Economics and Research Department / Ministry of Finance

December 2005

Economic Trends in Israel

Macroeconomic Review

- General data
- Product and employment
- Balance of payments and external stability
- Fiscal policy
- Monetary policy and inflation rate

contacts for comments and questions: sarel@mof.gov.il, eldadsh@mof.gov.il

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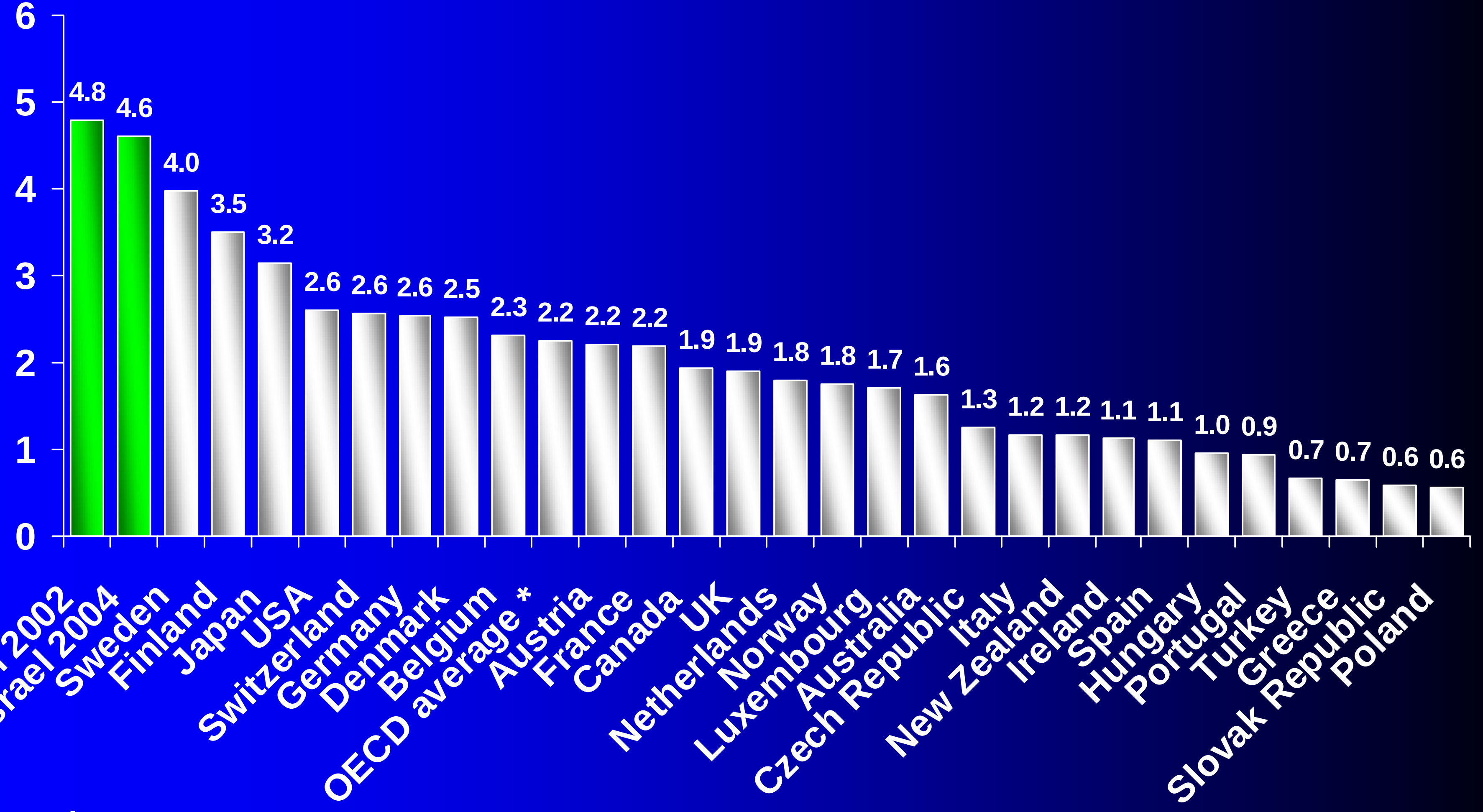
General data

1. Level of technology
2. Level of education

General data

1. **Level of technology**
2. Level of education

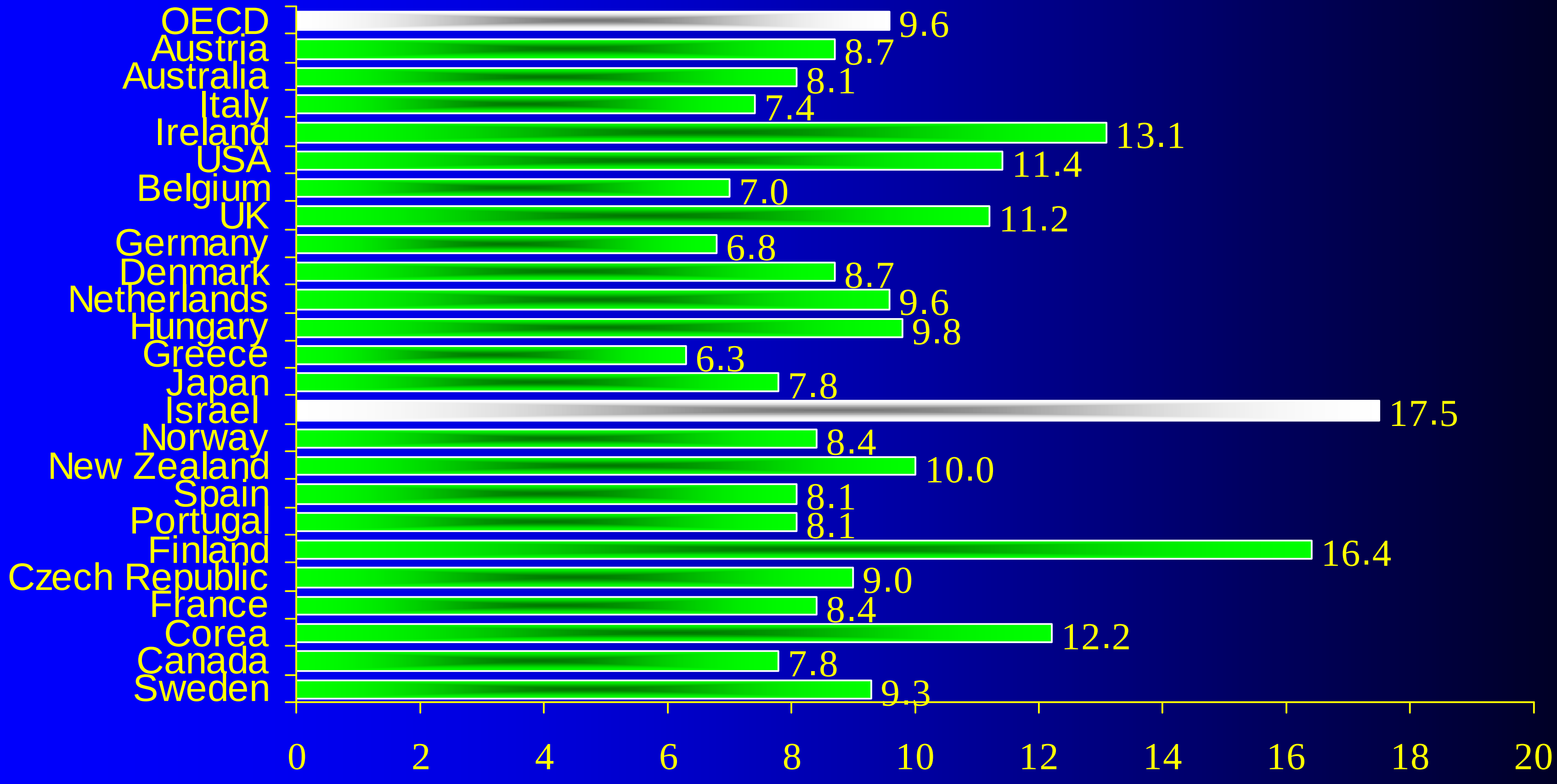
Expenditure on Civilian R&D as percent of the GDP in Israel and in OECD Countries, 2003



* Average of 30 OECD countries.

Israel ranks first in R&D investment (as percent of GDP).

ICT Product as percent of total business sector product, 2001



Israel ranks first in its proportion of ICT production in total business sector product.

General data

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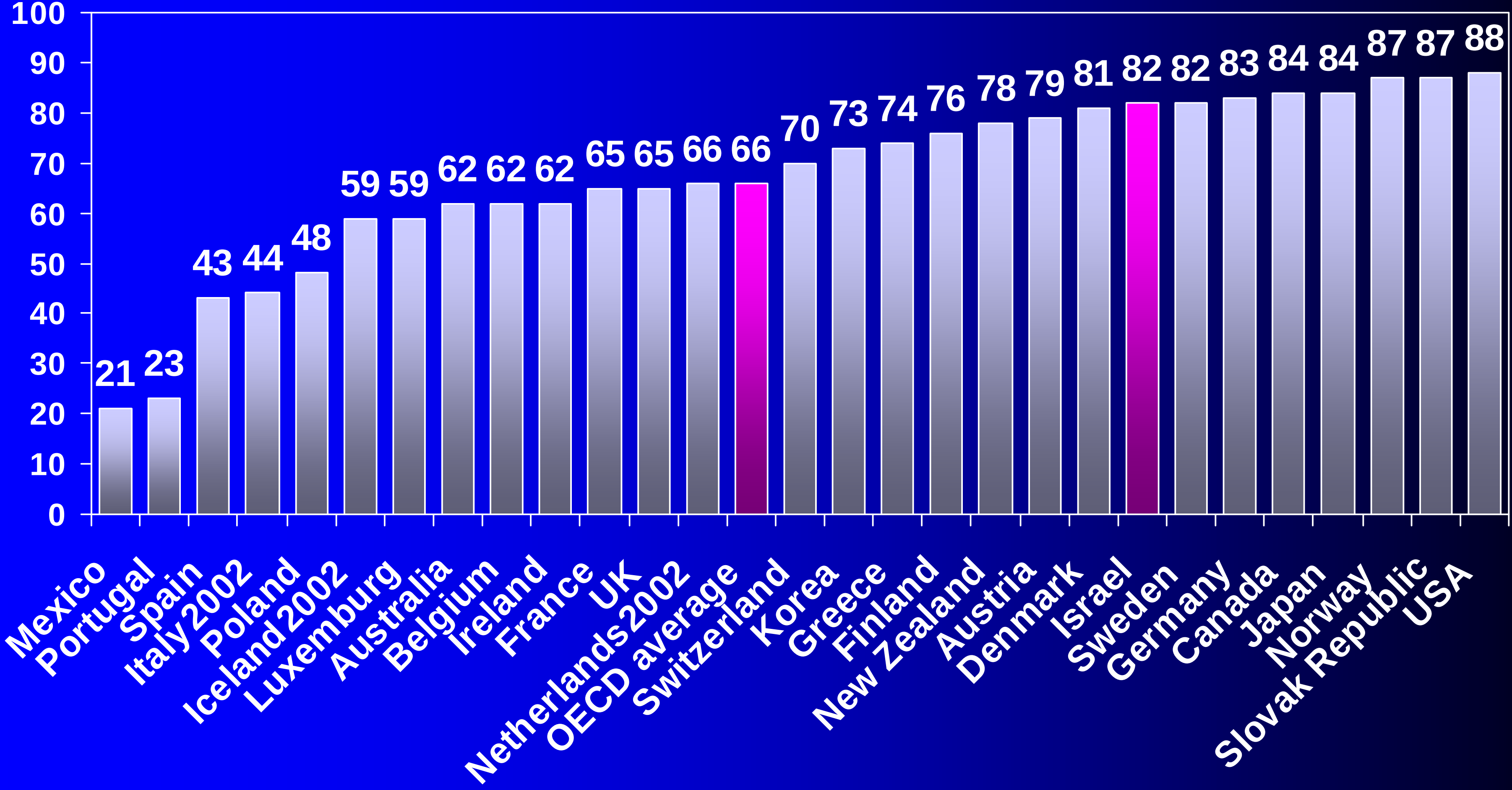
General data

1. Level of technology
2. **<u>Level of education</u>**

Percent of Population that attained at least upper secondary education, ages 25-64, 2003



One measure of the country's level of education is the percent of its population that has at least twelve years of schooling. By this measure, Israel ranks rather high by international standards.

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Product and Employment

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2. GDP per-capita – international comparison
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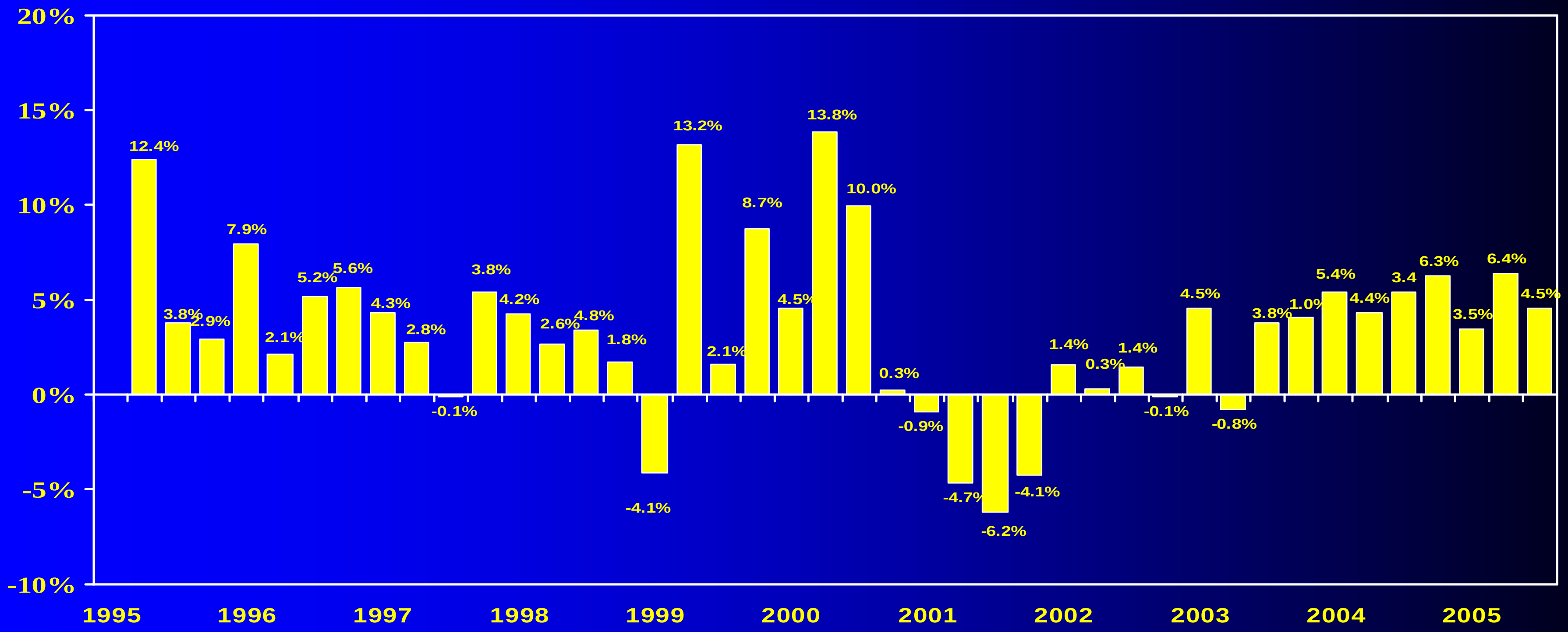
GDP Growth

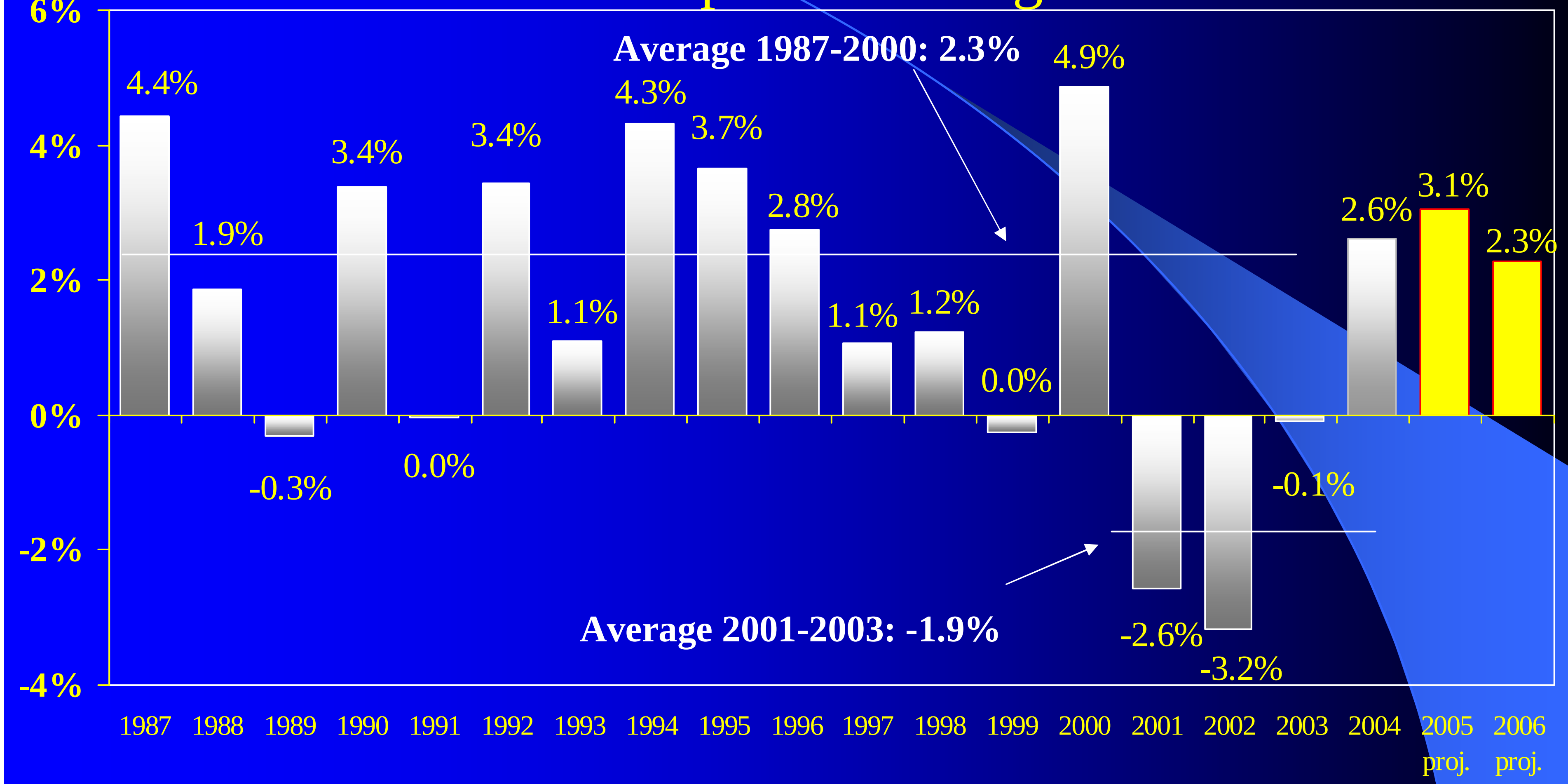
(quarter-on-quarter at annual rate, 1995Q2-2005Q3)



The growth rates are expressed as the rate of quarter-on-quarter change in annual terms. In 1999–2000, Israel experienced high growth rates relative to the economy's past performance and by international standards. Since October 2000, the growth rate has been declining due to the global economic slowdown, which has dampened demand for the high-tech products on which the Israeli economy relies, the decline on the Nasdaq index, which reduced investments in Israeli start-up companies and in high-tech industry in general, and due to the adverse effects of Palestinian terrorism on tourism, construction, agriculture, and exports to the Palestinian Authority areas. The tight monetary policy has been an additional impediment to growth. In 2002, a slump in private consumption caused the negative effects to spread to a larger number of industries. The recovery process began in 2003 and gathered speed in 2004 and 2005. While in 2004 the economy grew at a fast pace of 4.4 percent, the growth rate is expected to reach about 5 percent in 2005. Contributing factors to the rate of growth included the global economic recovery (manifested in the expansion of global trade and high-tech activity), less uncertainty and more credibility due to the adoption of a firm fiscal policy, relative calm on the security front, and a less contractionary monetary policy.

GDP/Person Growth

annual percent change



GDP per capita is an indication of a country's standard of living. Israel's per-capita GDP declined in 2001-2003 by 5.8 percent in cumulative terms. This is an unprecedented decline in the standard of living. In 2004, due to the economic recovery, the trend has changed and GDP per-capita climbed by 2.6 percent. This trend is expected to continue and to reach GDP per-capita growth of 3.1 percent in 2005 and 2.3 percent in 2006.

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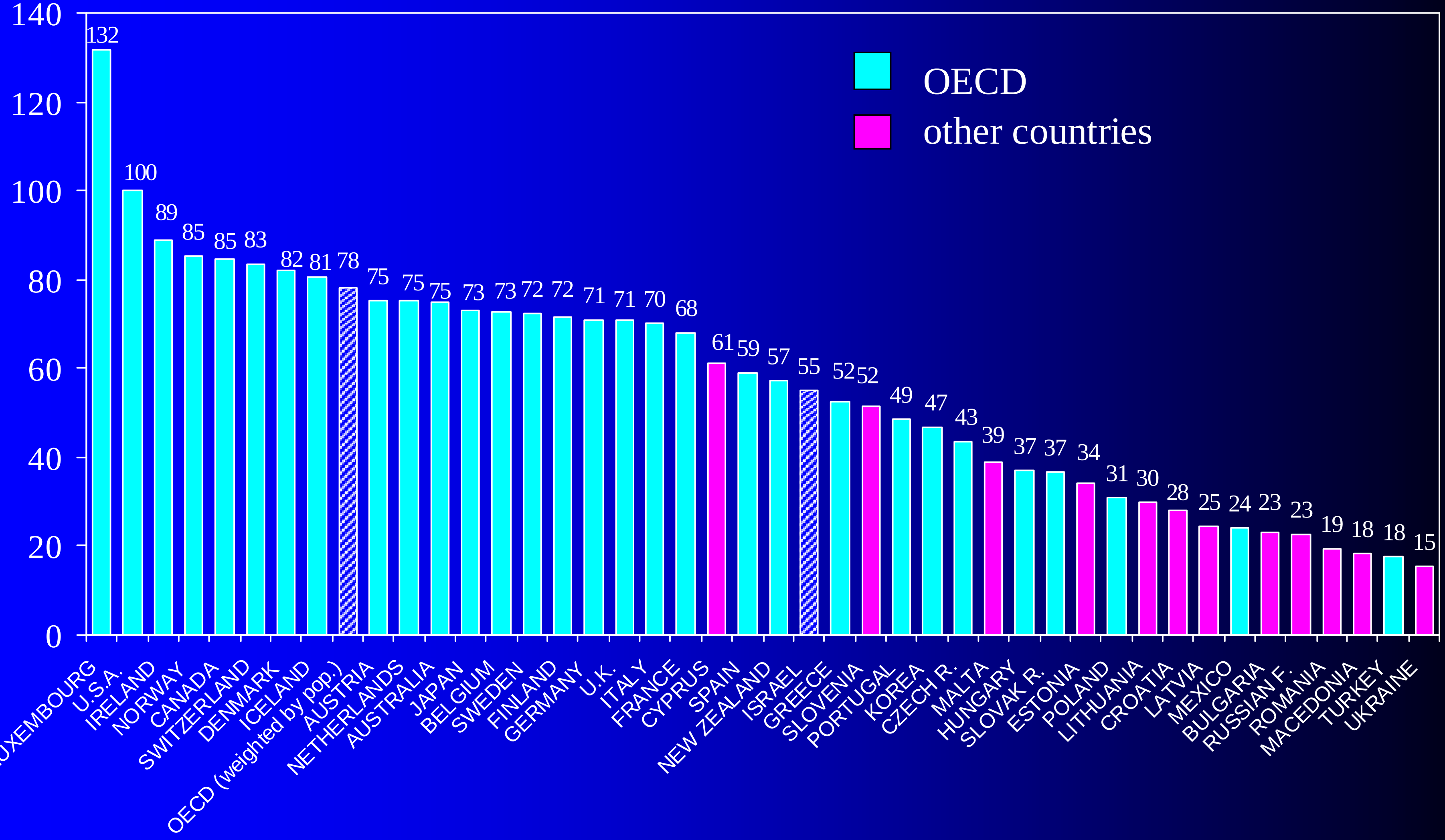
GDP/person (PPP-adjusted), index (USA = 100), 2004



In 2004, GDP per-capita was lower in Israel than in the U.S. and most Western European countries, but higher than in many OECD countries. Israel's GDP per-capita in 2004 was 70 percent of the weighted average in the OECD countries and 55 percent of GDP per-capita in the U.S.

