



Ministry of Finance
Office of the Director General
Economics and Research Department

Review of Developments in the Israeli Economy

**Annex to the State Budget for
2011-2012**

Jerusalem • October 2010

To the Members of Knesset:

I am honored to present this annex to the state budget for 2011-2012. This review covers the major macro-economic developments in Israel and globally during 2009 and the first half of 2010, as well as the forecasts used in the construction of the state budget.

2009 was marked by the recovery from the global crisis, which peaked in the fourth quarter of 2008 and the first quarter of 2009. The sharp declines in global demand led to a steep decrease in exports in the first half of the year. The global capital-market crisis and the high level of uncertainty caused sharp drops in the local capital market and stagnation in the non-bank credit market. As a consequence, the volume of investments and private consumption decreased significantly. Meanwhile, the labor market deteriorated, as evidenced by an increase in unemployment.

In the wake of five years of rapid growth and substantial improvement in external stability and fiscal balances, the Israeli economy had a strong starting point at the outbreak of the global crisis, with a strong financial system and no real-estate bubble. Israel's relative robustness was illustrated by its economy's faster and earlier recovery in comparison to other developed countries. The rebound began in the second quarter of 2009, with moderate positive growth, and escalated in the following quarters. Growth in the second half was led by Israeli exports, especially in the high-technology sectors, and by private consumption. Meanwhile, global and Israeli capital-market indices rose significantly, and the non-bank credit market showed gradual improvement. The upturn was also reflected in a faster-than-expected decrease in the unemployment rate and an increase in the number of employed persons. GDP growth in 2009 reached 0.8 percent, which translates into negative per-capita growth.

The improvement in economic stability in the years prior to the crisis allowed policymakers to respond with expansive monetary and fiscal policies, to a certain extent. Budget policy was designed to minimize the negative effects of the crisis on the Israeli economy, based on an awareness that the origins of the crisis were external and its consequences could not be entirely nullified. Fiscal policy therefore relied on the operation of automatic stabilizers, which took the form of a steep drop in tax

revenues in 2009, leading to an increase of the same volume in the budget deficit; government spending was not cut back to reduce the deficit. The fiscal policy applied in Israel differed from that of other developed countries that were hurt by the crisis directly, and did not entail large-scale stimulus plans or the nationalization of financial institutions. However, steps were taken that focused on preserving the normal operation of the capital markets, supporting population groups that suffered from the crisis, aiding small and mid-sized businesses, and allocating additional resources to research and development. As a result, the increase in Israel's ratio of debt to GDP was minor, whereas in most of the OECD countries this ratio worsened markedly.

The recovery of the Israeli economy continued during the first half of 2010. Specifically, growth rates in the first and second quarters were impressive; the large surplus in the current account of the balance of payments was maintained; and unemployment returned to the low rate of early 2008. However, the capital markets have experienced moderate declines in the last few months. On the global level, fiscal conditions in the developed countries have worsened in recent months, with a debt crisis emerging in some European states. The debt crisis has highlighted the high degree of uncertainty in the global economy and the threats to the ongoing recovery. Under these circumstances, in the coming years these countries are likely to scale back their stimulus plans and carry out cutbacks to reduce budget deficits and prevent rapid increases in debt.

As a small, open economy, Israel will be strongly affected by the rate and composition of global growth. Leading international organizations predict that the recovery of the global economy will continue in the coming years, but growth rates in the developed countries will be lower than in the years preceding the crisis. Accordingly, we estimate that growth in Israel will strengthen over the next three years, but remain below the growth rates of 2004-2007.

Sincerely,



Haim Shani

Director General

Table of Contents

1. Developments in the Israeli Economy in 2009 and the First Half of 2010.....	5
A. Development of the GDP and GDP Components	5
GDP and Business GDP.....	5
Private Consumption.....	7
Public Consumption.....	8
Investments	8
Exports	9
Imports	11
B. Balance of Payments	13
C. Labor Market.....	17
D. Capital Market.....	20
E. Budget Policy	23
F. Inflation and Monetary Policy	32
2. Highlights of Forecasts for 2010, 2011, and 2012.....	34
3. Developments in the Global Economy and Threats to the Recovery	40
4. Financing the Deficit.....	51
5. Capital Market Policy.....	53

