 2007/8 academic year, 500 schools did the same in the 2008/9 academic year, and the reform will be gradually applied at the other official schools over six years until full implementation on September 1 2013. The government intends to complete the reform at high-school grades, nursery schools, seminars and colleges.

Concurrently, a salary agreement was signed with the Teachers Federation on February 21 2008 and the Teachers Organization on January 24 2008 for a cumulative 5 percent cost-of-living increment as in the public sector, as well as a 4 percent increment in respect of erosion during the years 2002-2007 with effect from January 2008.

On April 14 2008 an arbitration ruling was issued regarding the completion of the erosion payments to teachers which had not been covered in the collective agreement or in the erosion arbitration ruling for the years 1999-2001, such as non-recurring compensation for the years 2002-2007 for pensioners insured in an accrual pension.

On January 18 2008 a salary agreement was signed between the universities and their senior academic staff for the years 2002-2009, following a 90-day strike. Under the agreement, a 24.2 percent cost-of-living increment was paid to senior academic staff, as follows:
14 percent – cost-of-living increment.
4.7 percent – increment in respect of the public sector agreement.
5.5 percent – application of seniority to half the academic increment.
The senior academic staff at the universities undertook to complete the 2007/8 academic year no later than the beginning of the 2008/9 academic year.

On April 17 2008, following negotiations between the government and public sector employers, and the New Histadrut in July 2007, a framework agreement was signed in the public service which provides a salary increment to employees represented by the Histadrut in the public service, as follows: In May 2008 a non-recurring bonus of 16.5 percent was paid for the period January 2008-November 2008 (based on a calculation of 1.5 percent a month). A salary increment of 3 percent will be paid in 2008 and a 5 percent salary increment will be paid in December 2009.

Under the agreement, an across-the-board committee was established for the purpose of compiling recommendations for principles for a change in the employment structure in the public sector, which will be concerned *inter alia* with increasing the employers' managerial flexibility.

In addition, it was agreed that pensioners who were insured in a budgetary pension, which until then had been indexed to the wages of active employees, would henceforth be indexed to the consumer price index once a year in January. A bill for changing the Civil Service Law with respect to pensions has now been submitted. Pensioners will be eligible for compensation in respect of the move to the new indexation method at rate of between 5 percent and 12 percent, according to their date of retirement. The same change will be applied in the security forces as well.

Negotiations will shortly be held with all the professional organizations belonging to the Histadrut, regarding the manner of distributing the salary increment as agreed in the framework agreement to all grades.

The average wage in the public sector (NIS 7,277.40 a month) rose by 2.7 percent in 2007. Real wages in the public sector increased by 2.24 percent.

Enforcement of the Budget Basics Law and supervision of budgeted entities

As a result of the serious findings contained in the Salary Commissioner's annual report, in July 1997 the government decided to establish a mechanism for enforcing Section 29 of the Budget Basics Law. This section stipulates that budgeted entities cannot change their employees' salary or retirement terms beyond what is accepted with respect to all State employees.

Following this decision, an Enforcement Unit was established at the wages and labor agreements department in the Ministry of Finance. The unit's function is to coordinate the activities required for the purpose of enforcing the Budget Basics Law, including the filing of lawsuits by the State in all matters relating to the revocation of agreements and arrangements and deviations from wage levels, and the prosecution of those responsible. In cooperation with the State Prosecutor, the Enforcement Unit is employing its authorities to increase the supervision on budgeted entities (including local government), and to prevent wage deviation.

The Enforcement Unit deals with wage deviations at local government, the Israel Electric Corporation, the Bank of Israel, the universities, and other supported and budgeted entities in the public sector. During eight years of enforcement, over 2,500 decisions have been made concerning the wage and pension conditions of thousands of employees in the public sector, leading to a cumulative saving of over a billion shekels and on an actuarial basis, of over NIS 2.5 billion. The enforcement activities have created a deterrent effect among the budgeted and supported entities. This deterrence has saved amounts estimated at hundreds of millions of shekels.

The enforcement and audit network was increased during the past year by means of external auditors. In addition, an Investigations Unit is currently being established for the purpose of taking disciplinary action against employees at budgeted and supported entities who violate the provisions of the Budget Basic Law and who thereby approve wage excesses.

Financing the Deficit[22]

The budget deficit is mainly financed by means of domestic and overseas borrowing and via the privatization of government assets.

Financing the budget deficit by means of large-scale borrowing focused in the local market could deter business entities from the market and lead to a rise in the long-term interest rate, thereby detracting from investment and growth rates. A decrease in the government's borrowing requirements will make it easier to finance business sector credit.

Trends in the years 1995-2004

During the years 1995-2004 the budget deficit was mainly financed by issuing bonds in the local market. Following the reform of the pension funds, the volume of non-marketable borrowing increased greatly. During that period the government issued bonds in overseas markets for the first time, in the USA, Europe and Japan. Borrowing in the USA during the years 2002-2004 was largely based on the US Administration's second guarantees program.