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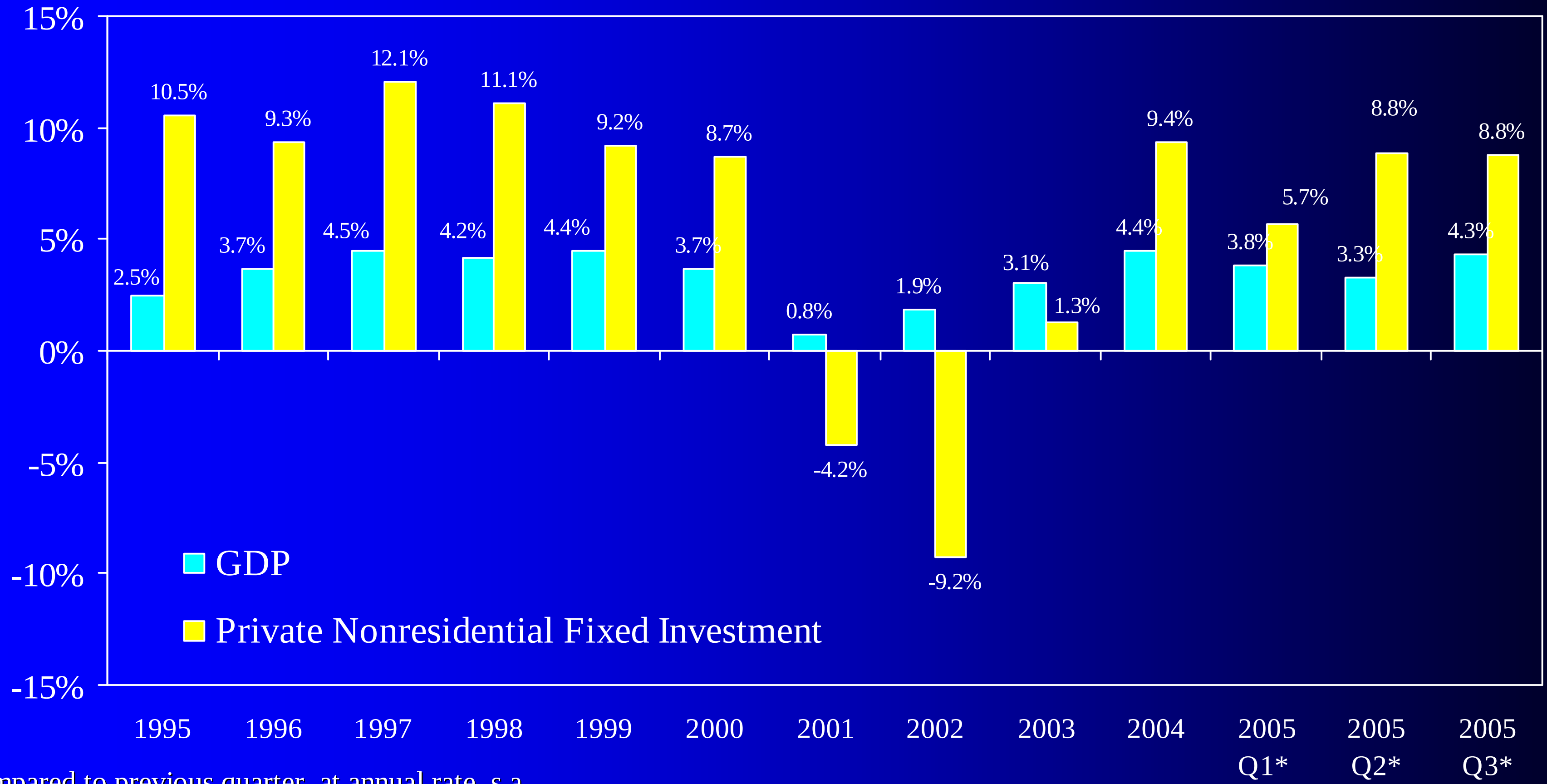
The U.S. Economy, 1995-2005

real growth rates of GDP and business investment

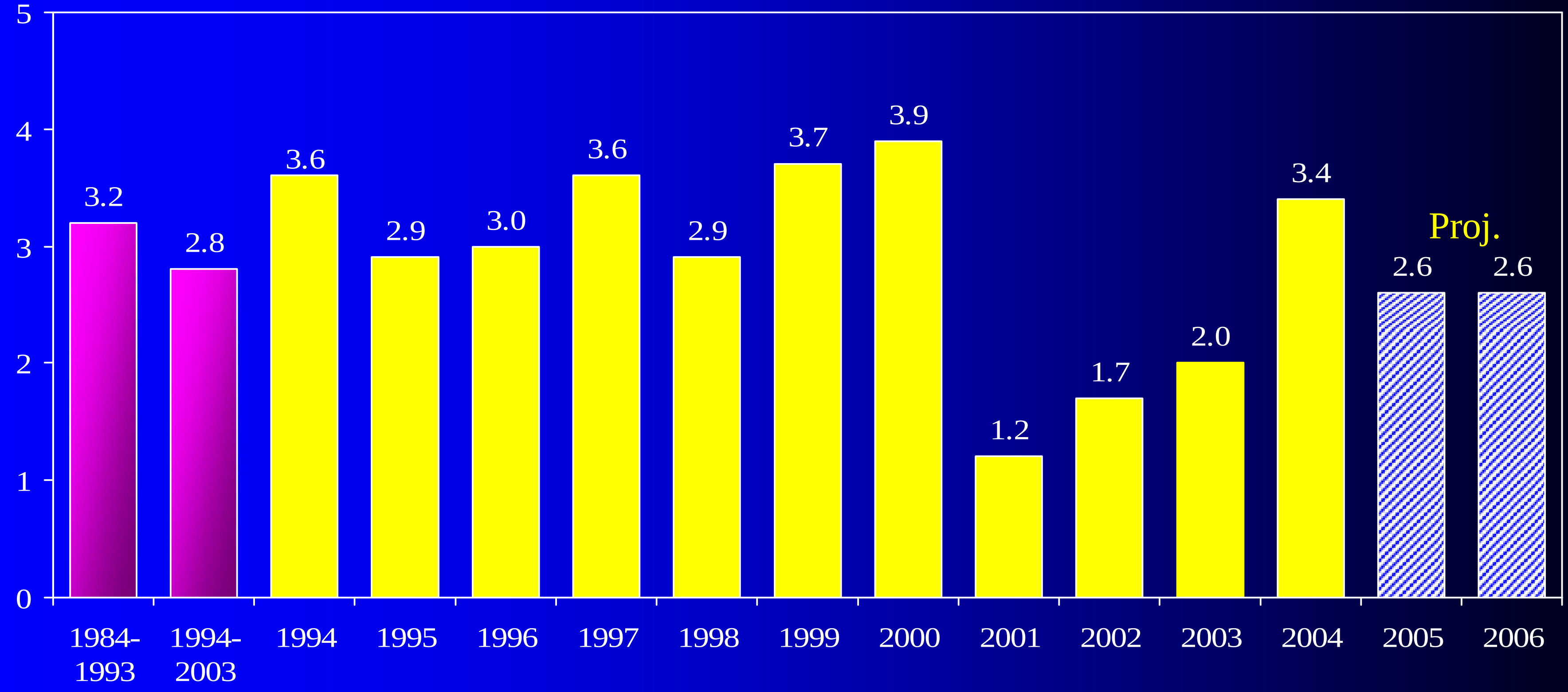


* compared to previous quarter, at annual rate, s.a.

The domestic slowdown in 2001 and 2002 was affected by the growth slowdown in the U.S. and by the composition of the GDP change there, which was focused on business investment decline. This downturn in investments by American firms led to a decrease in demand for Israeli exports, which are heavily tilted in the direction of these products. U.S. GDP growth and American corporate investments began to recover in 2003. This trend, foremost in investments by American firms, became much stronger in 2004 and 2005.

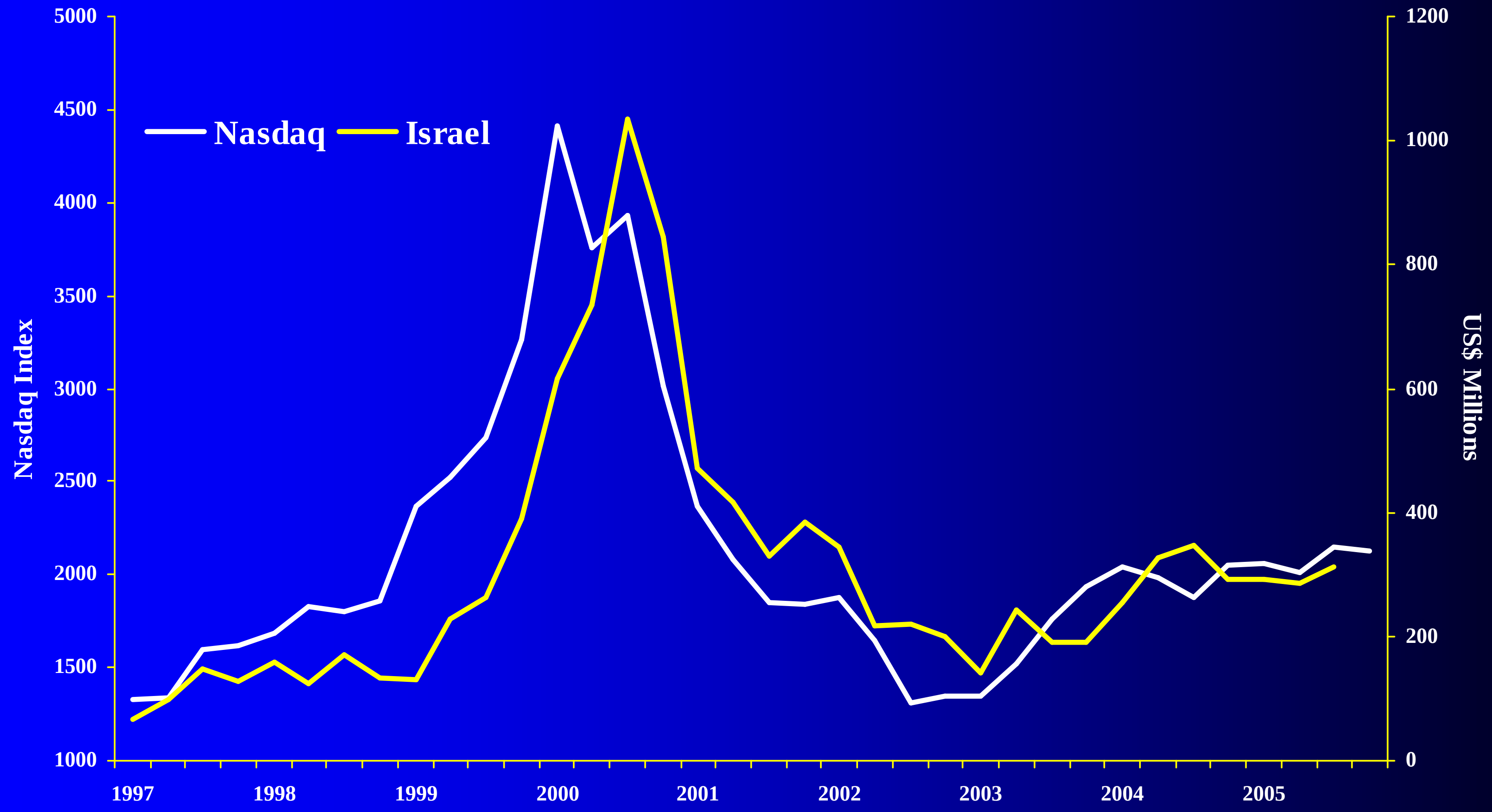
Growth in Advanced Economies

(weighted average: US - 44%, Euro area - 37%, Japan - 4%, UK - 8%, Asian NIEs - 7%)



The growth rate of GDP in advanced economies was calculated as a weighted average in terms of its share in Israeli exports. The global growth rate recovered in 2004 (relative to 2001–2003). The trend is expected to continue in 2005 and 2006 and support the growth in Israeli export, albeit at lower rates than in 2004.

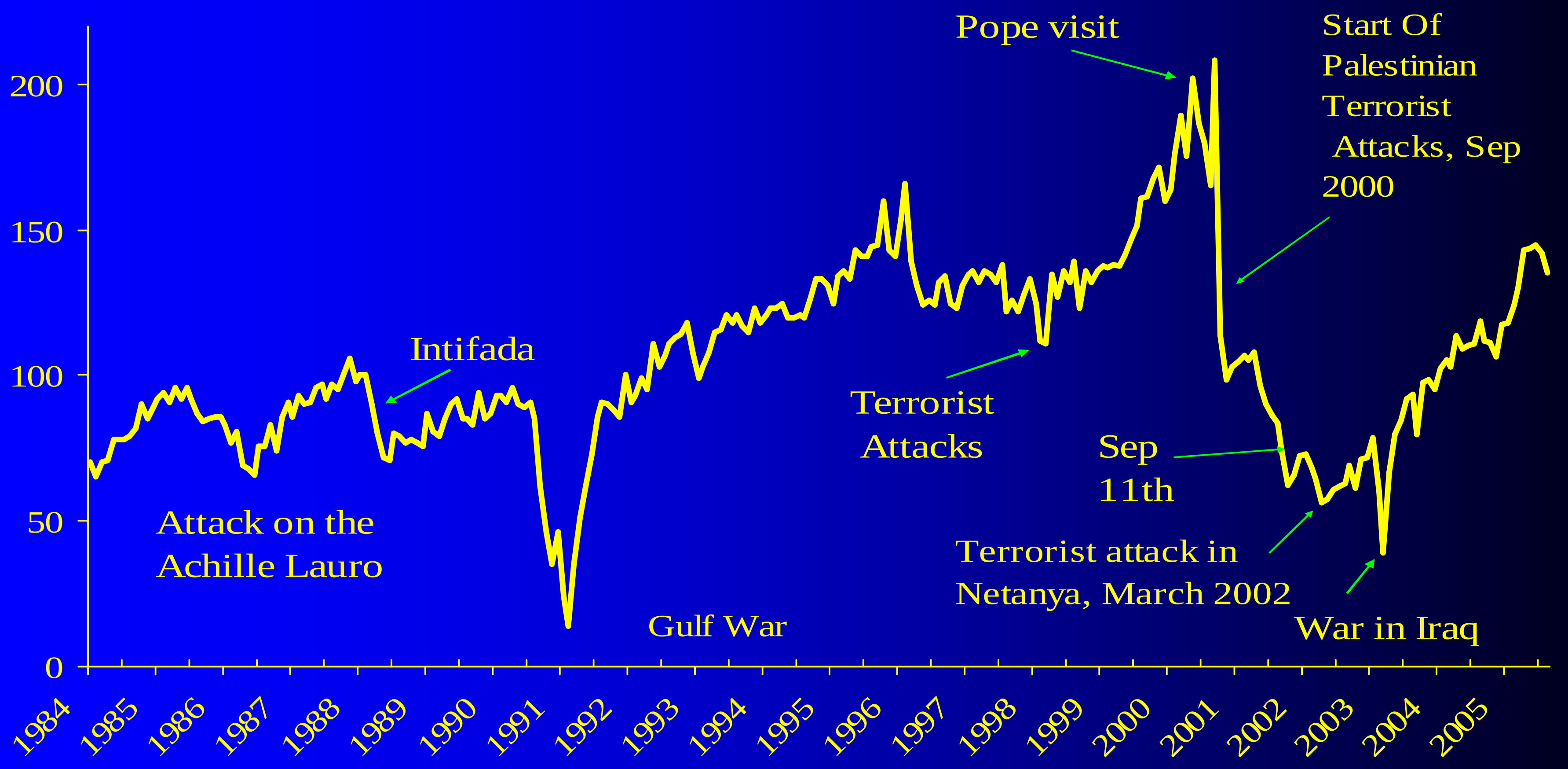
The Nasdaq Index
and Investment of VCs in Start Ups in Israel



The steep decline in the Nasdaq index in 2000–2002 had a severe downward effect on capital raised by VC funds. This, in turn, dampened investments in Israeli start-up companies (as well as in American companies). The decline was harmful to the high-tech industry and affected the economic downturn in Israel that began in late 2000. Since the end of 2002, the Nasdaq exchange has staged a recovery that helped to increase investments in Israeli start-up companies during 2003-2005, although the level is still lower than the peak of 2000.

Tourist Arrivals

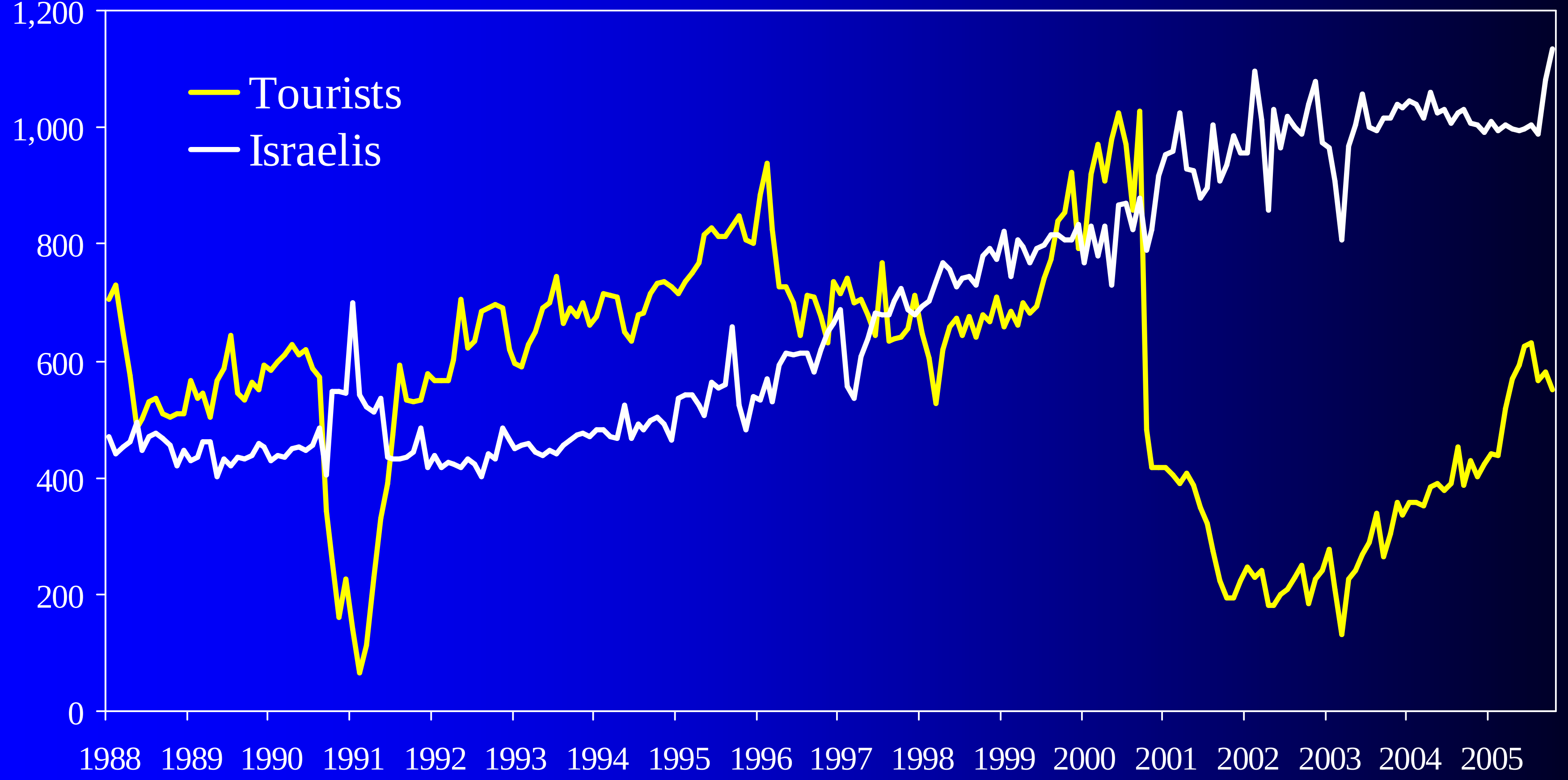
thousands per month



The domestic and global security situation reduced inbound tourism by 63 percent in the second half of 2003 relative to the first half of 2000. Since the second half of 2003, inbound tourism has been showing signs of recovery due to an improvement in domestic security, the favorable effects of the end of the war in Iraq, and the global economic recovery. Tourist arrivals by air were 70 percent higher in 2005 than in 2003—but still 20 percent lower than the level preceding the beginning of the Palestinian terror attacks.