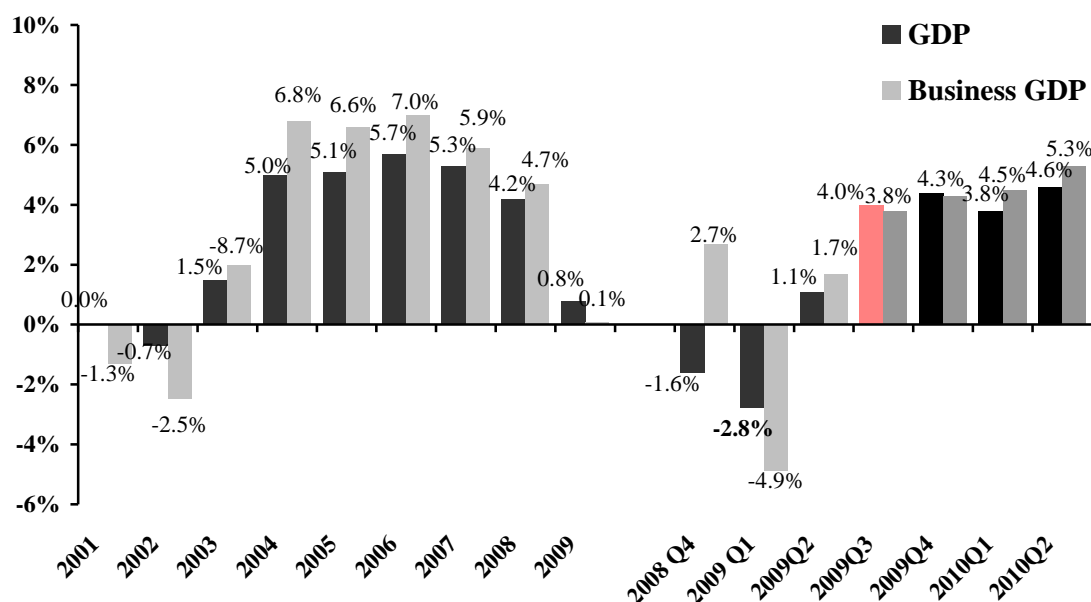
1. *Developments in the Israeli Economy in 2009 and the First Half of 2010*

A. *Development of the GDP and GDP Components¹*

GDP and Business GDP

GDP growth totaled 0.8 percent in 2009, meaning negative per-capita growth of 1.1 percent. The business GDP expanded by 0.1 percent. The year began with contraction of the GDP in the first quarter of 2009, further to the contraction in the last quarter of 2008. GDP gradually rebounded during the year, showing moderate positive growth in the second quarter, which intensified in the third and fourth quarters. This trend continued into the first half of 2010, with annualized growth rates of 3.8 percent in the first quarter and 4.6 percent in the second quarter. Growth in the first half of 2010 was led by the business GDP, which grew at annualized rates of 4.5 percent and 5.3 percent, in the first and second quarters respectively.

Diagram 1. Gross domestic product and business GDP
Real change, 2001-Q2 2010



Source: Central Bureau of Statistics.

¹ National accounting data presented in this section match the CBS publication of September 16, 2010, unless otherwise noted.

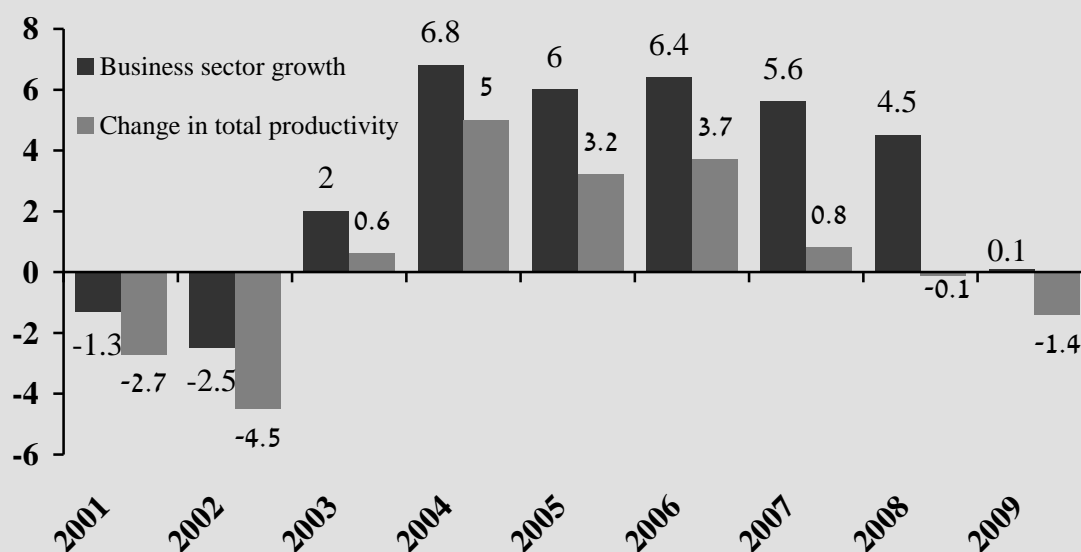
Box I: Business Sector Productivity

Business GDP stagnated in 2009, following several years of high growth rates, at an average of approximately 6 percent in 2004-2008. Total productivity² fell by 1.4 percent in 2009, further to a 0.1 percent decrease in 2008.

