

Senat Report No. 268 on Economic Issues:

The Israeli Economy: Current Conditions, Short- and Long-Term Forecasts

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Current Conditions

The Composite Index released by the Bank of Israel in May 2005 indicated a decline of 0.1%. This is the fourth consecutive decline in the index, a trend that contradicts the improvements observed during the parallel period in 2004. This decline reflects a reduction in the rate of economic activity as of early 2005.

In addition, responses to an industrial outlook survey indicate expectations for slowed growth in the first quarter of 2005 when compared to the last quarter of 2004. Among the industrialists who participated in the survey, about 43% reported a increase in output in the first quarter of 2005 as opposed to 49% who reported such increases during the fourth quarter of 2004.

Declines in sales in the local market were also observed: 31% of the participants in the survey reported a decline in sales in the first quarter of 2005 as opposed to the 28% who reported declines in the last quarter of 2004. This trend was repeated in exports, with a decline in the rate of those reporting growth in exports between the fourth quarter of 2004 and the first quarter of 2005.

Several changes were also discerned among macroeconomic parameters. For instance, the shekel was depreciated against the dollar (by about 3% since the beginning of June), in contrast to the preceding months, when the shekel was appreciated. According to the general consensus, the devaluation was caused by the dollar's gain in strength in international markets.

Similarly, a significant increase in foreign investment has been observed, to a level of \$5.3 billion during the first four months of 2005 in comparison to \$6.6 billion during entire 2004. This increase indicates expectations of economic growth in addition to improvements in fiscal policy and a stable monetary policy. Turning to the cost of living index excluding housing, a mild increase of an average 0.8% annually was observed during March-May. A somewhat larger increase (1.2%) was observed in the cost of living index excluding housing and produce during the same period, especially when compared with the 0.8% increase observed in the three preceding months (December-February).

As to wages and employment, a comparison of the first quarter of 2005 with the last quarter of 2004 indicates a decline of 0.7% in average gross wages in real terms, together with 0.4% increase in the number of jobs. We should note that during the first quarter of 2005, about 27% of all jobs available were filled by workers who earned less than half the average market wage — which equalled NIS3,482 monthly - for that period or NIS1,929 monthly.

Short- and Long-term Forecasts

Despite the uncertainty, basic indicators have been promising and supported the forecasted growth of 3.5% for 2005. Thus, for example, despite the decline in exports during the first quarter of 2005, exports have not only begun to increase recently, they have done so at a steeper rate. Additional indicators supporting a positive forecast include a surplus in the current balance of payments, an increase in tax revenues despite reductions in the tax rate as well as a reduction in the level of planned government expenditure. Similarly, government public debt is expected to decline in comparison to the previous year. However, several factors are likely to negatively influence growth expectations for 2005 in addition to the uncertainty regarding the peace process. These include the mild growth anticipated for the US economy, a partially response to the large deficit in the current balance of payments, as well as the economic deceleration observed in development countries, a trend that might diminish demand in international markets.

With respect to macroeconomic indices, a number of changes are expected to transpire within different time frames. In the short term, market instability is expected to continue, as is continued depreciation of the shekel. These trends are not expected to continue beyond a few months. The gap in interest rates between the shekel and the dollar is expected to narrow yet the interest rate in the Israeli market is likely to rise in the short term, until price stability is achieved, to offset the effects of the shekel's depreciation in addition to the rise in energy costs.

Against this background, we can expect the consumer price index to remain relatively high in comparison to the equivalent period during 2004. These conditions, together with the effect of other items included in the consumer price index, are like to drive inflation to a level of about 2% in 2005.

Israel is scheduled to begin implementation of a tax reform in 2006, to be concluded within five years (2010). The program's fundamental goal is to revise the existing tax system in order to make it more compatible with the systems operating in developed countries. Such a move is expected to enhance Israel's capacity to compete in the global market as well as promote the government's social policy objectives, especially improved distribution of income and reduction of poverty.

The tax reform's contribution to growth is expected to be visible as early as 2006. However, from a social perspective, this improvement is expected to dissolve in the long term: The reform will have no effect on reducing socio-economic gaps, which are high according to all international standards; it might even aggravate them. The main source for this fear lies in the permanent deficit, equalling about NIS7 billion, that will result from the reform's implementation. In order to finance this deficit, government expenditures will be reduced substantially, primarily through the reduction of per capita expenditures on health, education and welfare. Reductions in these spheres is expected to exert a strong negative influence on low-income individuals, which will more than offset the reform's benefits. Accordingly, we cannot forecast any reform-initiated growth after 2006. We should, however, note that social compromises integral to implementation of the reforms are to be distinguished from those that expand socio-economic gaps and intensify poverty, developments that stimulate government spending and negative growth in the long term. Despite the influence of these factors, the Ministry of Finance leadership continues to adhere to expectations about the reform's impact, based on the model applied in Ireland. They argue that although the tax reform will replace budget cuts and reduced spending in the short term, it will in fact stimulate growth, reduce gaps and raise the standard of living in the long term.

Summary

The Israeli economy has known long periods of uncertainty; despite such an atmosphere, it has witnessed years where economic growth was able to overcome the disruptive effects of political and security issues. Israel is again in the throes of such uncertainty, reflected in a range of economic indicators such as the exchange rate against the dollar and financial markets fluctuations. Despite the pressures and constraints, we can expect the economy to grow at a rate of 3.5% in 2005 and even higher in 2006.

Yet, if the tax reform in its current form is implemented, growth will not be stimulated in the long term. In effect, no conditions supportive of growth are expected to appear in the far future. A contradictory trend is anticipated: A rise in the percentage of families with incomes below the poverty line intensified income inequality and expanded socio-economic gaps.