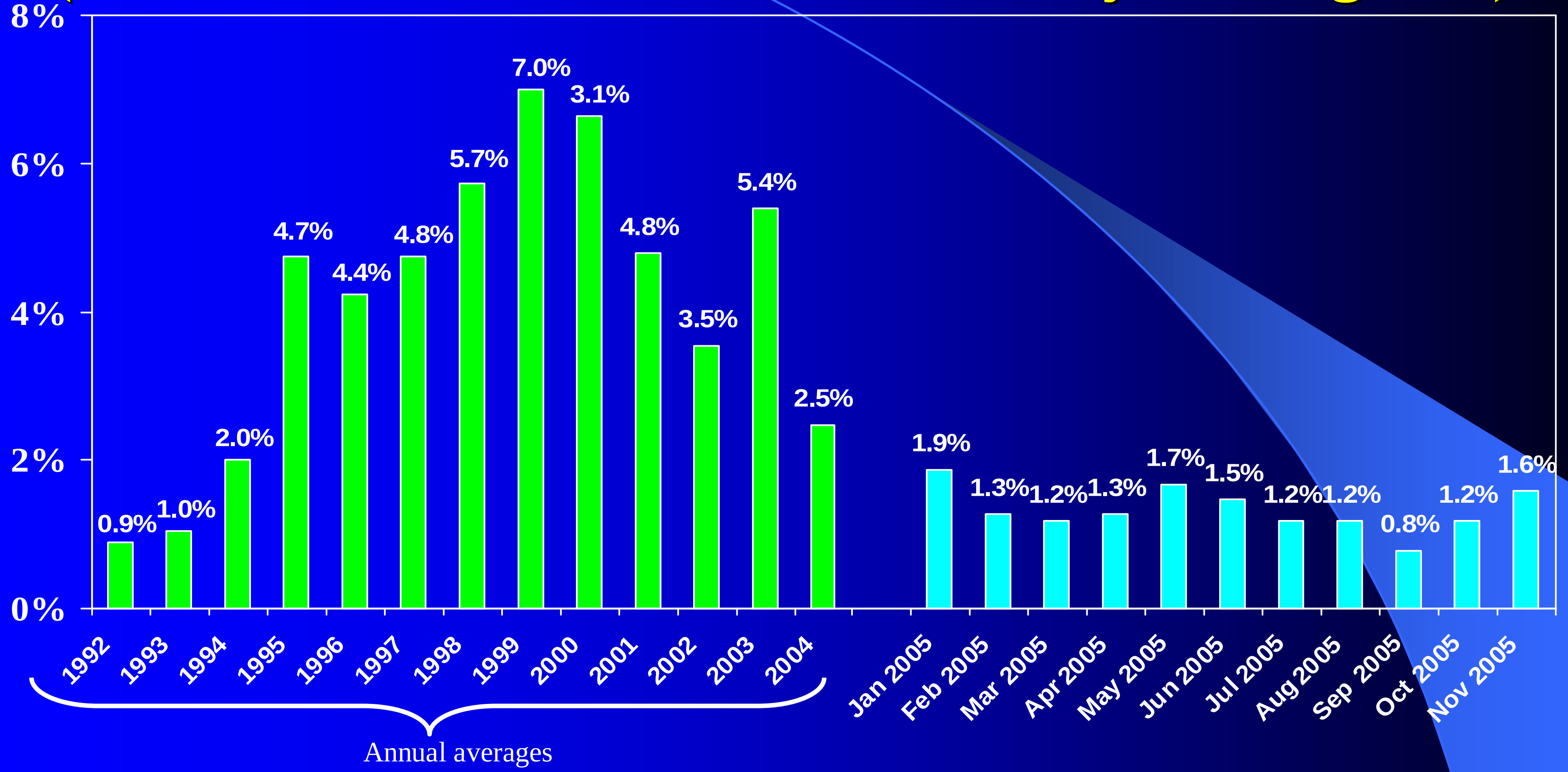
Person-Nights at Hotels

thousands per month



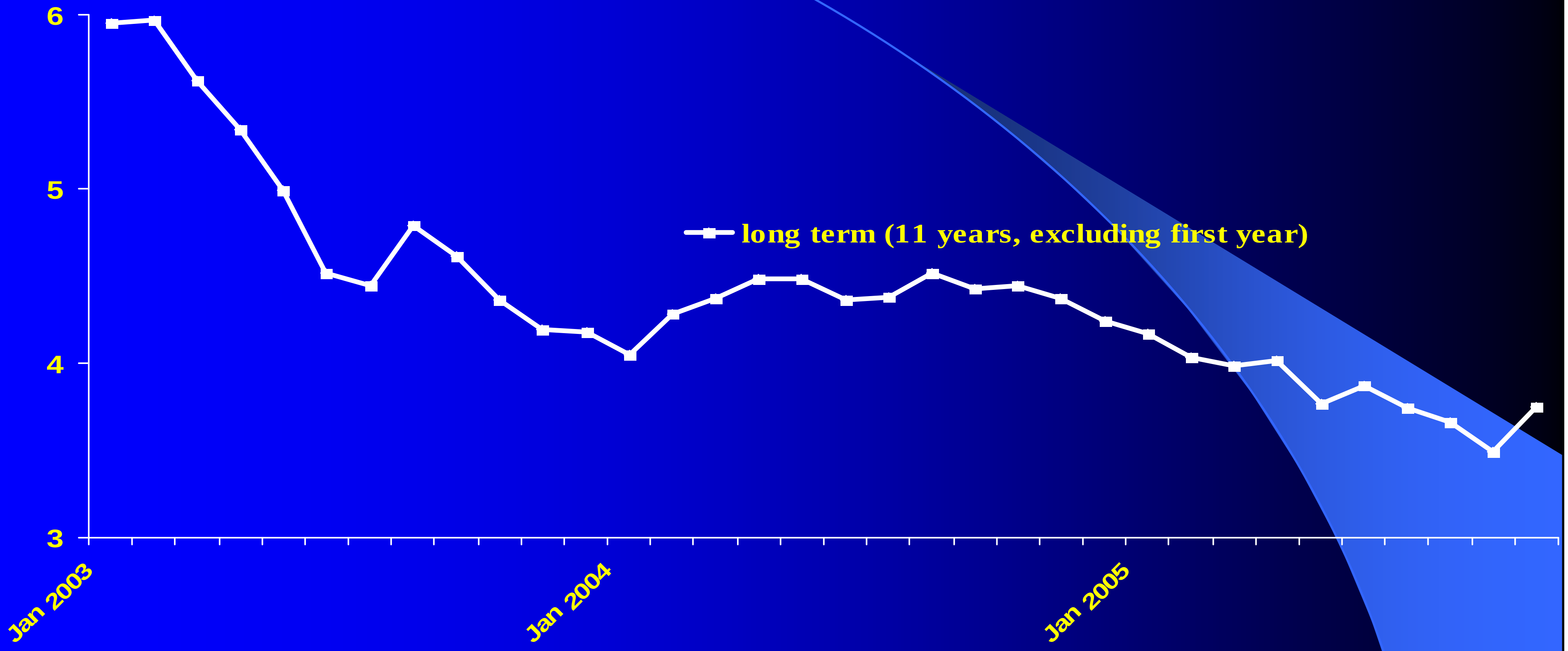
The blow to tourism from the end of 2000 until the second half of 2003, was softened slightly by the substitution of domestic tourism for inbound tourism due to promotions and price-cutting.

The Short-Term Real Interest Rate
(Derived from the Bank of Israel's key lending rate)



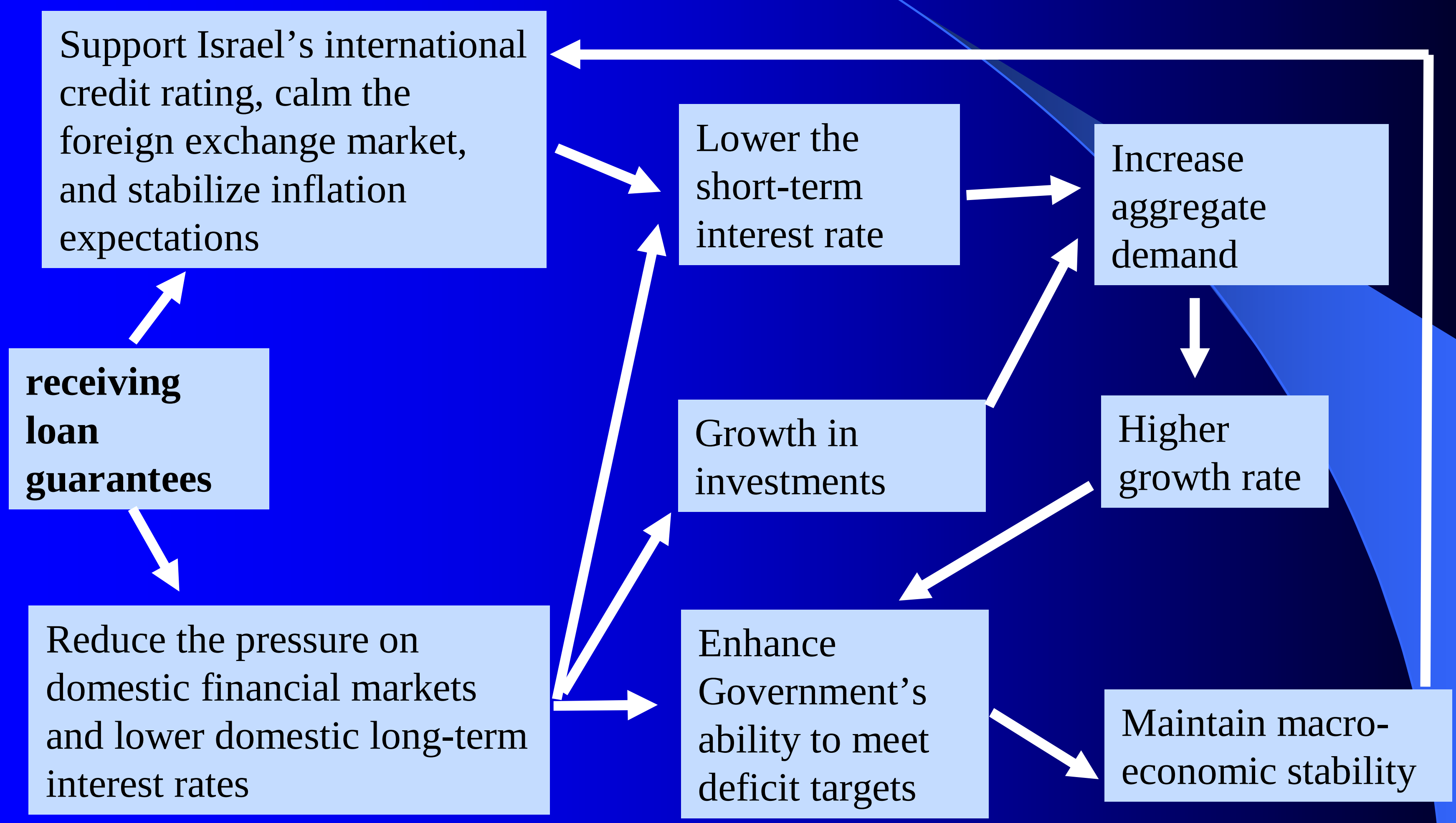
Contractionary monetary interest rates in 2001–2003 contributed to the deceleration of GDP growth and delayed recovery from the recession. During 2004, the central bank's nominal interest rate came down from 4.8 percent to 3.9 percent. This trend continued through the beginning of 2005, as the interest rate decreased gradually to 3.5 percent until February 2005 and stayed at this level until September 2005. As a result, the real interest rate was lower in 2004 and 2005 than in previous years. In September through December, BOI interest rate was raised to 4.5 percent, due to the continuing rise of global interest rates, as well as published indicators showing fast economy growth and a decrease in unemployment rates.

Real Long-Term Interest Rate in View of the Improvement in Fiscal Credibility



The favorable turnaround in domestic activity in 2003–2004 was supported by firm government measures to restrain public expenditure, an essential step in returning the budget deficit and the public debt to a downward trajectory, and by structural reforms that bolstered the recovery and reinforced sustainable growth. An economic program to cope with the steep increase in the rate of the budget deficit was applied in the middle of 2003. The tough fiscal policy that was part of the program, coupled with policy measures incorporated into the 2004 and 2005 budgets, did much to enhance fiscal credibility. This, coupled with the receipt of the U.S. Government guarantees, made the financial markets more confident and brought down the real interest rate on long-term indexed bonds.

The Macroeconomic Effects of Loan Guarantees



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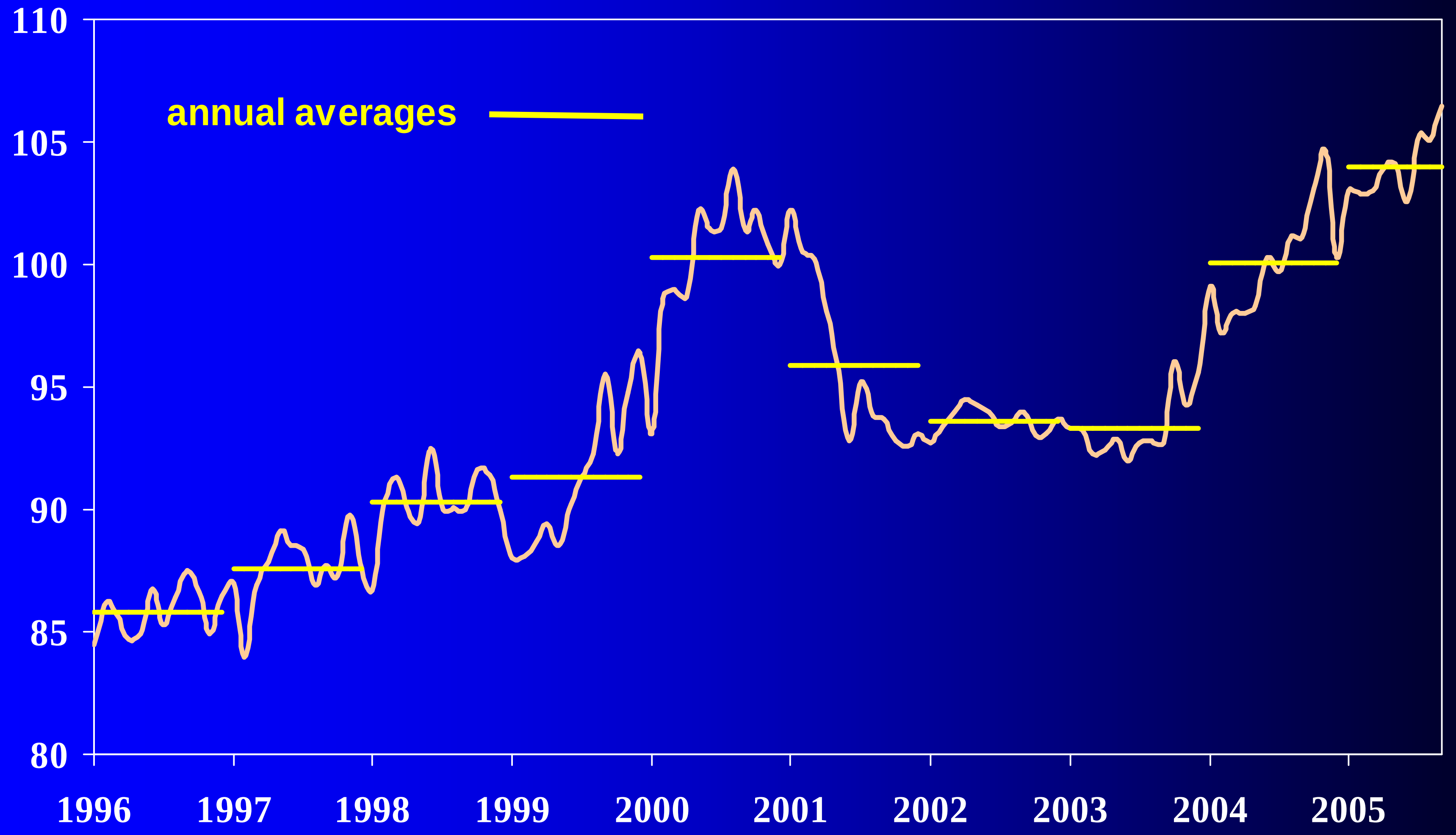
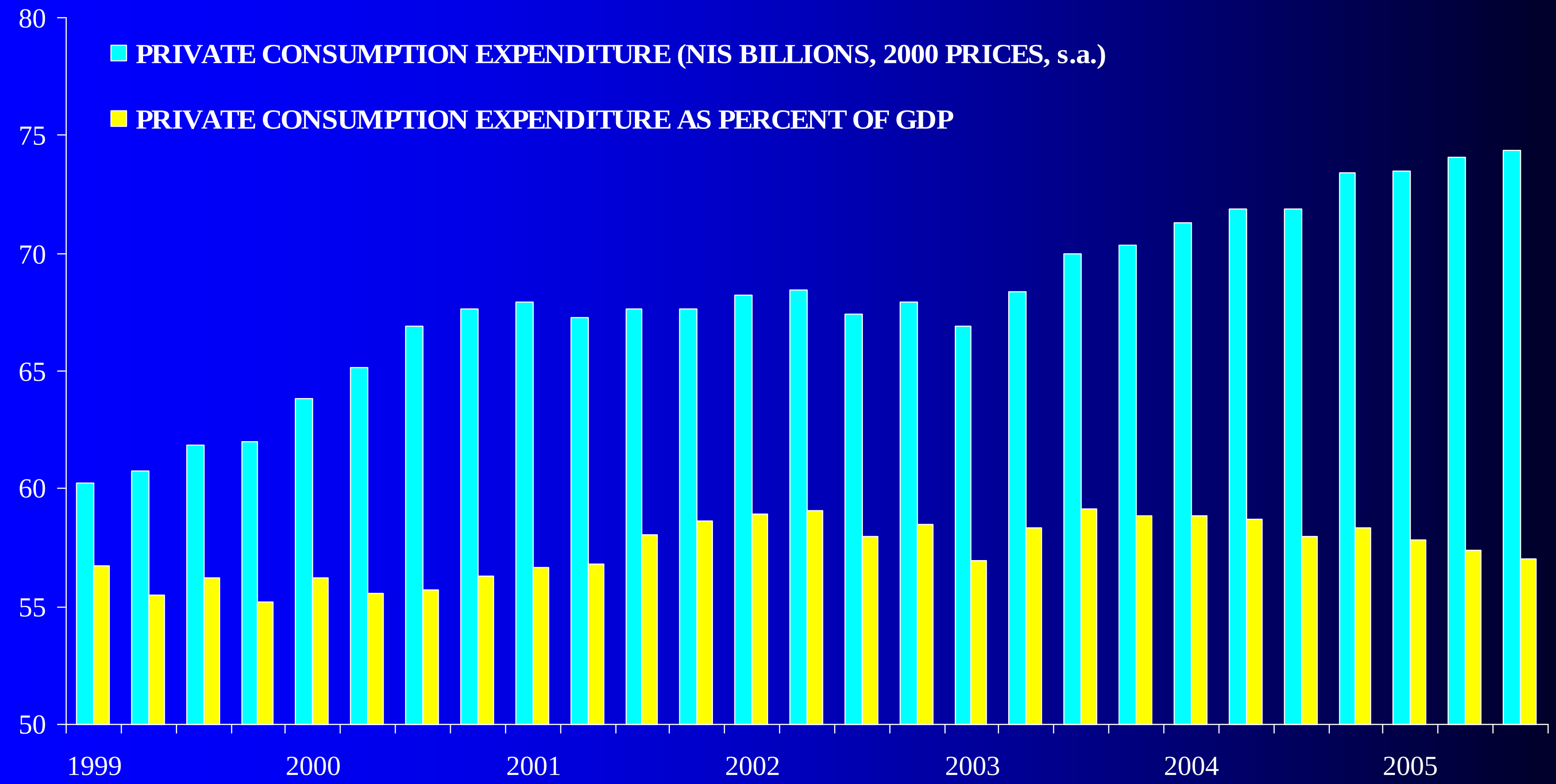
Industrial Production Index



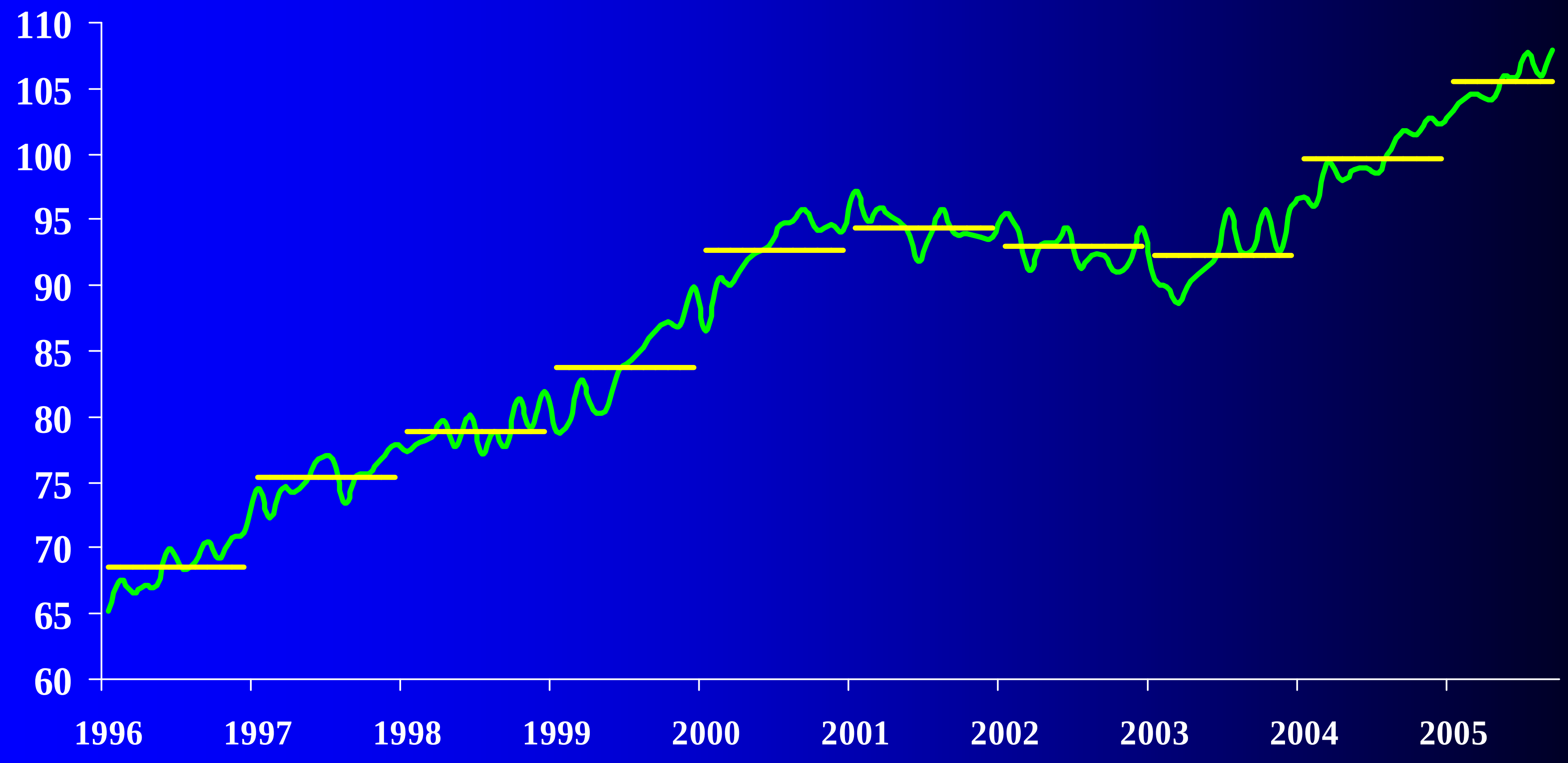
The economic slowdown was reflected in a decline in industrial production from late 2000 to the end of 2001. From 2002 to the first half of 2003, industrial output was stable at a lower level. A recovery began in the second half of 2003.