During 2009, the business sector contended with stalled demand, mainly a decline in the demand for exports. The lower demand and manufacturers' pessimistic mood, as reflected in the purchasing managers' index in the first half of 2009, led to adjustments in the volume of employment and investments. In the labor market, new workers were not recruited in the first half of the year, and work hours were cut back. This policy caused labor productivity to remain flat in 2009. Meanwhile, the supply of capital continued to grow at a significant rate during 2009, leading to substantial erosion of capital productivity.

Diagram 2. Business GDP and total productivity

Rates of change, 2001-2009



Source: Central Bureau of Statistics, Bank of Israel, calculations by the Economics and Research Department.

² Total productivity is a measure of the increase in GDP not accounted for by the increase in production inputs (capital and labor).

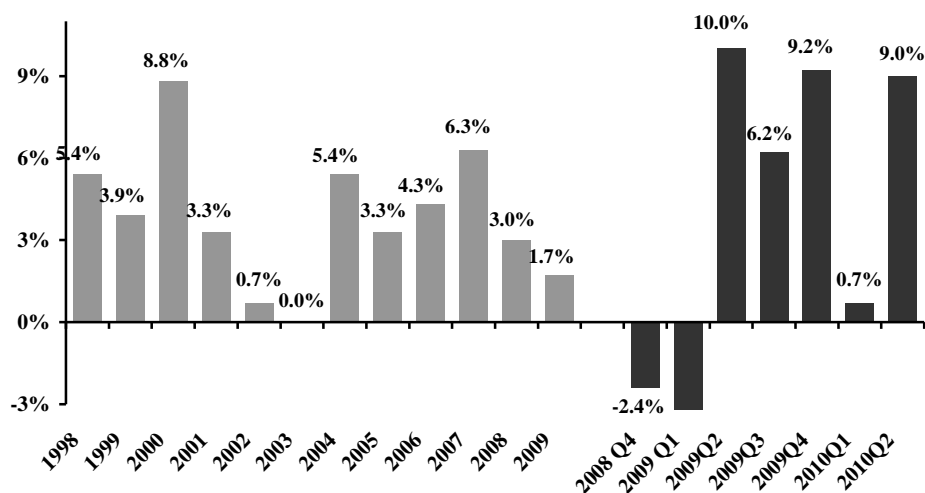
Private Consumption

Private consumption grew by 1.7 percent in 2009, a low rate compared to recent years, reflecting stagnation in per-capita consumption. Notably, consumption of durable goods decreased by 6.3 percent in 2009.

The slowdown in private consumption in early 2009 was influenced by factors including the downturn in the labor market in the first half of the year. This led to a decrease in the number of employed persons and a decrease in real wages, as well as sharp declines in the capital markets, which damaged individual wealth and consumer confidence. The substantial improvement in private consumption in the second half of 2009 was influenced by the sharp gains in the capital markets during that period and by the considerable decrease in uncertainty.

Diagram 3. Rate of change in private consumption

Real change, 1998-Q2 2010



Source: Central Bureau of Statistics.

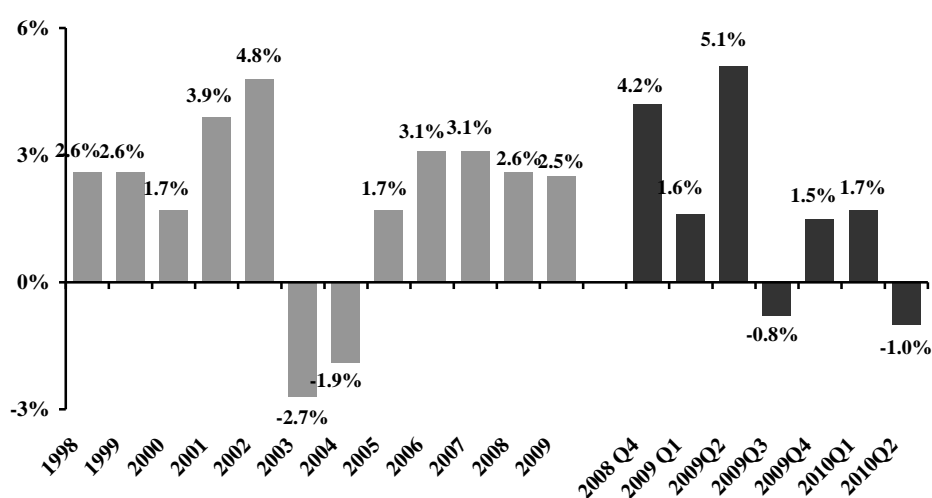
This improvement slowed in the first quarter of 2010, as private consumption expanded at an annualized rate of 0.7 percent, reflecting an increase in current consumption offset by a decrease in consumption of durable goods (such as household goods). During the second quarter of 2010 private consumption expanded at a significant annualized rate of 9.0 percent, influenced by a substantial increase in consumption of durable goods.

Public Consumption

Public consumption increased by 2.5 percent in 2009, similar to the increase in 2008. Civilian public consumption grew by 4.5 percent, while defense consumption decreased by 2.7 percent due to a sharp decrease in defense imports. Public consumption increased at an annualized rate of 1.7 percent in the first quarter of 2010, and decreased at an annualized rate of 1.0 percent in the second quarter.