Trends in the years 2005-2007

During the years 2005-2007 two parallel processes developed: Privatization receipts accounted for a relatively high proportion of deficit finance, at a time when the size of the deficit as a percentage of GDP was decreasing continually. The deficit amounted to 1.6 percent of GDP in 2005, 1 percent in 2006 and in 2007 a budgetary break-even was recorded. Concurrently, as a result of the relatively low

[22] This section was prepared by the Accountant-General's Department.

borrowing requirements, it was not necessary to issue bonds guaranteed by the US Administration, and foreign currency loans were based on independent issues in the euro market, and the global market, and on issues by the Bonds organization.[23] The majority of domestic bond issues were based on the tradable market.

2008 and forecast for 2009

The above-mentioned trends are expected to intensify in the years 2008-2009: Since borrowing requirements are not expected to increase to any major extent, the probability of having to use the guarantees program is not high. In addition, foreign currency finance is expected to be largely based on independent issues abroad and on independent issues in the global and/or euro market. The majority of domestic borrowing will be based on tradable issues.

Capital Market Policy[24]

The Israeli capital market progressed rapidly during recent years, towards becoming a developed, modern and advanced market conforming to international standards. This development was reflected by a large growth in trading turnover on the stock exchange, an increase in business sector issues of capital via the capital market, and an upturn in the volume of investment by foreign investors. But after five positive years, the Israeli capital market began to experience a period of recession and growing risk. The weakness in the capital market, which began in the second half of 2007, derived from the negative developments in the global macro-economic environment resulting from the increase in commodity prices and the global credit crunch. After nearly a decade of growth in the volume of issues and in the market segment of non-bank credit, a slower pace of issues by the business sector is now apparent.

Despite the increased uncertainty notable in the short term, it is acknowledged that a competitive capital market that permits the effective diversification of risks and helps to increase the sources of credit for the business sector is a precondition for the development of a modern economy, and for

[23]A sovereign issue took place in the euro market in 2005 and, a sovereign issue took place in the global market in 2006, while no sovereign issues took place abroad in 2007.

[24] This section was prepared by the Capital Market, Insurance and Savings Department.

attracting foreign investors to Israel. The awareness of the need for a developed capital market as part of an efficient financial services sector motivated the measures that were adopted in recent years in order to increase the competitiveness of the capital market for the purpose of conforming to the standards of the world's most advanced markets. The measures taken covered the liberalization of institutional investors' investment policy, including an abolition of the restrictions on the volume of investment abroad and a reduction in the rate of investment in designated bonds at the pension funds. These measures enable institutional investors to manage savers' money efficiently and in accordance with the economic criteria that are accepted at similar entities worldwide, concurrent with the expansion of the non-bank credit market; increasing competition in the capital market and the efficiency of the market by removing the management of the provident funds and mutual funds from the banks, the amendment to the Provident Funds Law, which facilitates a simple and easy comparison between all financial products, the entry of the banks into the area of pension advisory and providing regulatory coverage for assuring the mobility of the public's long-term savings between the different entities; regulating the activity of market makers in the stock exchange, which has contributed to an increase in the level of tradability and transparency in the capital market; and the equalization of the rates of tax on investments abroad and in Israel.

Concurrent with the increased competitiveness and the minimization of conflicts of interest in the capital market, institutional investors' growing exposure to the capital markets in Israel and abroad and the intention to develop a repo market and a securitization market, which should increase the efficiency of risk management and the allocation of credit in the economy, considerable emphasis is being placed on the instilment of a high level of norms for management, supervision and transparency, and on strengthening the financial stability of the institutional investors that manage an increasingly large proportion of the public's money. Among the notable developments in this respect is the adoption of the Solvency II Directives, which relate to the capital structure of the insurance companies. The adoption of these changes represents a fundamental and comprehensive change in the regulations governing the assurance of the insurance companies' repayment ability and capital adequacy, in order to enhance the protection of the money of savers and those insured at the companies, and to increase competition in the insurance industry.

- Regulatory coverage of the regulations for proper corporate governance at institutional investors, with reference, *inter alia*, to the effective functioning of the board of directors, and the strengthening and regulation of the internal auditing network. This is intended to increase transparency, to enhance the institutional investors' performance, and to help them achieve their objective.

- Adapting the guidelines for the management of credit risks, which are one of the principal risks facing the institutional investors. This is in order to assure proper managerial, professional and operational support for the management of credit risk, while strengthening internal and external monitoring and control mechanisms.

The increased sophistication and development of the financial services sector in Israel as a whole and of the capital market in particular is a necessity dictated by technological reality and the globalization of financial services. The concentration of worldwide financial activity in international financial centers makes it necessary for the supervisory authorities, the business sector and the institutional investors to bring their standards of efficiency, sophistication, transparency and corporate governance norms to the same level as those practiced in other developed countries in order to maintain and to increase the competitiveness of the Israeli economy. The measures taken in recent years in order to negate conflicts of interest and to increase the competition in the capital market are measures that are necessary in order to conform to these standards.