Private consumption expenditure



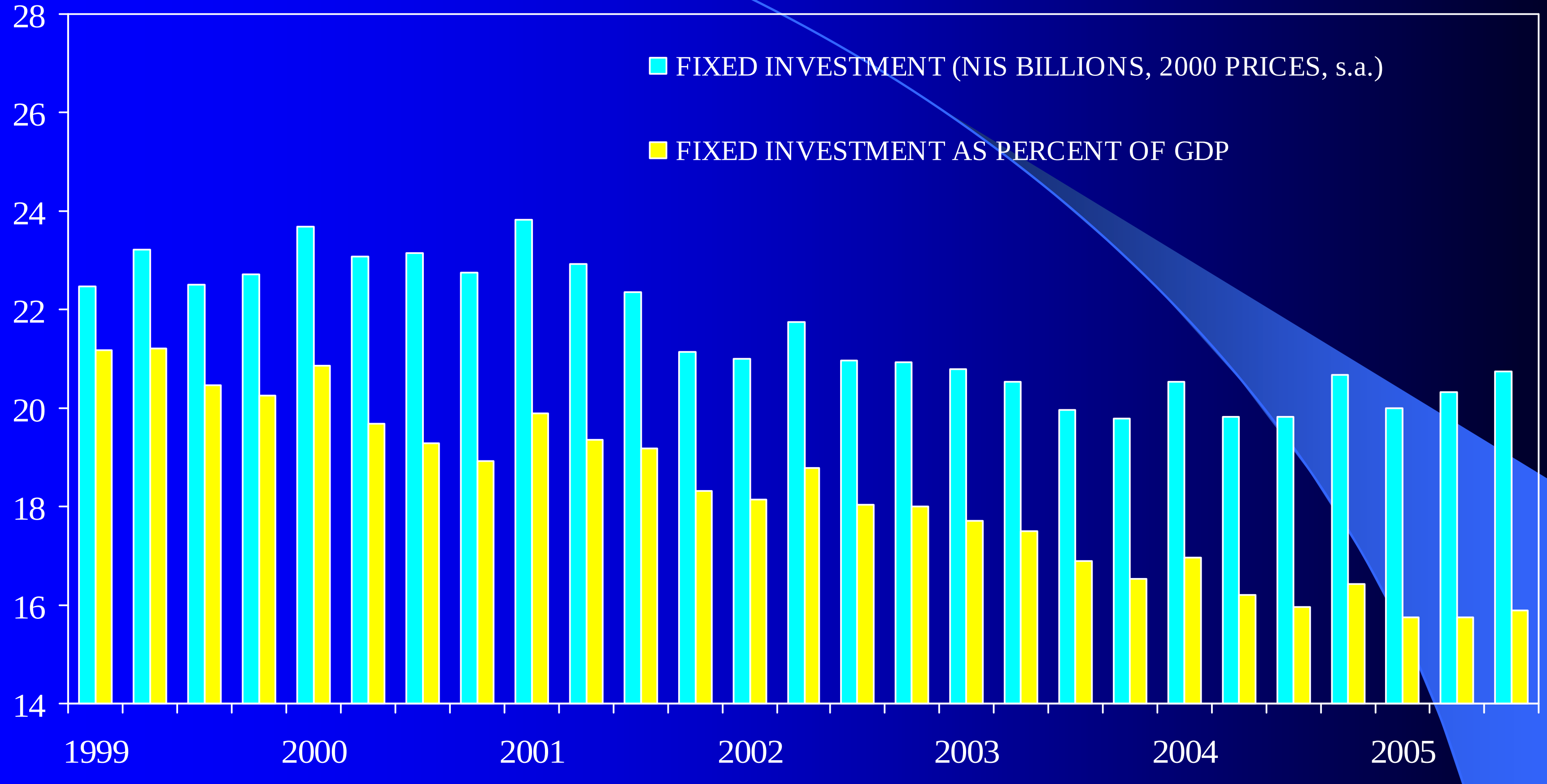
In 2001, despite the economic slowdown, private consumption increased in absolute terms and as a share of GDP. In 2002, on the other hand, private consumption declined moderately as the duration of the recession prompted households to adjust their estimates of permanent income downward. This trend gathered strength in the first quarter of 2003 in view of the war in Iraq. Private consumption advanced briskly from the second quarter of 2003. In 2004, private consumption increased at a healthy 5.2 percent pace. During 2005, the private consumption continued to rise, albeit at a slower pace. The main reasons for the continued acceleration in 2004 were economic recovery, higher real wages, lower tax rates and expectations of further tax cuts due to the restraint of government expenditure and structural changes in the economy, an increase in the public’s assets portfolio, and lower real interest rates.

Commerce and Services Sectors real monthly revenue index



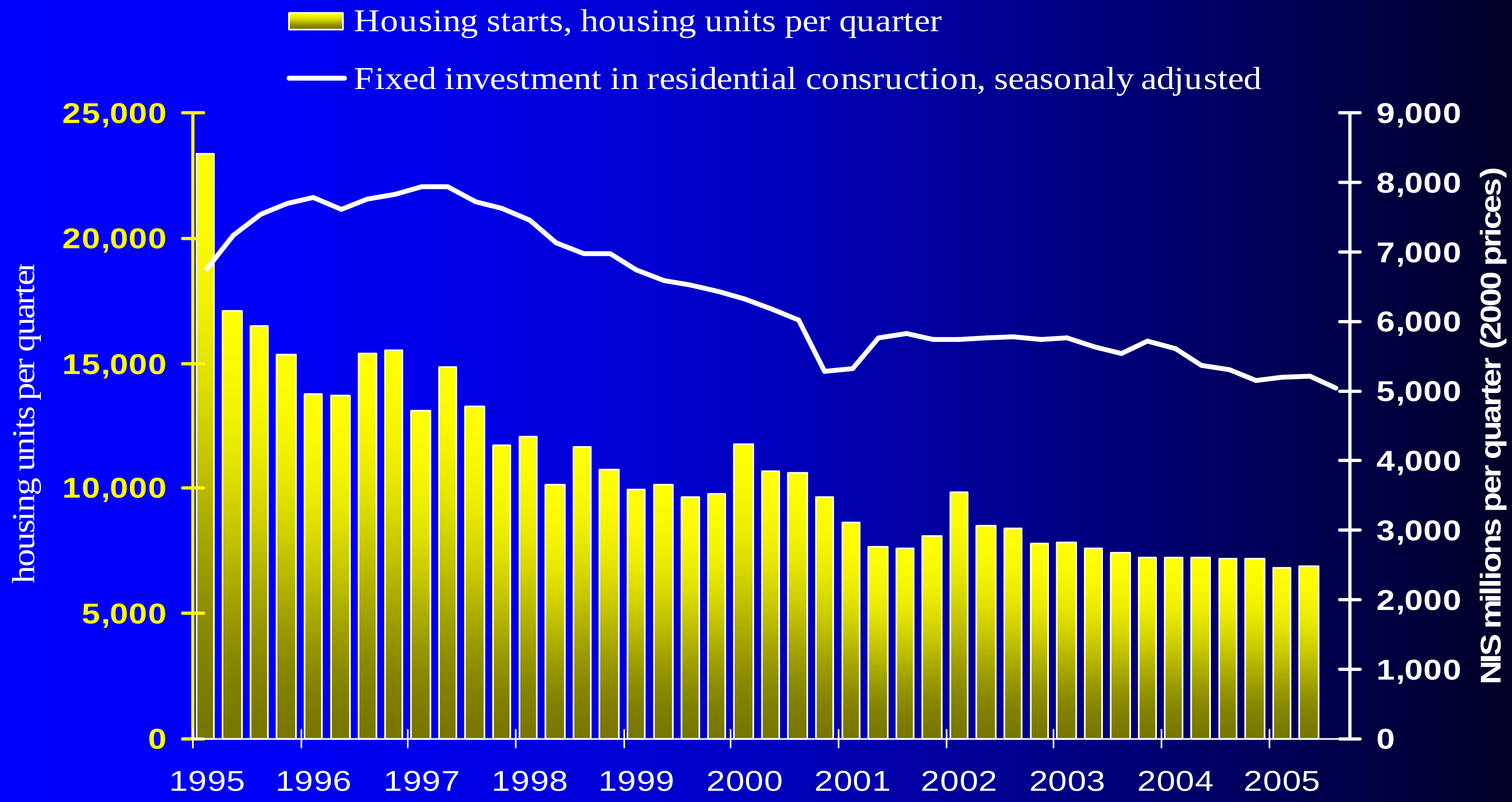
Revenues in trade and services declined in 2002 and in the first half of 2003 after being stable in 2000 and 2001. The revenues data have been pointing to recovery since the second half of 2003. These developments reflect changes in private consumption.

Fixed Investment



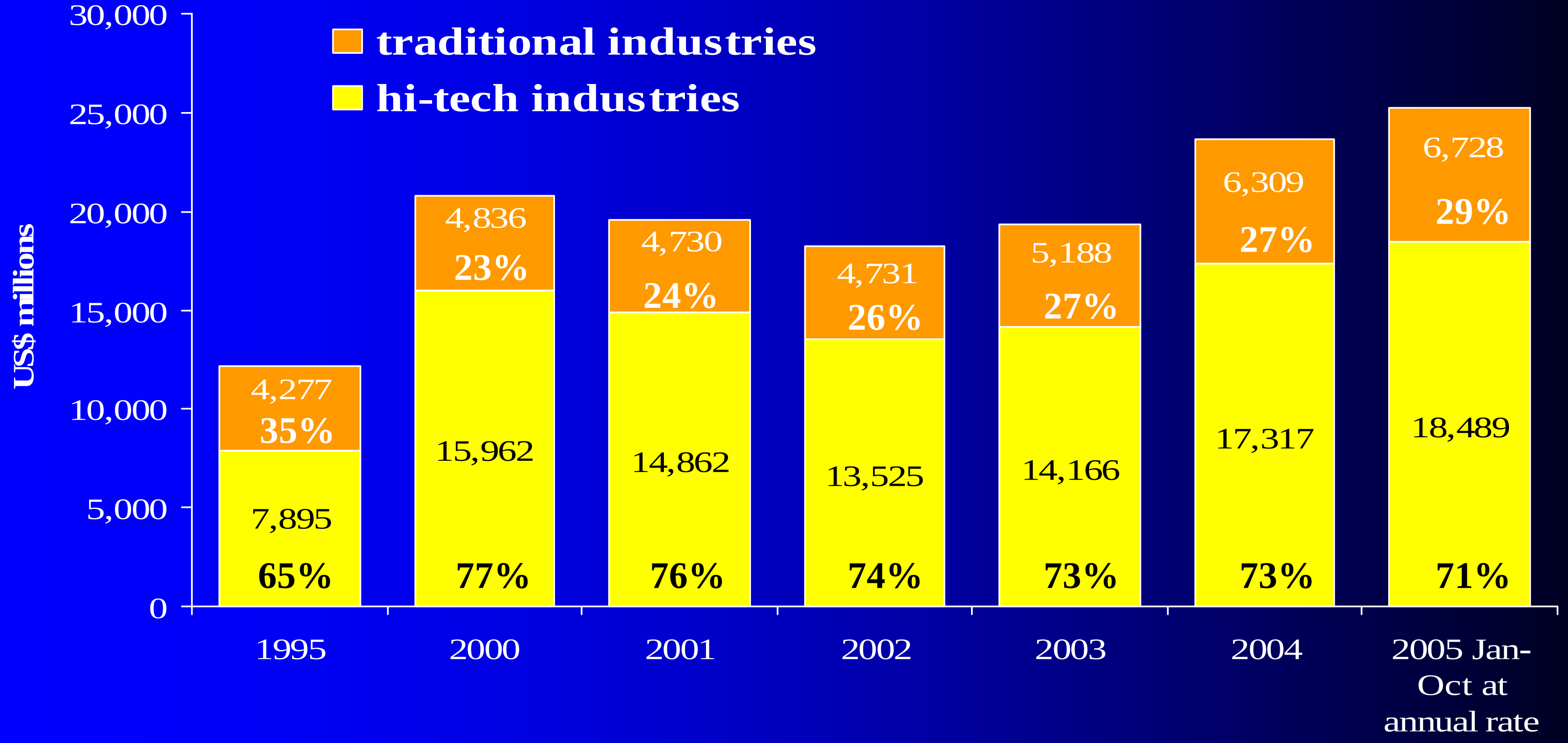
Fixed investment decreased in the last few years. The contraction in 2001–2003 affected most industries in the business sector and reflected the security and economic uncertainty, the global slowdown, and domestic monetary restraint. The decline in 2004, in contrast, traced mainly to a decrease in construction investment, a field in which rather large surpluses relative to demand had built up during the recent recession years. Net of the effects of dwelling stocks, investments in machinery, equipment, and transport vehicles increased. In 2005 the fixed investment is expected to grow slightly.

Housing Starts and Fixed Investment in residential construction



Housing starts attest to the trend of future activity, since homebuilding lasts about a year and a half. The decrease in homebuilding starts has continued, with variations, since 1997, although the number of starts seems to have leveled off in 2004.

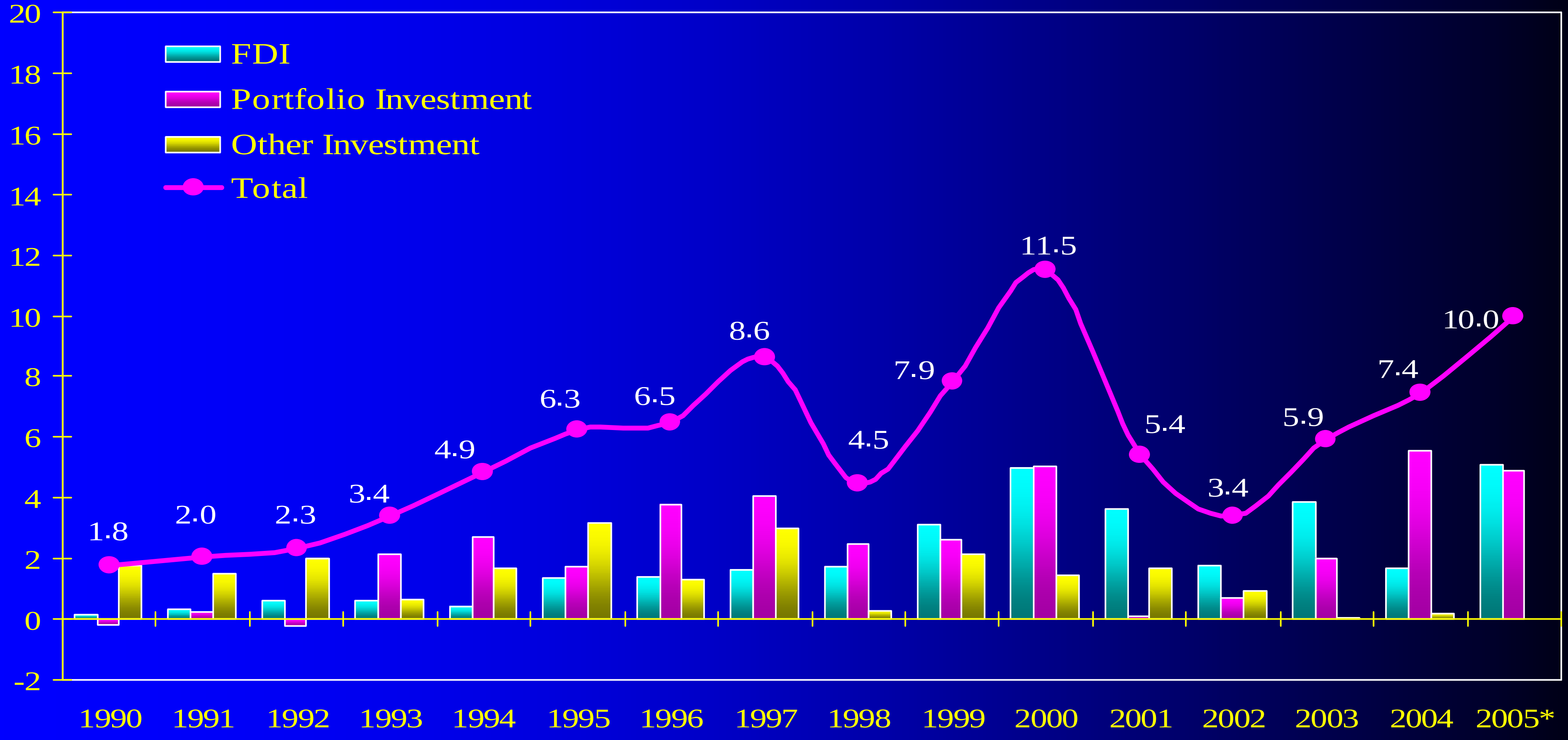
Structure of Industrial Exports



The recession in 2001–2002 was also reflected in a decrease in exports. Exports recovered slightly in 2003. This trend gathered strength in 2004 and 2005, and reflects the effect of the real depreciation of the NIS in 2002-2004, the global economic recovery, the expansion of global trade and high-tech activity, the decrease in real domestic wages in 2002-2003, and corporate efficiency measures. Both high-tech and traditional industries took part in the upturn in exports.

Net Inflows of Foreign Investment

US $ billions



* JAN-OCT 2005 at annual rate

The increase in net foreign investment in Israeli enterprises—direct, portfolio, and other—plunged from $11.5 billion in 2000 to $3.4 billion in 2002 due to the global slowdown, the NASDAQ crisis, and the security situation. Starting 2003, investments grew and came to $7.4 billion in 2004 and $10 billion in 2005 (January-October at annual rate).

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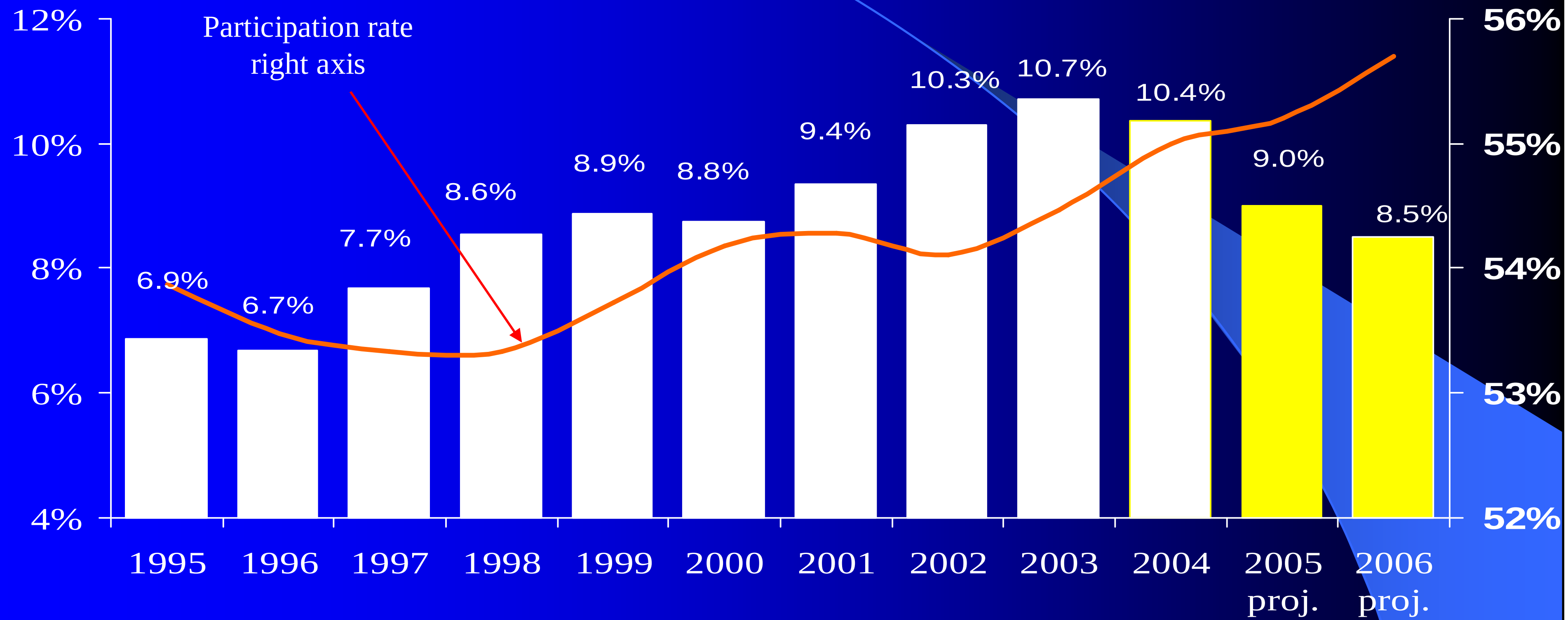
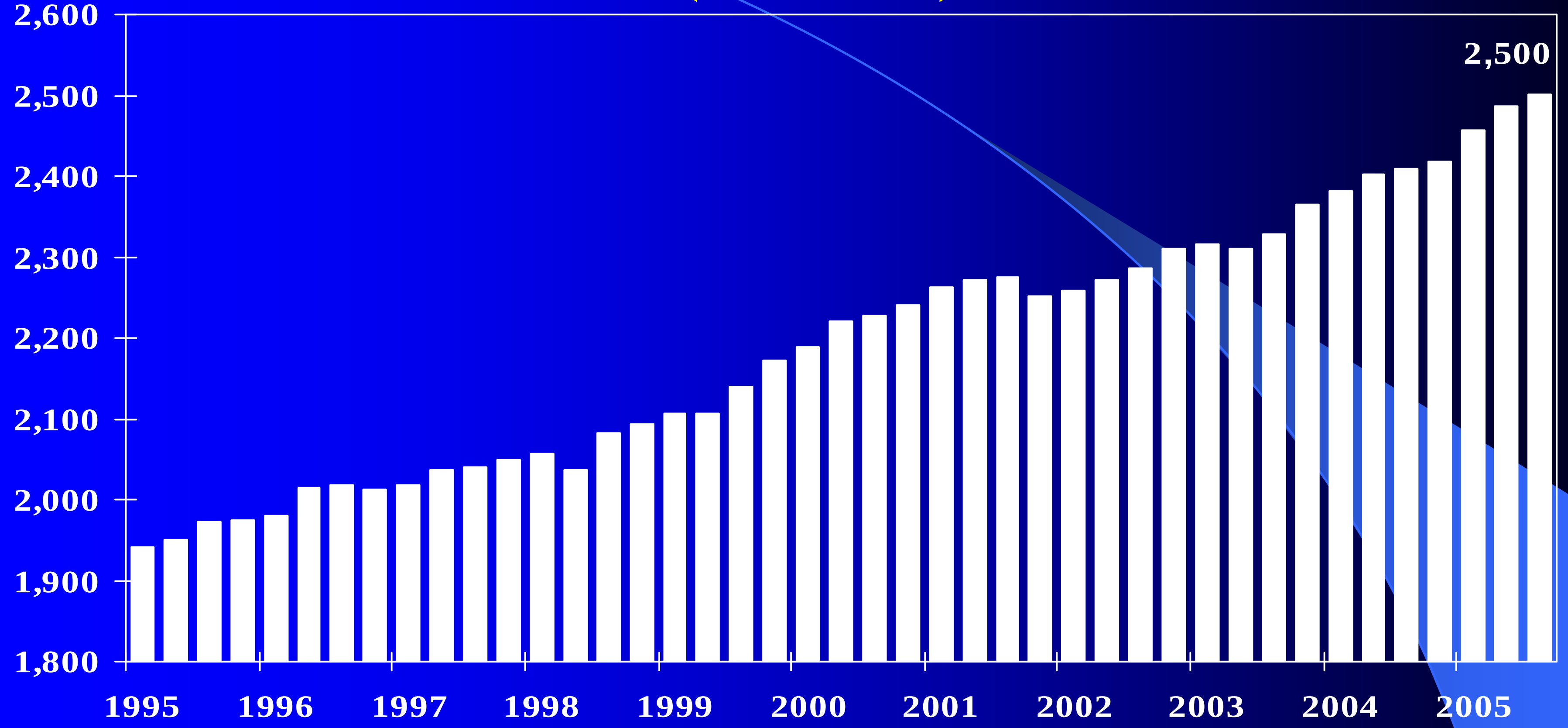
The Unemployment Rate and the Participation Rate



One reflection of the recession that began in 2000 was, among other things, an increase in the unemployment rate from 8.8% in 2000 to 10.3% in 2002. Despite the economic recovery that began in 2003, the unemployment rate continued to climb that year and peaked at 10.9% in the second half. In 2004, the unemployment rate fell to 10.4% on annual average. This trend continues in 2005, when the unemployment rate is expected to be 9 percent. A perceptible increase in the average participation rate is a direct result of the government policy of reducing transfer payments and the number of foreign workers, while encouraging a transition from welfare towards work. The rise in the participation rate (that is lower in Israel than other countries), despite it slowing down the decrease of unemployment rate in the short run, works favorably for improving the economy and the labor market in the long run.