Diagram 4. Rate of change in public consumption

Real change, 1998-Q2 2010



Source: Central Bureau of Statistics.

Investments

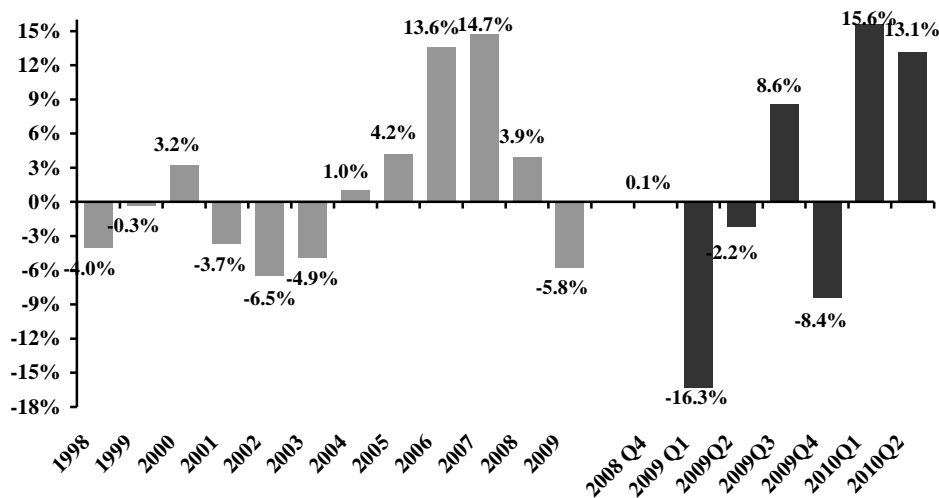
Investments in the economy are the component most sensitive to expectations regarding economic developments. Consequently, investments were one of the first items to respond to the developments in the global economy, as early as the first half of 2008. In order to temper the damage to total investments in the economy, the government decided to recognize accelerated depreciation for tax purposes during 2008.

Gross domestic investments contracted by 8.9 percent in 2009, as a result of a 5.8 percent decrease in fixed-asset investments and a sharp decline in inventories. A particularly steep decrease occurred in investments in machinery and equipment. This decrease was somewhat offset by an increase in residential construction.

Developments in investments were inconsistent over the course of 2009. The trend of contraction that began in the second quarter of 2008 persisted during the first and second quarters of 2009; fixed-asset investments expanded in the third quarter but decreased again in the fourth quarter. Significant annualized increases of 15.6 percent and 13.1 percent respectively were recorded in the first and second quarters of 2010.

Diagram 5. Rate of change in fixed-asset investments

Real change, 1998-Q2 2010



Source: Central Bureau of Statistics.

Exports

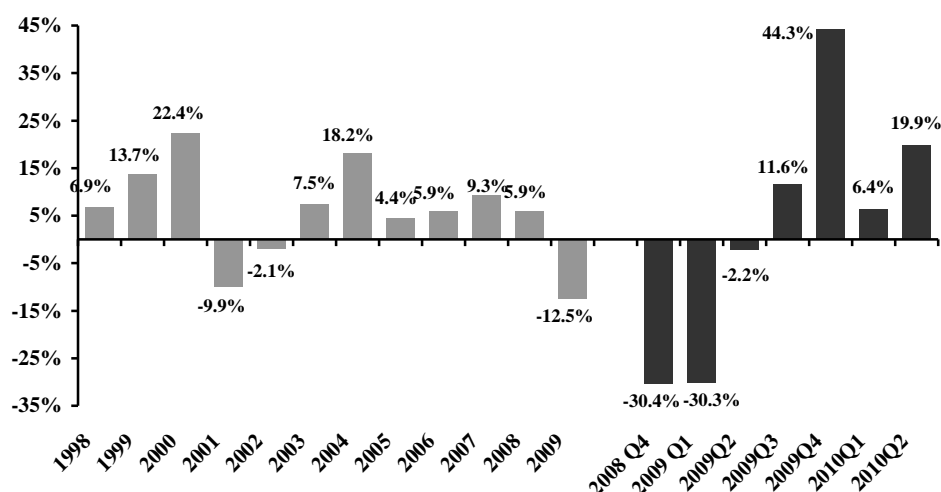
The decrease in global demand and in the volume of global trade led to an even greater fall in exports in 2009 than at the apex of the earlier crisis, in 2001 (which was strongly influenced by the dot-com crash in late 2000). Total Israeli exports contracted by 12.5 percent in 2009. Similar rates of decrease occurred both in exports of goods (12.7 percent) and in exports of services (11.9 percent). A rapid expansion of exports began in the second half of 2009, continuing through the first and second quarters of 2010. Still, exports of goods and services in the second quarter of 2010 remained slightly lower than the peak levels of the first quarter of 2008. An examination of the components of exports indicates that in the second quarter of 2010, exports of goods, which comprise more than two-thirds of total exports, were slightly higher than the peak level of the first quarter of 2008, while exports of services were about 16 percent below the peak level. Most of the difference in exports of services

stemmed from exports of business services and of software and research and development services.

As noted, the severe damage to exports was directly affected by the global crisis, which caused a decrease in global demand and a sharp contraction in the volume of global trade. This negative effect encompassed most sectors: in 2009, industrial exports (excluding diamonds) decreased by 9.2 percent, tourism by 24.3 percent³, and exports of other services (excluding start-up companies and tourism) by 8.6 percent. Diamond exports fell steeply, by 31.1 percent, further to a sharp decline in 2008.

Diagram 6. Rate of change in exports

Real change, 1998-Q2 2010



Source: Central Bureau of Statistics.

The recovery in exports of goods, which began in the second half of 2009 and continued through the second quarter of 2010, was not consistent across the various sectors. Industrial exports of high technology⁴ expanded sharply during this period, while in other types of technology exports did not return to pre-crisis levels.

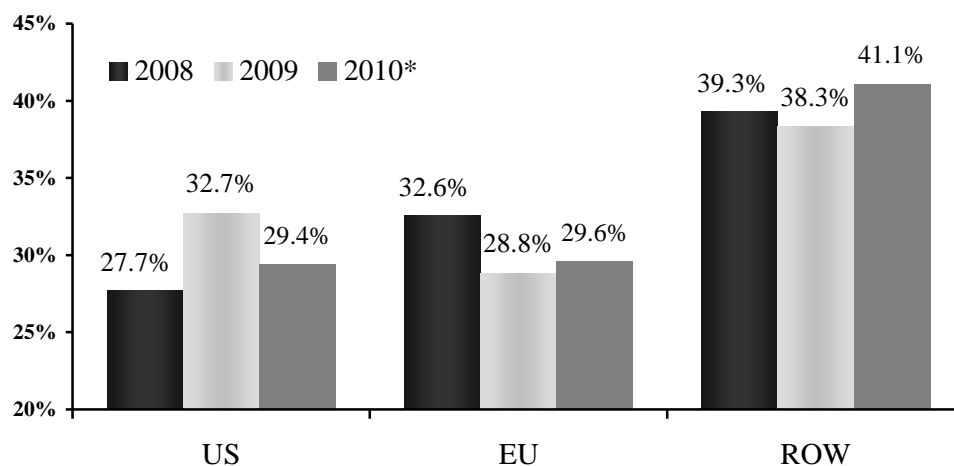
³ Part of the decrease in tourism resulted from the effects of Operation Cast Lead, which began in late December 2008 and ended in mid-January 2009.

⁴ In particular, exports of electronic components increased sharply, mainly due to the commencement of exports by the new Intel plant in Kiryat Gat.

The proportion of goods (in dollar terms; excluding diamonds, ships, and aircraft)⁵ exported to the United States increased in 2009 relative to recent years, although in dollar terms there was no significant change in the volume of exports to the US. The increase was mainly offset by a decrease in the proportion of exports to the eurozone, which fell from 33 percent in 2008 to 29 percent in 2009. The majority of the increase in exports of goods in 2010 occurred in markets other than the US and the eurozone.

The majority of industrial exports to the US are in the high technology sectors (approximately 60 percent in 2008), versus 30 percent to the European Union. The chemicals sector, which is part of the mixed-high technology category, stands out in industrial exports to the European Union, comprising about one-third of these exports.

Diagram 7. Distribution of exports of goods by target countries, 2008-2010



* Data for 2010 refer to January-August.

Source: Central Bureau of Statistics.

Imports

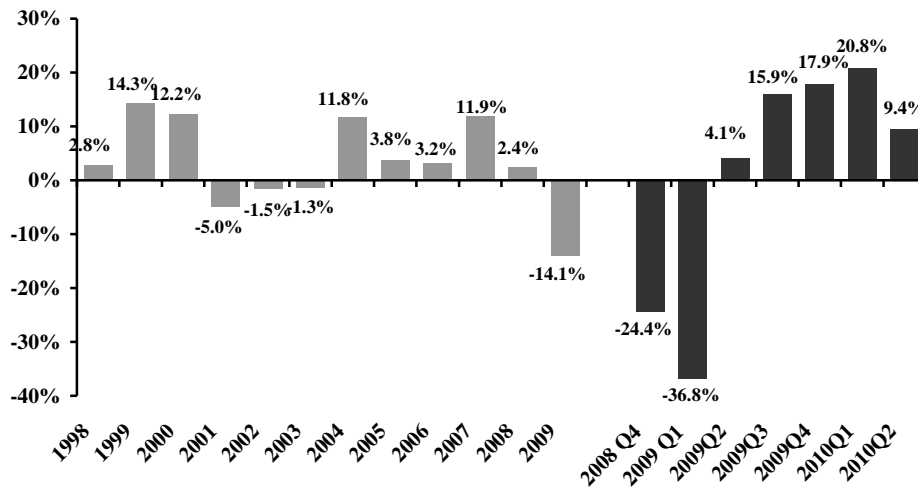
In 2009 Imports of goods and services contracted by 14.1 percent. The steep decrease in imports resulted from the downturn in domestic activity and the decline in demand for exports. The reduction in imports was led by a decrease in imports of investment products and raw materials.