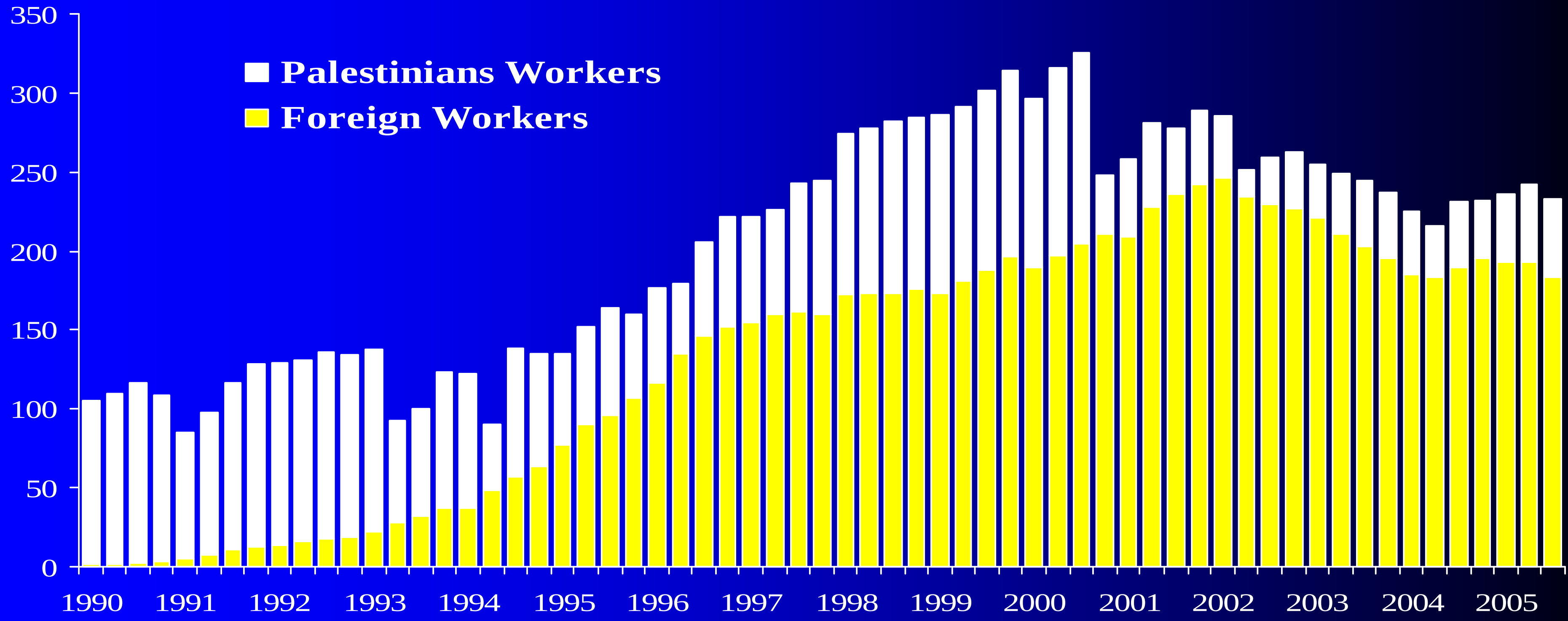
Employment of Israelis
(Thousands)



Despite the still high unemployment rate, the labor market took a turn for the better as Israelis returned to the employment cycle and new jobs were created. The number of Israelis employed increased markedly in 2003-2005 (by 190,000 between the second quarter of 2003 and the third quarter of 2005), reflecting, among other things, the economy recovery and the successful implementation of Government policies that aimed to downsize the population of foreign workers and reduce transfer payments.

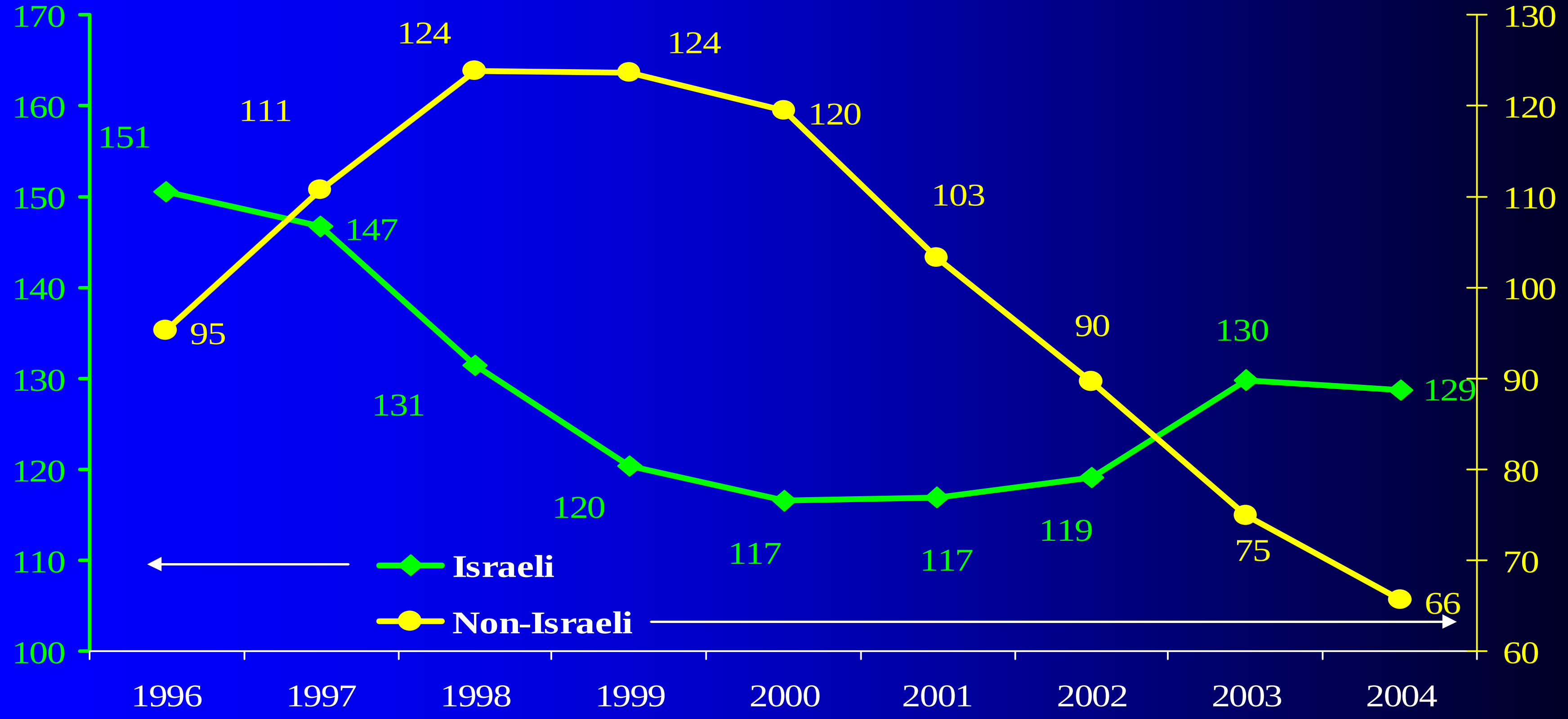
Non-Israeli Workers

(Thousands)



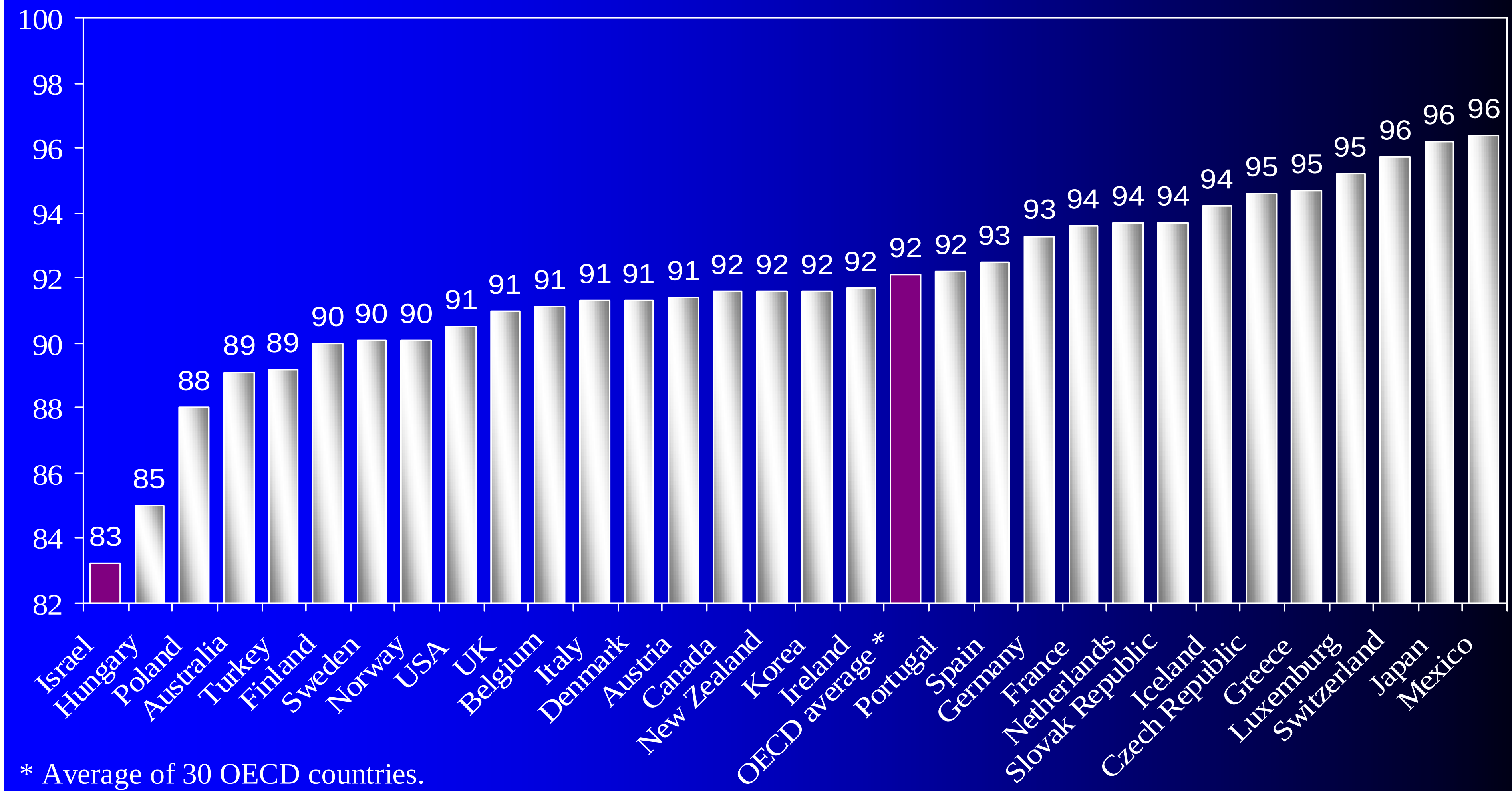
The proportion of non-Israeli workers (Palestinians and foreign) in total employment peaked at 12.3 percent of total employment in 1999 and fell since then gradually to 8.6 percent in the end of 2004. The share of foreign workers in employment climbed steadily from the early 1990s, partly because they replaced Palestinian workers who were unable to enter the country due to security restrictions. Israel ranks second in the world in the share of foreign workers in total employment (after Switzerland, which has a lower unemployment rate). The number of foreign workers has an immense influence on unemployment and inequality in income distribution. Due to the government's policy, the population of foreign workers has declined in the fisrt half of 2005 by 54,000 (22 percent) since the peak in the first quarter of 2002. However, the number of such workers is still large, at about 193,000 in the second quarter of 2005.

Israeli and Non-Israeli Employees in Construction (thousands)



The issue of substitution between Israeli and non-Israeli workers is reflected in the construction industry, where the advent of foreign workers has pushed wages down, made construction work less attractive to Israeli workers, and lowered the number of Israelis in the industry. In 2001- 2004, employment of Israelis in construction increased even though the construction industry was mired in a severe recession. This is due to a decline in the number of Palestinians reported to work after the eruption of the terror offensive and also because the number of foreign workers was reduced later on. The decline in the population of non-Israeli employed in 2003 and 2004 reflects the government's successful implementation of its policy of reducing the numbers of foreign workers.

Participation rate of Men, Ages 25-54, 2004



* Average of 30 OECD countries.

One reason for the lower standard of living in Israel than in Western Europe and the U.S. is that Israel has a low labor-force participation rate, especially among men. This is due to a low participation rate among the ultra-Orthodox, to the large population of foreign workers who depress wage levels in industries such as construction and agriculture, making them unattractive to Israelis, and to the level of transfer payments. The purpose of the economic policy of using fewer foreign workers and reducing transfer payments is to boost the labor-force participation rate.

Real Wages (CPI-adjusted)
Years Ending August
Index 2000-2001 = 100

The real wage per employee post increased in 2003-2005. In the recent year ending in August 2005, due to the economic recovery, real wages rose by 1.8% in the business sector and by 2.3% in the public sector. The higher rise in the public sector reflects, among other things, the end of the wage cut that was implemented as part of the government's plan to revive the economy in 2003.

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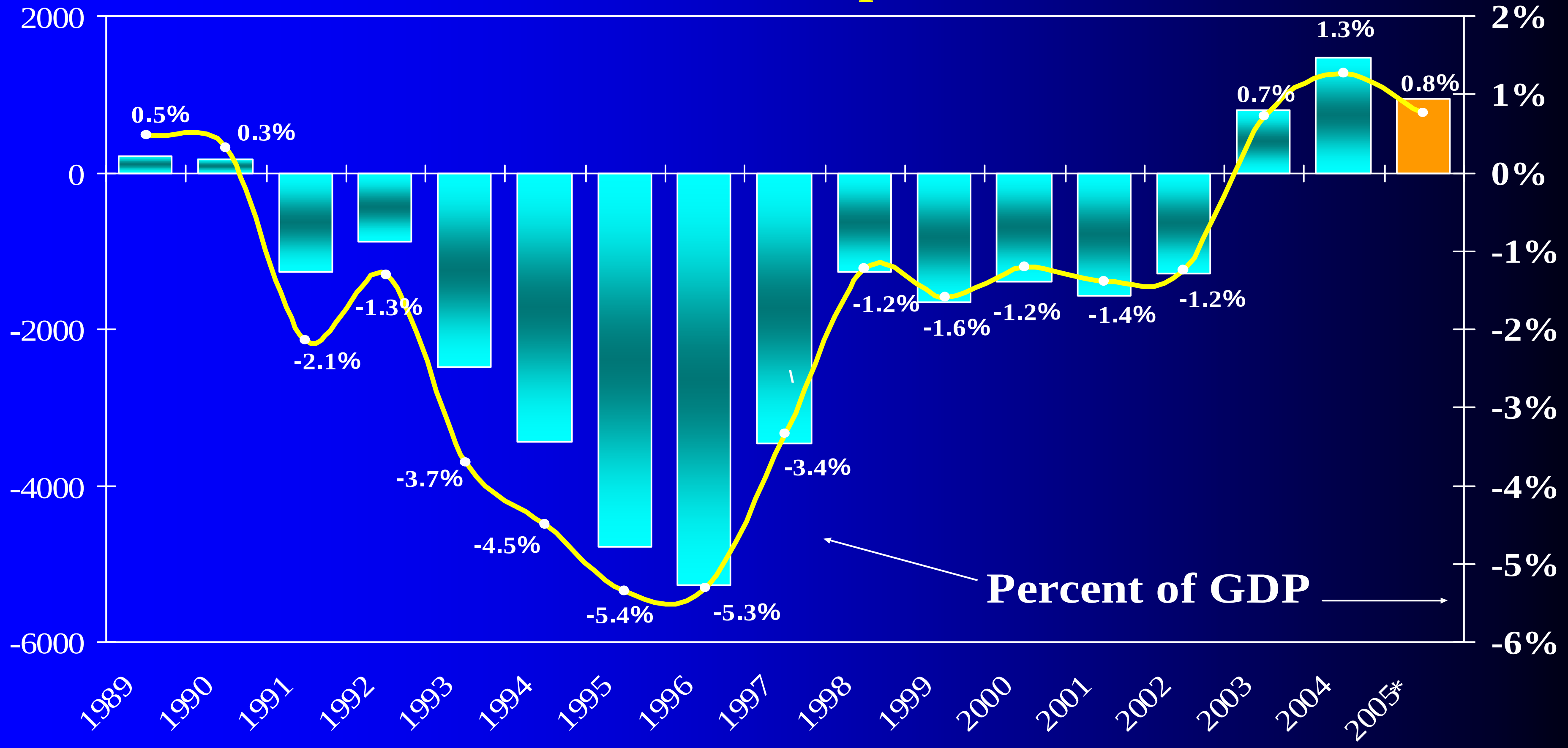
Balance of Payments and External Stability

1. Balance-of-payments
2. Foreign reserves
3. External Debt

The Current Account

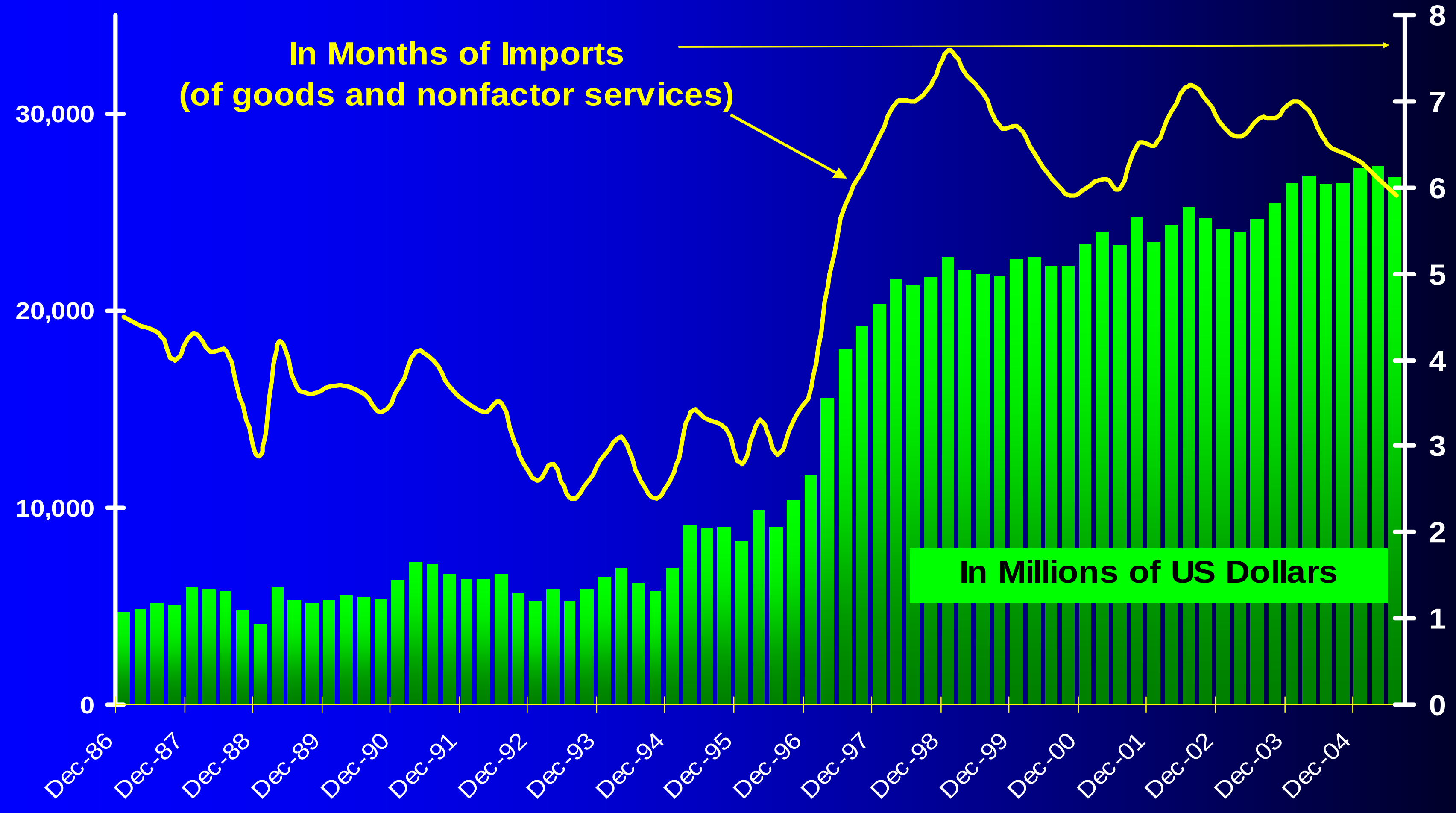
millions of dollars & percent of GDP



* 2005H1 s.a at annual budget

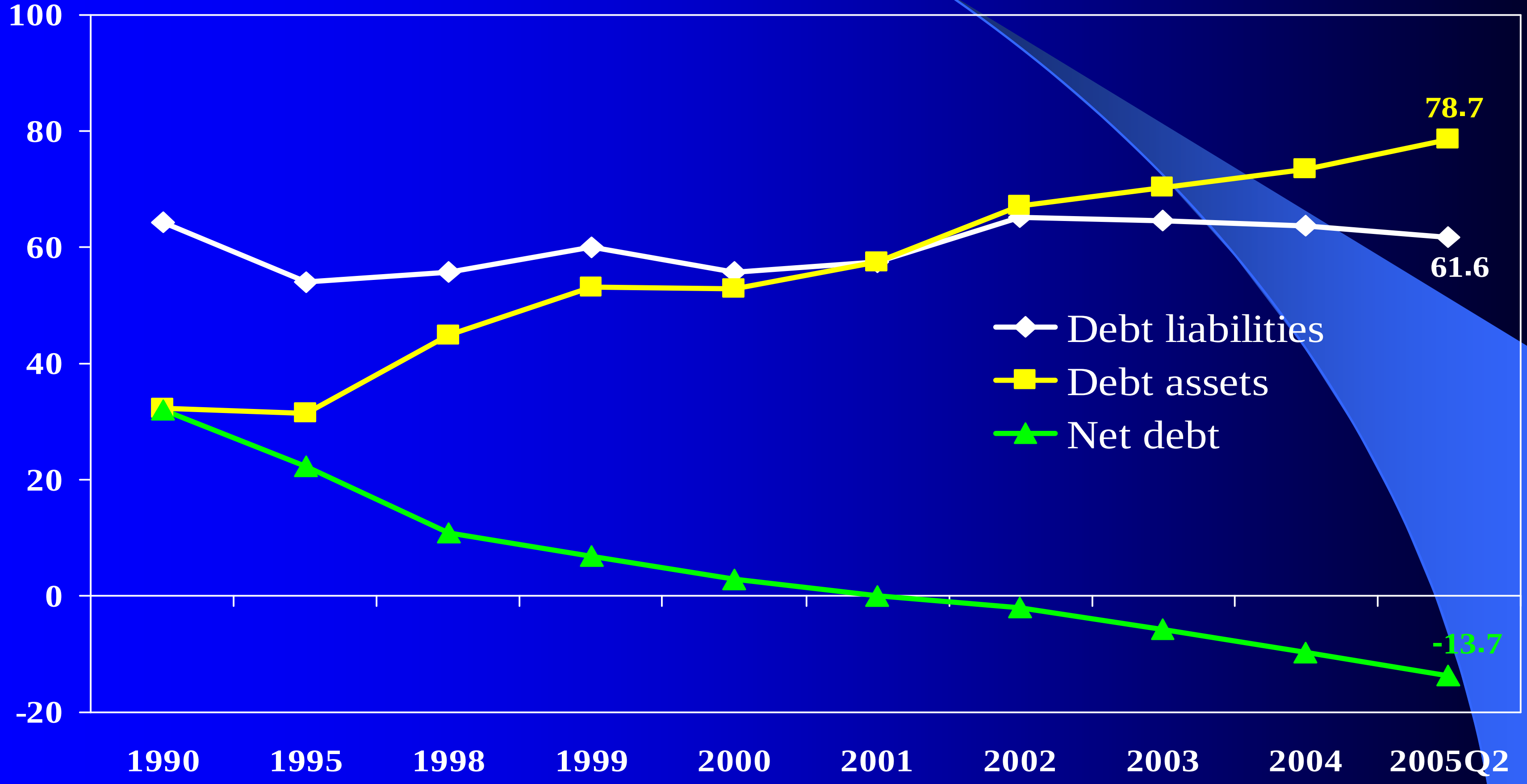
The current account of the balance of payments is the net balance of total export receipts less total payments for imports of goods, services, and factors, and unilateral transfers (including the American grant in aid). This is the most important indicator of the state of the economy vis-a-vis the rest of the world in terms of imports and exports. The account in 2003-2005 ended in a small surplus. The surplus attests to high external stability both by international standards and relative to the deficits that were observed in the mid-1990s.