⁵ These figures are presented in current US dollars, in contrast to the export figures presented earlier, which are calculated in NIS and therefore include the effect of changes in exchange rates.

The contraction of imports that began in the second quarter of 2008 halted in the second quarter of 2009; in the second half of 2009, imports expanded significantly. This trend continued into the first and second quarters of 2010, with imports expanding by 20.8 percent, or an annualized rate of 9.4 percent. However, imports remained lower than the peak level of early 2008, by 7 percent.

Diagram 8. Rate of change in imports

Real change, 1998-Q2 2010



Source: Central Bureau of Statistics.

B. Balance of Payments

The current account of the balance of payments showed a high surplus of USD 2.3 billion in the second quarter of 2010, constituting approximately 4.4 percent of GDP, further to the high surpluses in the first quarter and during 2009. The total surplus in the current account in 2009 was USD 7.6 billion, representing approximately 3.9 percent of GDP. This was a continuation and escalation of the trend of surpluses in the current account that started in 2003. For comparison, the surplus was USD 4.9 billion (2.9 percent of GDP) and USD 1.6 billion (0.8 percent of GDP) in 2007 and 2008, respectively.

The large surplus in the second quarter of 2010 resulted from a relatively high surplus in net exports (exports minus imports), similar to the developments in the preceding quarters and in contrast to the deficit. Net exports have shown a relatively large surplus since the first quarter of 2009, due to the sharper decline in imports than in exports that quarter. As the recovery began in the second quarter of 2009, exports also increased rapidly. However, the volume of trade remained lower than the peak of early 2008. In the second quarter of 2010, exports were still about 5 percent lower than the peak of the first quarter of 2008, while imports of goods and services were 15 percent below the peak level of the second quarter of 2008⁶.

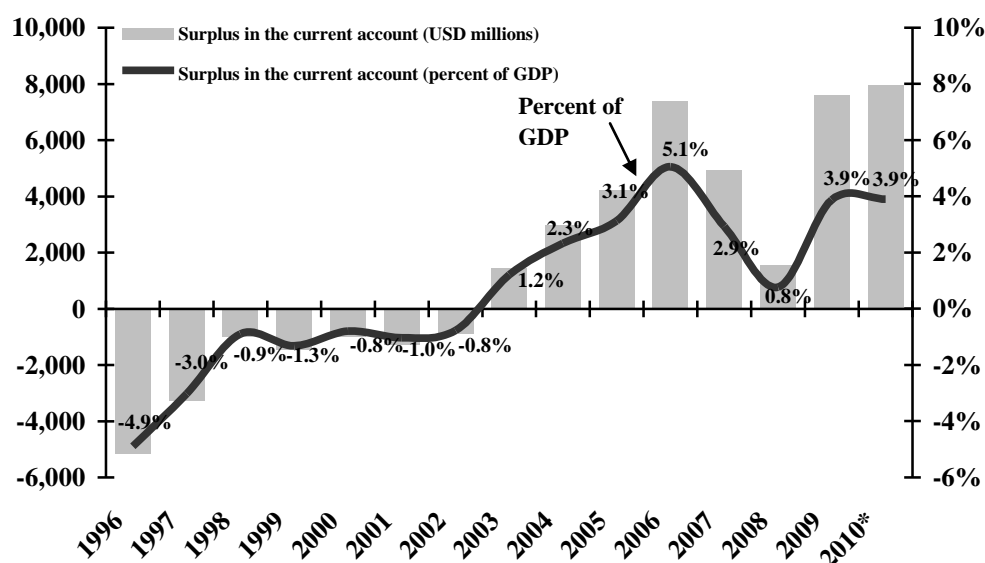
In addition, the high surplus in 2009 was influenced by factors including the real depreciation of the shekels and the significant improvement in Israel's terms of trade⁷, due to the decrease in global commodity prices in general and oil prices in particular relative to the average prices in 2008.

⁶ This calculation is based on data net of seasonal effects, in current dollars, and therefore does not take the effects of exchange rates into account.

⁷ Terms of trade are defined as the ratio of export prices to import prices. The improvement in terms of trade in 2009 reflects a sharper decrease in import prices than in export prices.

Diagram 9. The current account of the balance of payments

USD billions and percent of GDP, 1996-2010*



* 2010: First half, annualized.

Source: Central Bureau of Statistics.