Official Reserve Assets



The reserves include foreign currency held by the Bank of Israel in short-term accounts abroad (mainly U.S. Treasury bills). Israel's reserves are high both by international standards and in terms of months of imports. This assures Israel's ability to finance its liabilities in the short term and to meet its import needs, and it corroborates the assessment of the low probability of a balance-of-payments crisis.

External Debt, Gross and Net
(percent of GDP, end-period)



The net external debt (total external liabilities less external assets) was minus 13.7 percent of GDP at the end of the second quarter of 2005. These figures reflect that Israel's external assets are greater than its external liabilities as opposed to previous years, where liabilities were greater than assets. This gives further indication that there is no significant risk of a balance-of-payments crisis.

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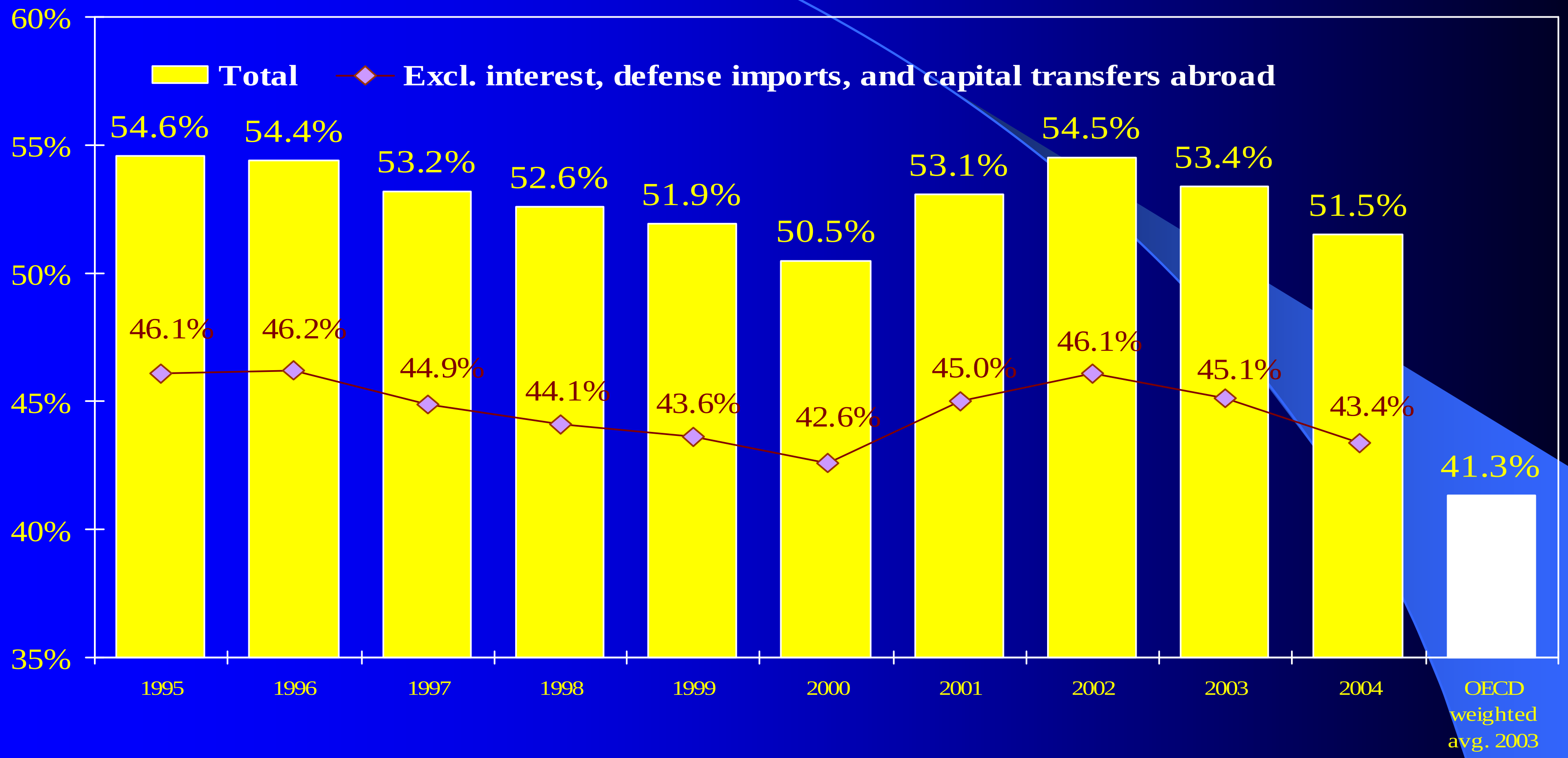
General Government Expenditure
(as percent of GDP)



Government expenditure as percent of GDP increased in 2001 and 2002 due to the recession (which reduced GDP) and the need to increase the defense budget despite cutbacks in other public expenditure. Government expenditure as a percent of GDP declined in 2003. The reasons for the decrease include cuts in the government budget, a decline in real wages in the government sector, and a halt to the rapid increase in the public sector employment. A further decline occurred in 2004, as a result of a decrease of about 2 percent in public consumption in real terms, coupled with a real increase in GDP. Following further steps taken in 2005 and the economic recovery, governmental expenditure is expected to decline as percent of GDP, despite a real growth in public consumption.

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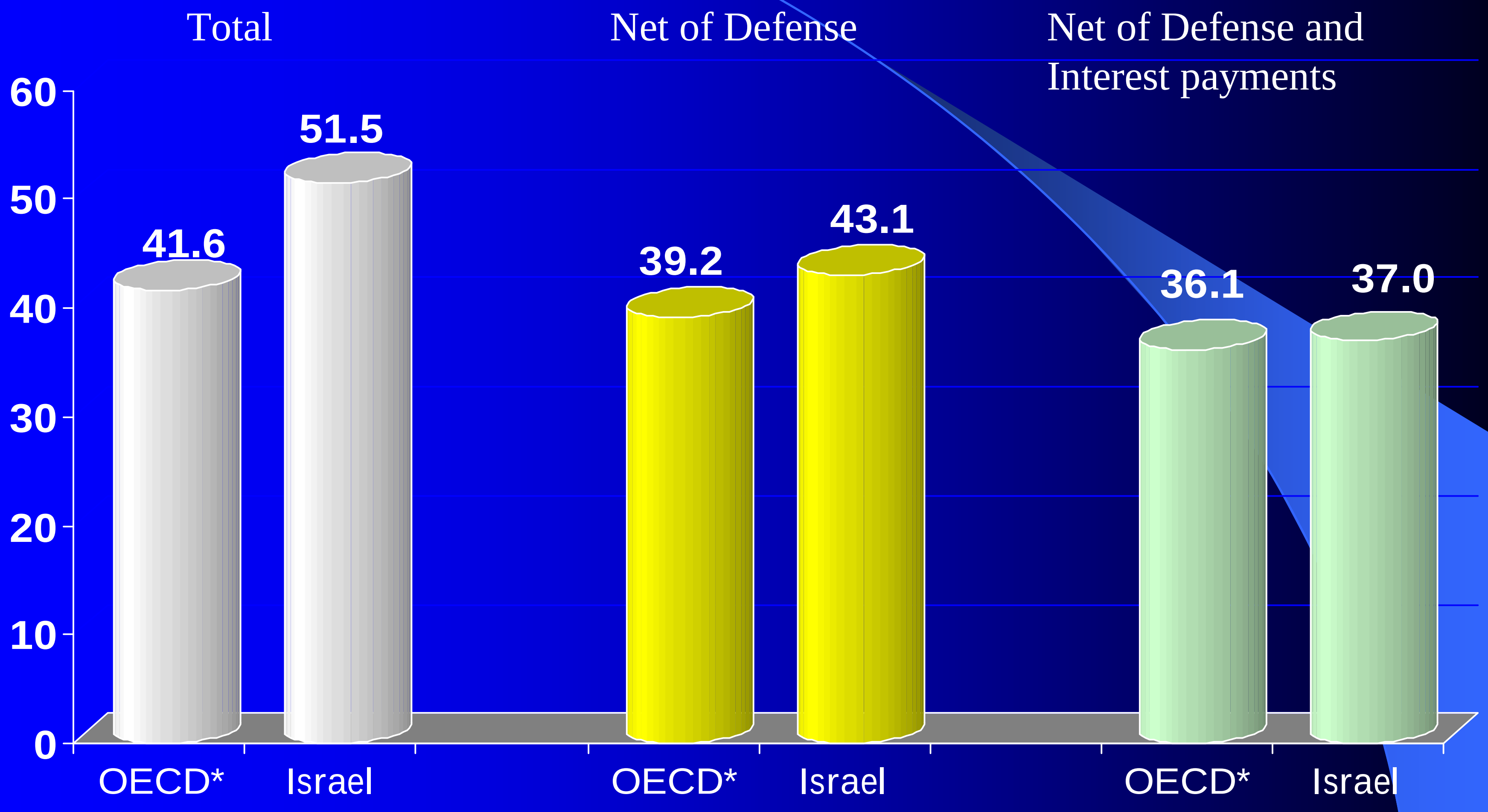
General Government Expenditure, 2004

percent of GDP

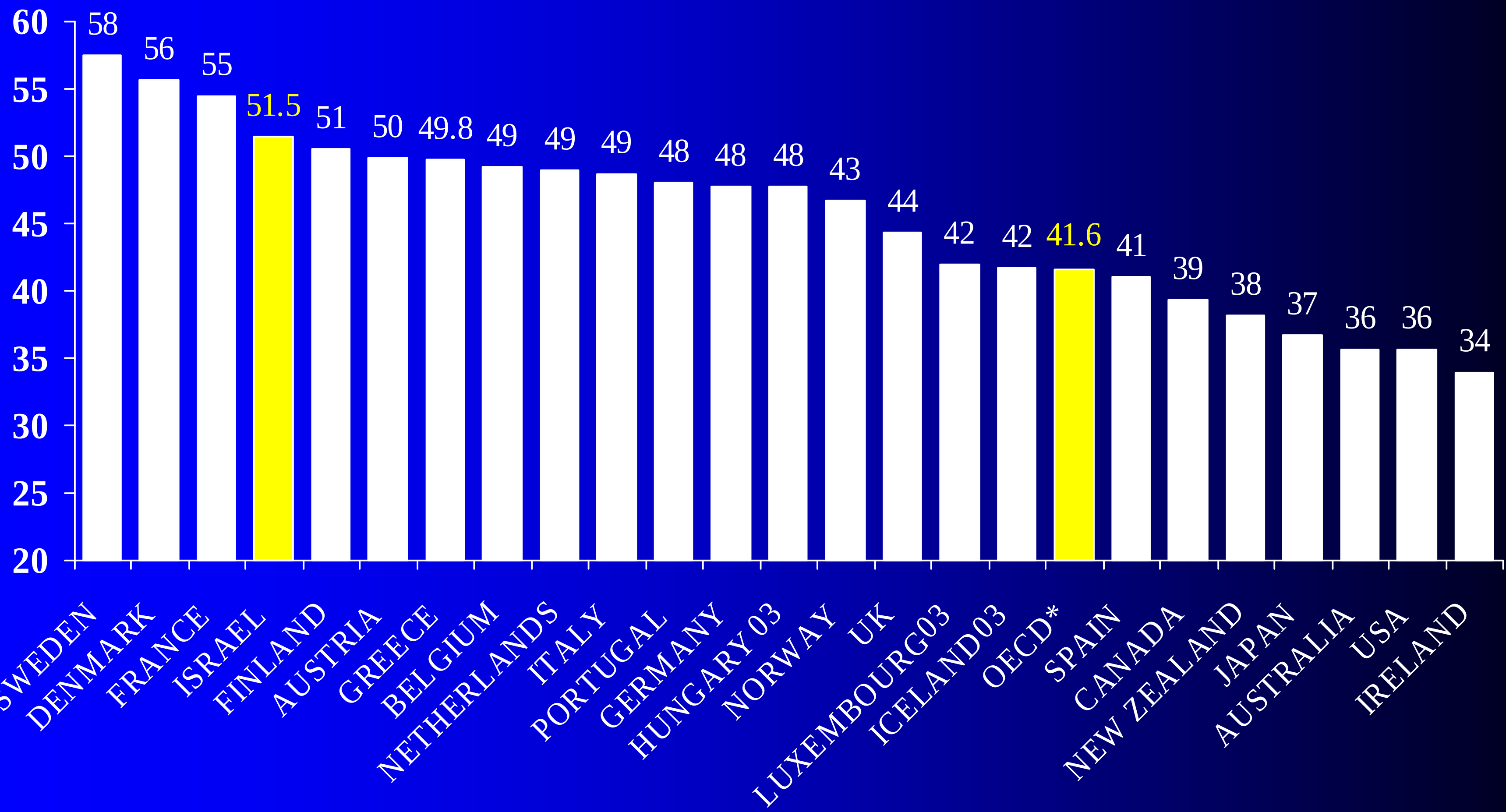


* Average of 23 countries, weighted by population size•
For the OECD countries, data on defense consumption and interest payments are for the most recent available year•

Israel has a high public expenditure/GDP ratio by international standards—due to large defense outlays, steep interest payments on the public debt, but also a relatively high share of civilian expenditure in GDP.

General Government Expenditure

percent of GDP, 2004



*Average of 23 countries, weighted by population

Public expenditure as a share of GDP declined in 2004 compared to 2003 and are projected to decline further in 2005, but is still high by international standards.

Fiscal Policy

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Fiscal Policy

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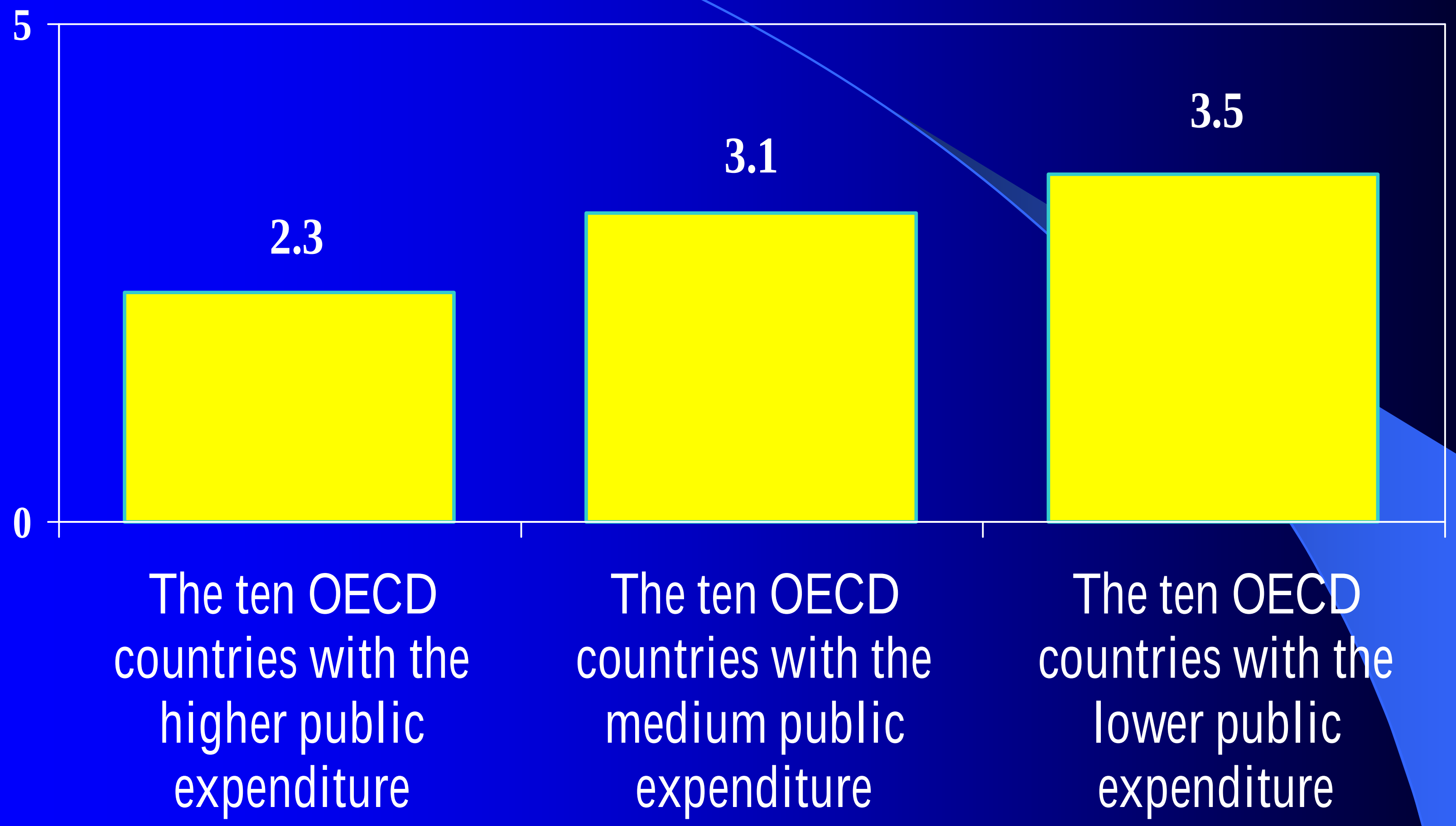
Average Growth Rate of OECD Economies (percent per year)

During 1996-2005, based on the World Economic Outlook of the IMF, May 2004



Most empirical studies point to a negative correlation between the level of government expenditure and the rate of economic growth. This negative relationship reflects the effect of an increase in government expenditure on the interest rate and, accordingly, the downward effect on investments, the creation of pressure in the labor market that pushes wages up and reduces corporate profits, and the increase in the tax burden, which is adverse to growth. Furthermore, companies in the public sector sometimes operate less efficiently than those in the private sector.

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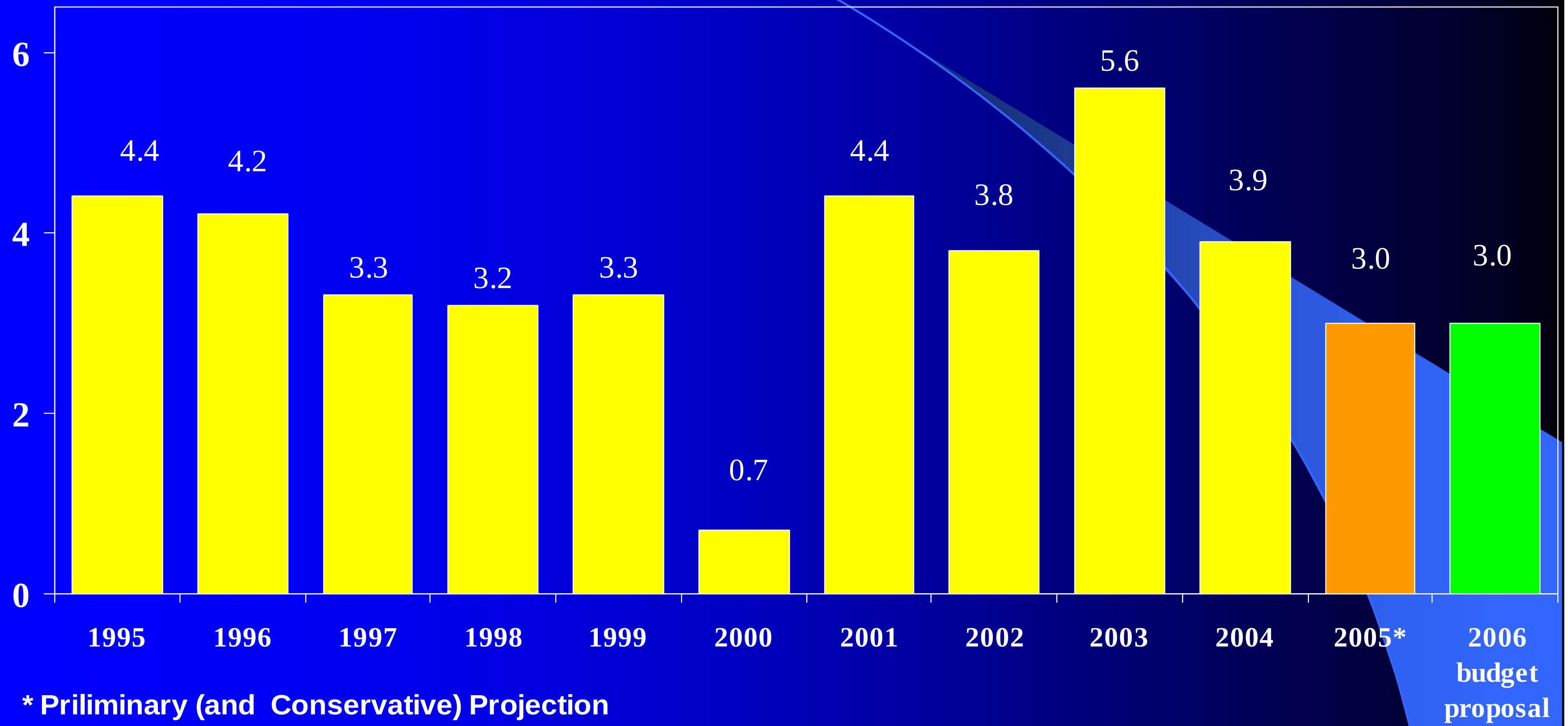
Budget Deficit
(as percent of GDP)



*** Priliminary (and Conservative) Projection**

The large deficit in 2003 reflected the effects of the recession, especially steep decreases in wages and private consumption, and a much lower price level than warranted by the inflation targets. These factors contributed to a steep downturn in government revenues from taxes and other sources. The 2004 deficit was 3.9% of GDP. From 2005 to 2010, real government expenditure in each fiscal year shall not increase by more than 1% over expenditure in the previous fiscal year, and the deficit shall not surpass 3 percent of GDP in any case.

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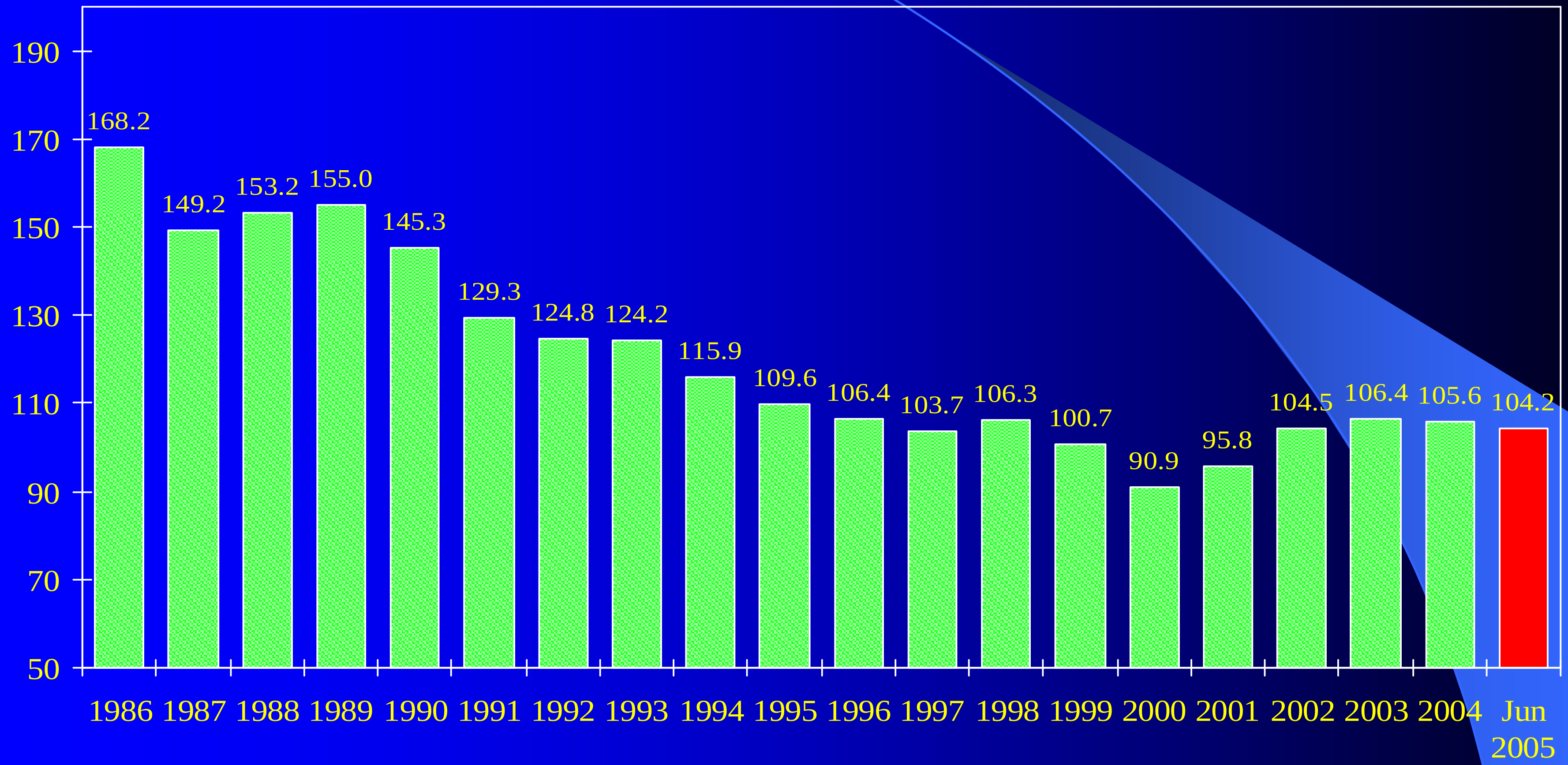
Gross Public Debt

as percent of GDP, 1986-2005



The public debt is a result of budget deficits in the past. After the mid-1980s, when the Economic Stabilization Program was applied, the public debt as a percent of GDP declined steadily and came to 91 percent of GDP in 2000. In 2001–2003, due to the deceleration in the economy and the decline in revenue taxes on one hand, and the difficulty to decrease government expenditure on the other hand, the gross public debt rose to 106.4 percent of GDP in 2003. As a result of the economy recovery and the withstanding of the deficit target, the gross public debt decreased to 105.6 percent of GDP in 2004 and 104.2 percent of GDP at the end of June 2005.

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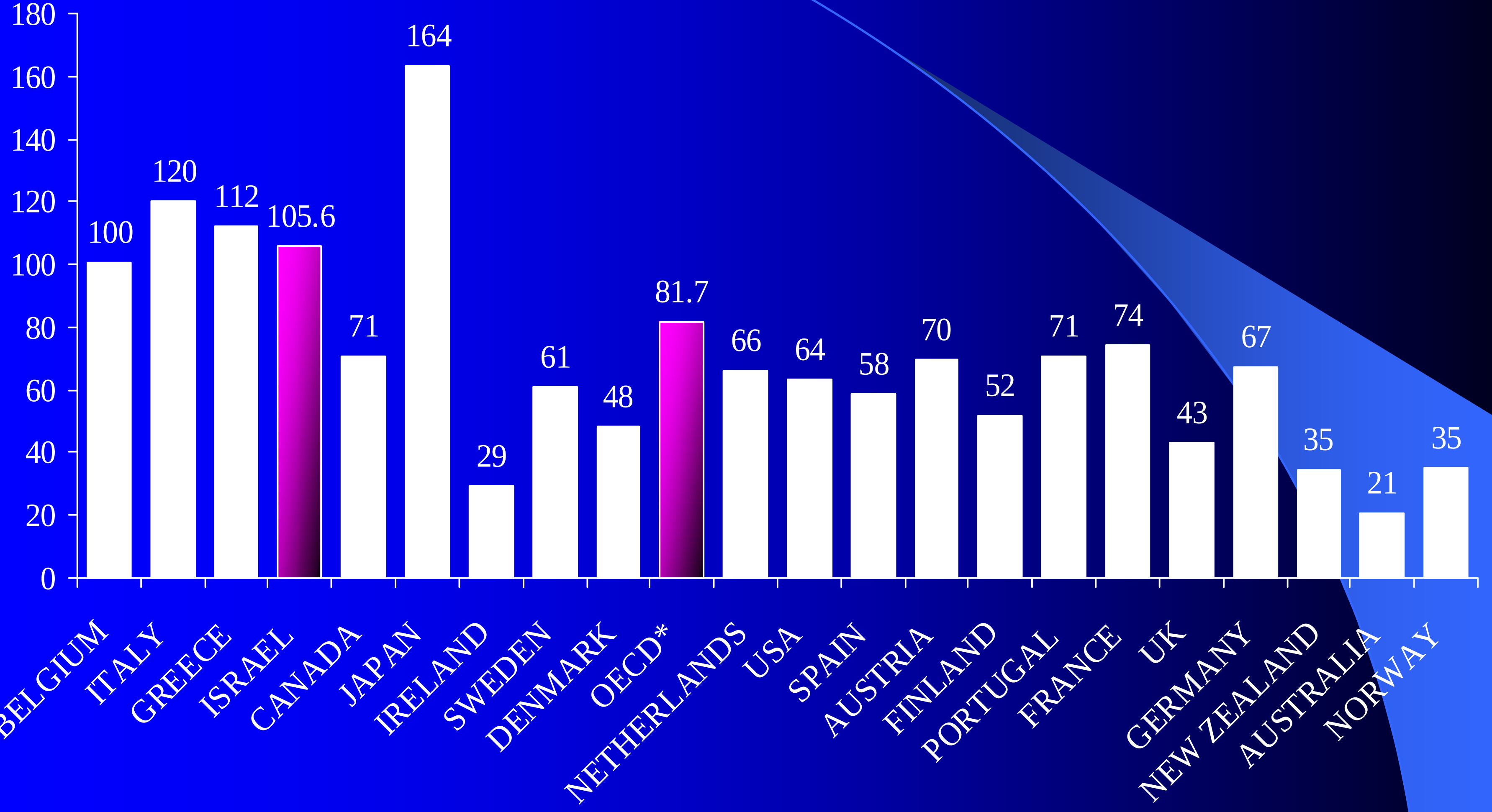
Gross Public Debt
percent of GDP, 2004



* Average of 20 countries, weighted by population.

Israel's public debt (as percent of GDP) is larger than that in most OECD countries.

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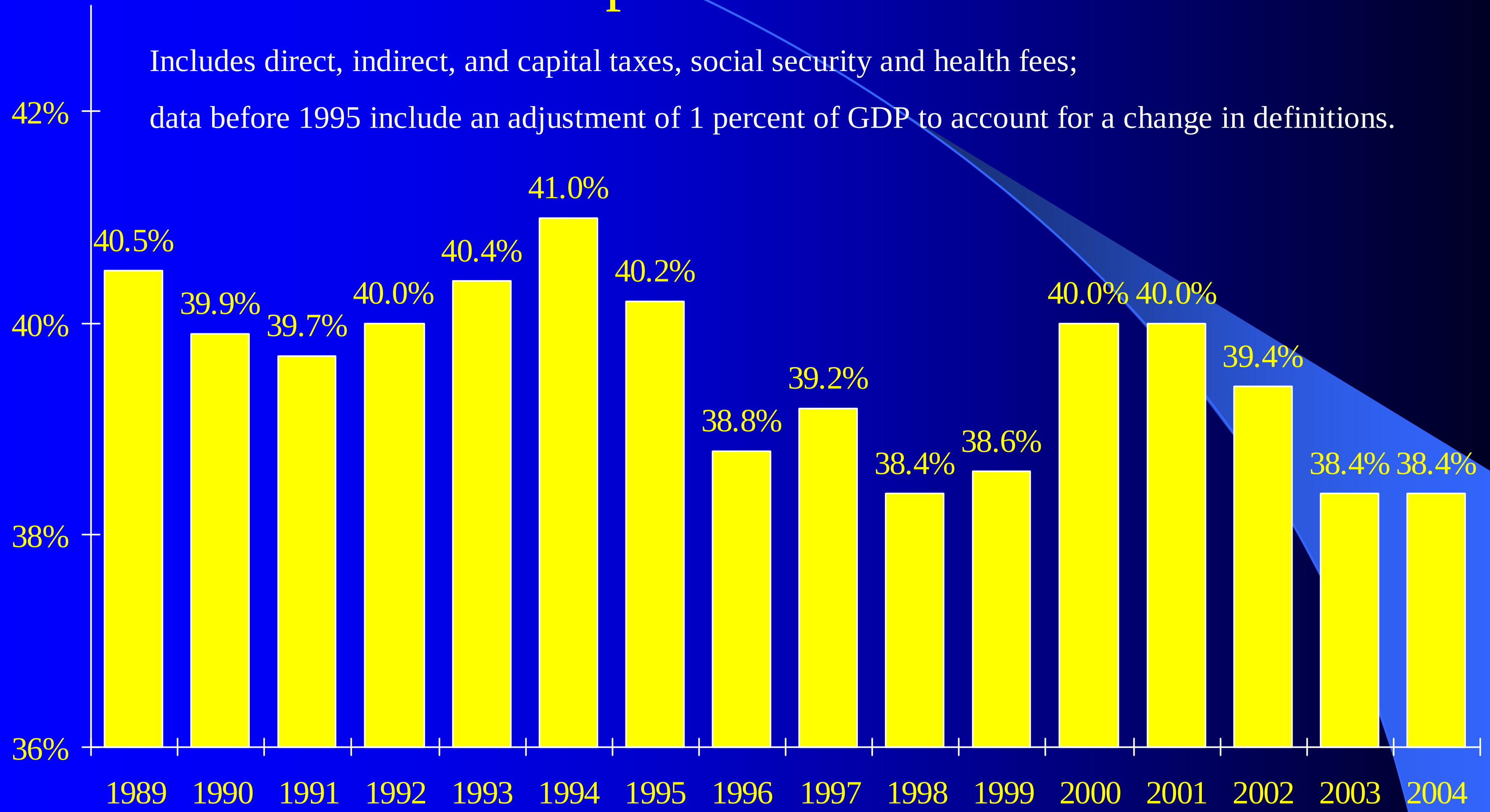
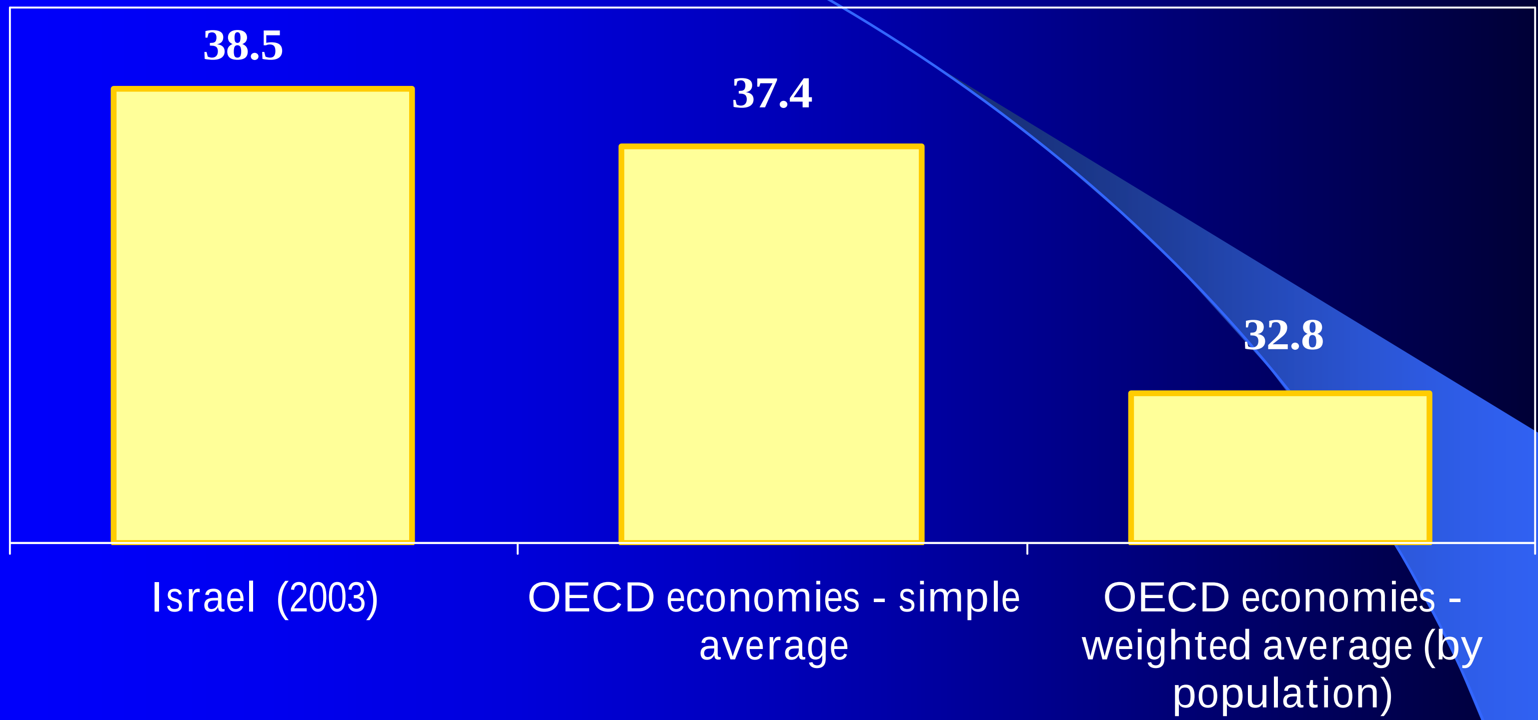
The Gross Tax Burden
as percent of GDP



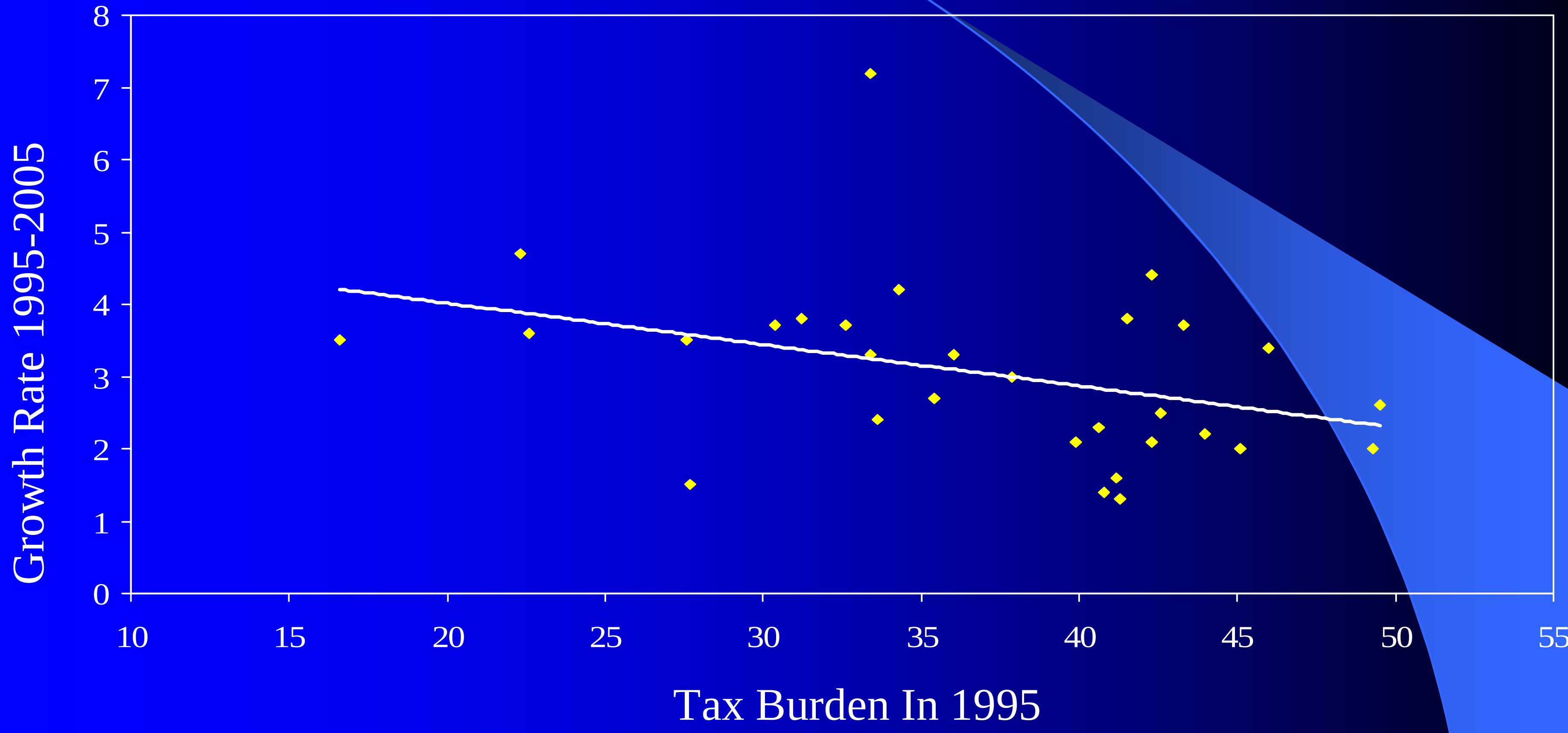
The tax burden declined in 2003, mainly due to a steep decrease in collection of income tax that reflected the effects of the recession (especially the wage decrease) and, to a lesser extent, the effects of the direct-tax reform. Indirect-tax collection also slipped, mostly due to a steep decline in imports of consumption goods in the first half of the year and a price level that was much lower than a level that would be consistent with the inflation targets. In contrast, the stability in the tax burden in 2004, relative to 2003, is a reflection of the effects of the tax reform on one hand, and the recovery of tax collection caused by the economic growth on the other hand.

Tax burden as percent of GDP - international comparison 2003



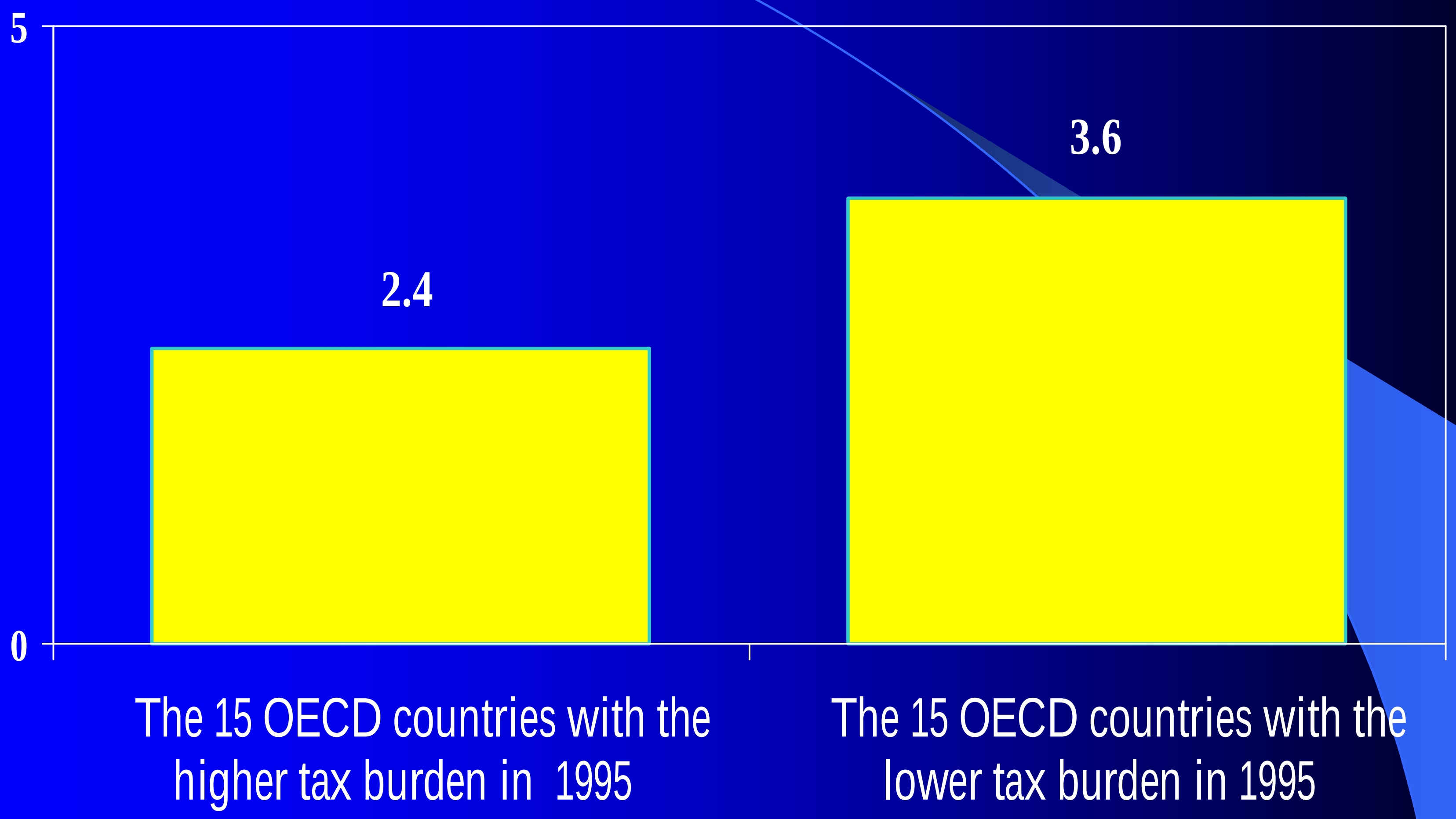
Israel's tax burden resembles the average tax burden (simple arithmetic mean) in the twentieth wealthiest countries—the United States, Canada, Japan, and seventeen Western European countries that have relatively high tax burdens. The tax burden in the total class of OECD countries, a more appropriate reference group for Israel in standard-of-living terms than the affluent Western European countries, is 37.4 percent of GDP. The comparison of the average tax burden is more relevant if the OECD countries are weighted by population size. By this standard, the average tax burden in the OECD countries is only 32.8 percent of GDP. Thus, average Israelis shouldered in 2003 a burden that was 5.7 percent of GDP heavier than that endured by average citizens in the OECD countries. This discrepancy, in terms of the size of Israel's GDP in 2004, means NIS 4,405 per resident or NIS 30.0 billion for the public at large.