Table 1. Surplus in current account, 2009 and H1 2010*

(In USD billions, current prices)

Current account components	Surplus/deficit in 2008	Surplus/deficit in 2009	Surplus/deficit in 2010*	Change in 2009 vs. 2008
Goods account	7.2-	0.1-	1.6-	7.1
Of which: Exports of goods	57.2	45.9	55.8	11.3-
Imports of goods	64.4	46.0	57.5	18.4-
Services account	4.2	4.7	6.0	0.5
Of which: Exports of services	24.8	22.0	23.8	2.8-
Imports of services	19.9	17.1	17.8	2.8-
Revenue account	4.1-	4.6-	5.8-	0.5-
Current transfers account	8.5	7.4	9.5	1.1-
Current account	1.5	7.6	8.0	6.1

* 2010: First half, annualized.

The capital account, a mirror image of the current account, includes the balance of investments by foreigners in Israel and by Israelis overseas, and the change in the state's foreign-currency reserves. In 2009, non-residents provided an inflow of foreign capital in the amount of USD 9.9 billion to Israel. The proportion of direct investments was lower than in previous years; foreign direct investments totaled USD 3.9 billion, similar to the level in 2005. Foreign direct investments in Israel continued to decline in the first half of 2010, reaching a low point for the last few years in the second quarter of 2010. Total foreign investments in the first half of 2010 reached USD 4.3 billion (or USD 8.6 billion annualized), mainly due to the large volume of investments in securities in the first quarter of 2010.

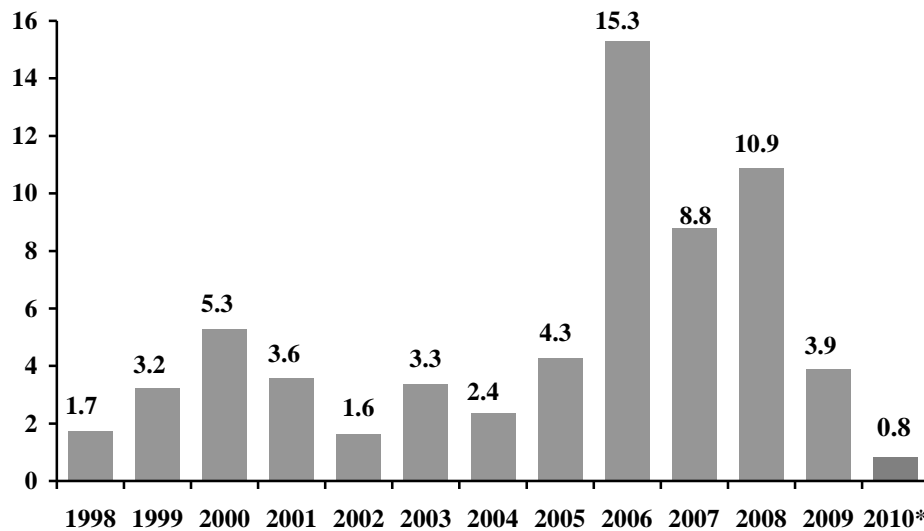
Table 2. Foreign investments in Israel

USD billions

	Direct investments	Investments in securities	Other investments	Total investments
2005	4.3	3.6	0.4	8.3
2006	15.3	9.1	2.8	27.1
2007	8.8	1.6	3.7	14.1
2008	10.9	1.0	1.8-	10.1
2009	3.9	2.4	3.7	9.9
2010*	0.8	8.1	0.3-	8.6

* First half of 2010, annualized.

Diagram 10. Foreign direct investments in Israel
USD billions, 1998-Q1 2010



* First half of 2010, annualized.

Source: Central Bureau of Statistics.

The increase in foreign-currency reserves in 2009 (due to purchases by the Bank of Israel) and the volume of investments overseas by Israelis were high relative to the past, at USD 20.9 billion. In particular, the volume of investments in foreign securities by Israelis was the highest since 2006. The large volume of investments overseas by Israelis and the increase in foreign-currency reserves continued in the first half of 2010.

Table 3. Investments overseas by Israelis

USD billions

	Direct investments	Investments in securities	Other investments	Increase in foreign-currency reserves	Total investments
2006	15.5	8.0	10.5	0.2	34.2
2007	8.6	3.8	8.6	1.7-	19.4
2008	7.2	2.0	10.9-	14.2	12.5
2009	1.2	7.6	4.5-	16.6	20.9
2010*	5.5	10.4	3.7-	12.1	24.3

* First half of 2010, annualized.

C. Labor Market

The deterioration that began in the labor market in late 2008 continued into the first half of 2009. The downturn took the form of a sharp rise in unemployment in the first quarter of 2009, and an additional, though more moderate, increase in the second quarter. Conditions improved in the second half of 2009 and unemployment fell, though it remained higher than in 2008. The unemployment rate for 2009 was 7.6 percent. The number of employed persons in 2009 remained flat compared to 2008; the increase in unemployment for the year resulted from the natural growth of the civilian workforce and the stagnation in employment.