The tax burden and the growth rate in OECD economies



Most empirical studies point to a negative correlation between the tax burden and the growth rate. A high tax burden slows growth by dampening investment, distorting business decisions, reducing labor supply, weakening incentives for the accumulation of human capital, inducing greater tax evasion, and causing labor and capital to flow to countries that have lower tax rates. In the long run, a high tax burden also correlates with a high level of public expenditure, which also slows the growth rate.

Average Growth Rate of OECD Economies (percent per year)
During 1996-2005, based on the World Economic Outlook of the IMF, May 2004



The average annual rate of growth among 15 OECD countries with low tax burden was 3.6 percent during the period 1996-2005. On the other hand, during this period the average annual rate of growth among 15 OECD countries with high tax burden was 2.4 percent.

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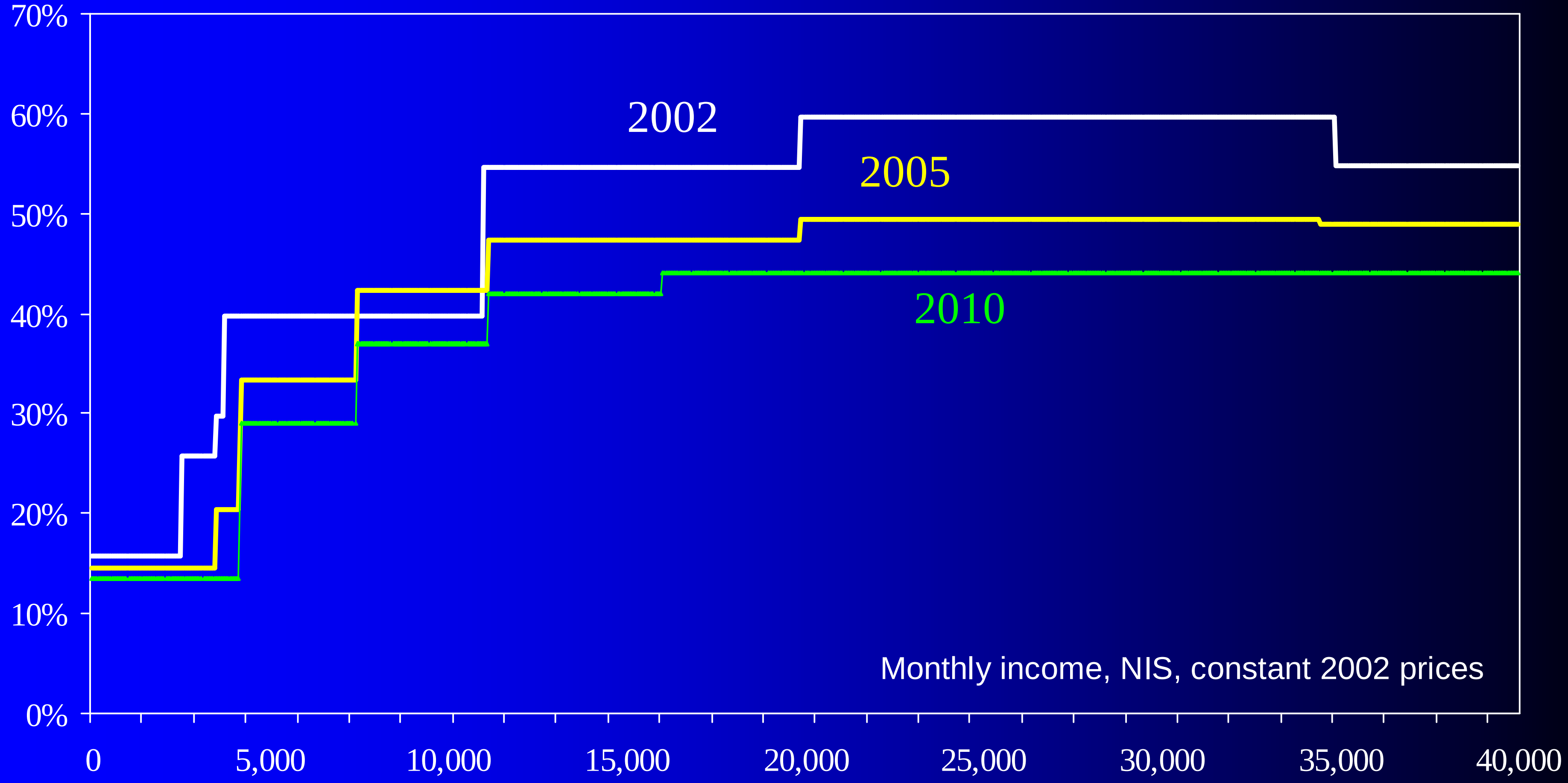
Marginal tax rate on labor income, before and after the tax reform

(including income tax, employee's social security tax, and health tax)



Due to the tax reform, the marginal tax rate on labor income (including income tax, National Insurance contributions by employees, and health tax) declined gradually from 2003. The March 2003 economic plan moved up the phases of the planned reform while a second plan in July 2005 expanded and deepened the reform. The reform will come to an end in 2010, when the marginal tax rate on employee's income be 44 percent.

Economic Trends in Israel

- General data
- Product and employment
- Balance of payments and external stability
- Fiscal policy
- Monetary policy and inflation rate

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Monetary Policy and Inflation Rate

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3. BOI real interest rate
4. Real interest rate and real effective exchange rate

Monetary Policy and Inflation Rate

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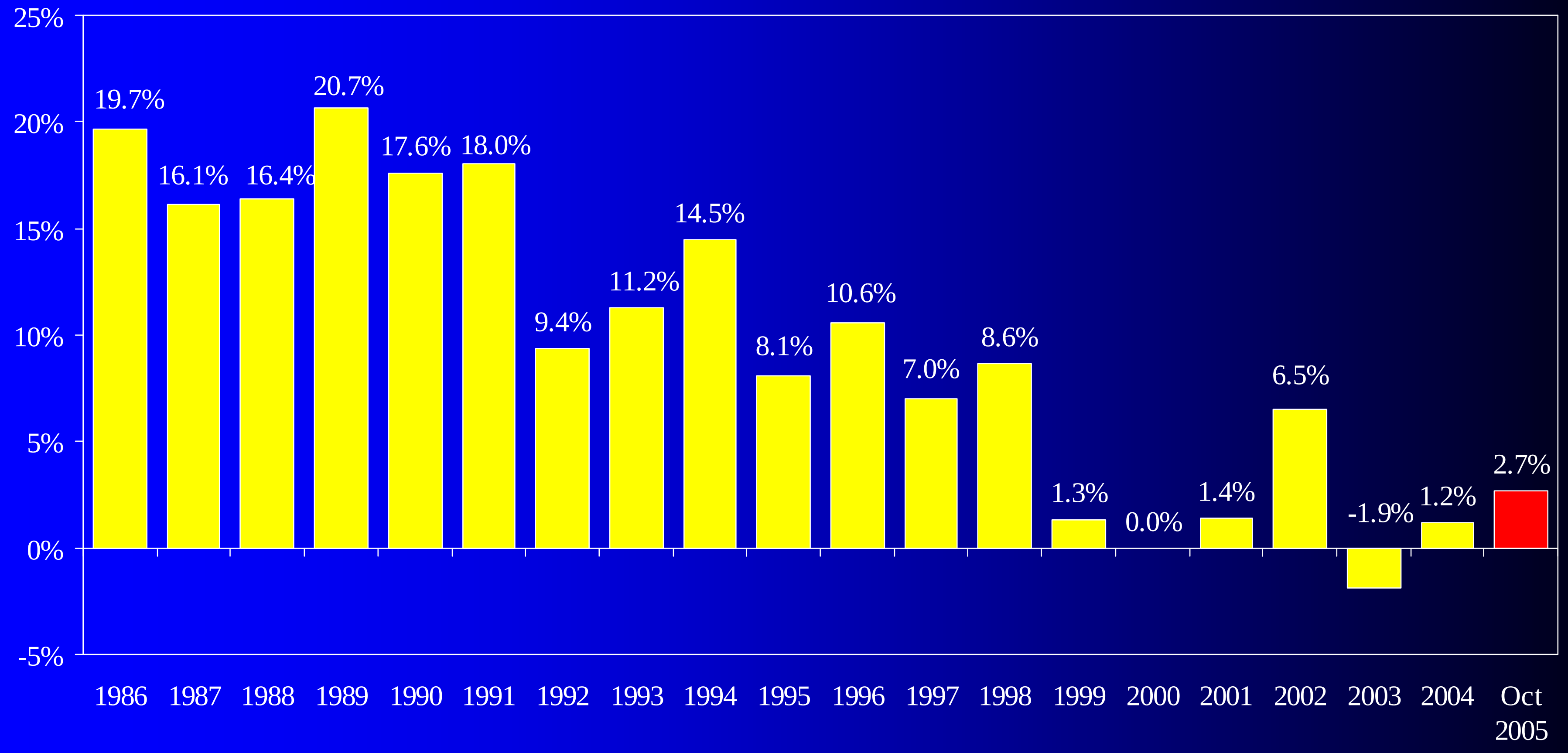
Annual inflation, 1986-2005
(end-of-period)



Inflation since 1999 has been close to zero. The inflation rate in 2002 reflected a non-recurrent increase in prices due to currency depreciation after several years of high interest rates that had delayed the exchange-rate adjustment. During 2003, the Consumer Price Index declined by 1.9 percent, missing the inflation target of 1–3 percent by a large margin. During 2004, the Consumer Price Index climbed by 1.2 percent and during the most recent 12 month period (up to October 2005) it rose by 2.7 percent.

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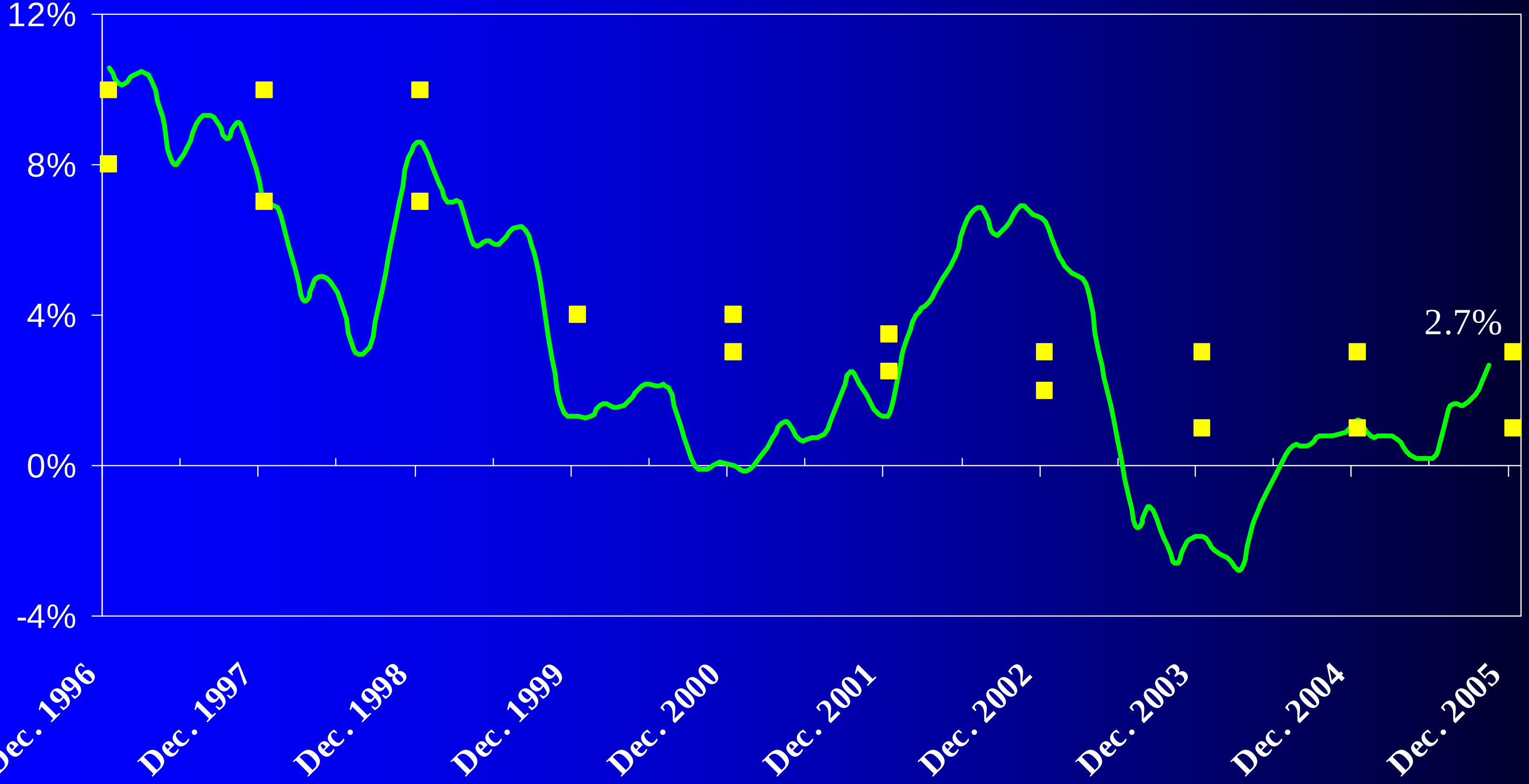
12–month Rate of Change in the CPI and Annual Inflation Targets



In 2005 the inflation rate is expected to reach near the high end of the inflation target. This is achieved after a long period in which the inflation was below the target.

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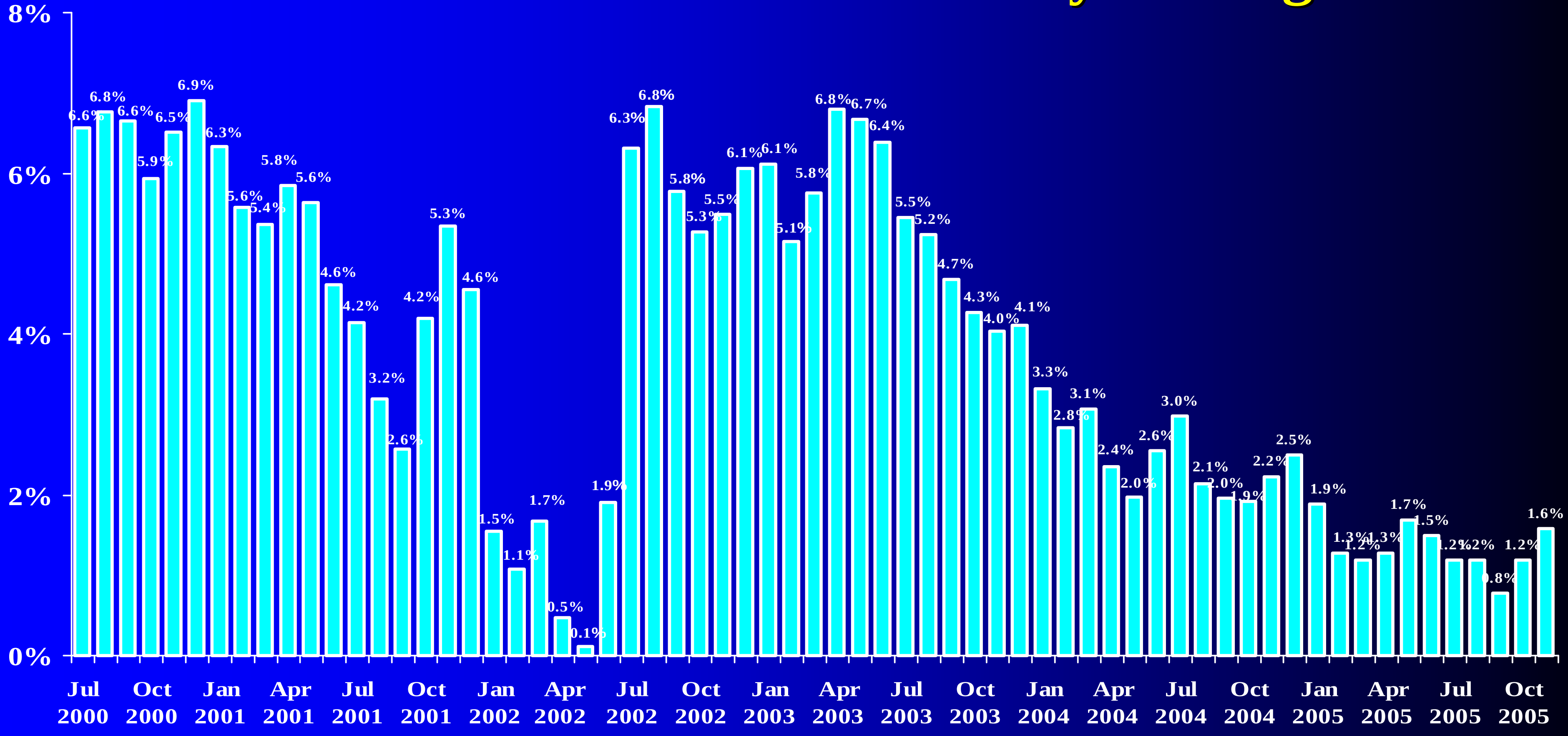
Short-Term Real Interest Rate,
Derived from the Bank of Israel's key lending rate



Real interest rates, derived from the central bank's key rate, have fallen from a high rate of more than 6 percent in mid-2003 to 1 percent in recent months. The real interest rate in 2004-2005 was lower than in previous years. In September through December the BOI interest rate rose by 1 percentage point, up to 4.5 percent due to the continuing rise of global interest rates, as well as published indicators showing fast economy growth and a decrease in unemployment rates.

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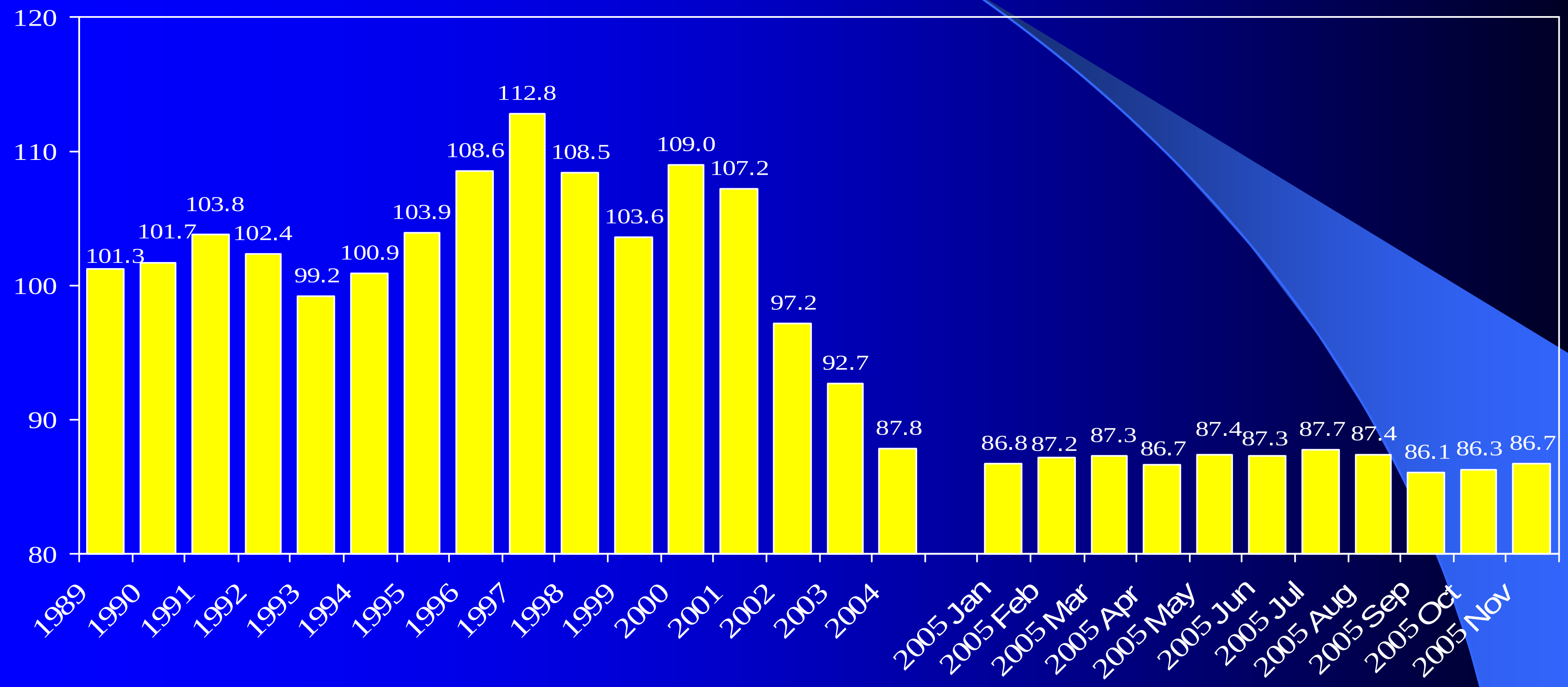
Real Effective Exchange Rate

(index, Jan. 1989 = 100)

Basket: US 50%, Euro 28%, UK 5%, Japan 5%, others 11%

increase means real appreciation, decrease means real depreciation



The real depreciation during 2002-2004 reflected an adjustment of the exchange rate due to real shocks that struck the economy from October 2000. The adjustment was delayed because the Bank of Israel kept real interest rates high in 1999–2001. The adjustment became possible only after a steep interest rate cut in late 2001 that led to steep depreciation in the first half of 2002. Real depreciation continued in 2003–2004, as Israel had lower inflation rates than the other advanced countries. The real depreciation helped to make export industries more competitive and supported the economic-recovery process.