The downturn in the labor market in 2009, which resulted from the economic crisis, followed several consecutive years of substantial improvement. The unemployment rate in 2008 was the lowest in twenty years, at 6.1 percent; the workforce participation rate reached a record level of 56.5 percent, after rising rapidly over the course of the last decade⁸. There was no significant change in the participation rate in 2009.

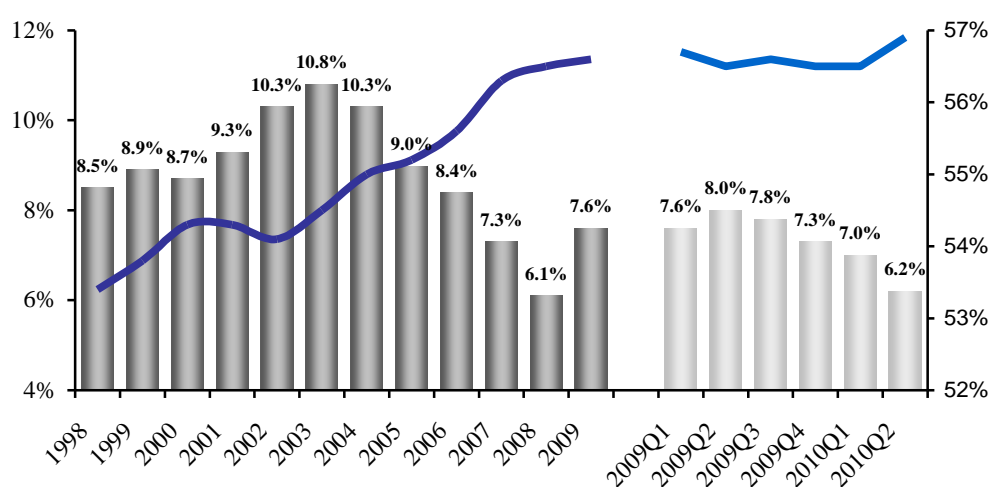
The labor market usually experiences a delayed response to changes in business cycles, but the current crisis was marked by a quick, sharp reaction in the labor market both at the entry into and exit from the recession. The main cause was most likely the fact that the consequences of the global crisis for the local economy were anticipated, allowing employers to adjust in advance. Thus, the number of part-time employees increased at the expense of full-time employees as early as the second half of 2008. Likewise, the labor market stabilized and recovered earlier than expected, both in comparison to previous recessions and to the developed economies. Accordingly, as the economy rebounded in the second half of 2009, employers brought the number of work hours per employee back up. A possible explanation for the rapid recovery is that employers expected a far more prolonged and severe recession, so that their initial response was essentially an overreaction which was later adjusted. Employers' ability to quickly adjust the volume of employees and work hours demonstrates the high flexibility in employment enjoyed by Israel's business sector.

⁸ The participation rate has been flat since mid-2007, following a rapid rise in the preceding years. The participation rate in the working-age population (15+) was 54.5 percent in 2003, compared with 56.5 percent in 2008. However, the participation rate in Israel remains significantly low in comparison to the developed countries.

The labor-market downturn in 2009 was not consistent across sectors. The proportion of industry-sector employees out of total employees in the Israeli economy decreased in 2009. The more severe damage to this sector relative to the other sectors seems to have been related to the contraction of exports and investments. The improvement was also not uniform across sectors; the increase in the number of employed persons in the second half of 2009 was led by an increase in employees in public services.

Diagram 11. Participation rate and unemployment rate

1998-Q2 2010



Source: Central Bureau of Statistics.

Table 4. Key labor market indicators, 2005-Q1 2010

	<u>Participation</u> <u>rate</u>	<u>Unemployment</u> <u>rate</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Full-time</u>	<u>Part-</u> <u>time</u>
2005	55.2%	9.0%	2,495.0	246.2	1,608.8	716.3
2006	55.6%	8.4%	2,574.6	235.6	1,636.9	752.0
2007	56.3%	7.3%	2,684.2	212.2	1,714.4	786.0
2008	56.5%	6.1%	2,774.8	181.7	1,801.6	785.5
2009	56.6%	7.6%	2,782.1	230.3	1,813.5	794.7
2008 Q4	56.5%	6.5%	2,785.4	193.2	1,734.9	853.1
2009 Q1	56.7%	7.6%	2,773.3	226.6	1,762.6	829.1
2009 Q2	56.5%	8.0%	2,760.4	239.6	1,771.1	813.2
2009 Q3	56.6%	7.8%	2,784.2	234.2	1,832.9	782.2
2009 Q4	56.5%	7.3%	2,810.6	220.8	1,887.5	754.4
2010 Q1	56.5%	7.0%	2,827.4	212.2	1,842.3	828.0
2010 Q2	56.9%	6.2%	2,884.4	191.0	1,824.4	882.1

Source: Calculations by the Economics and Research Division based on Manpower Survey data for the first quarter of 2010 and previous Manpower Surveys.

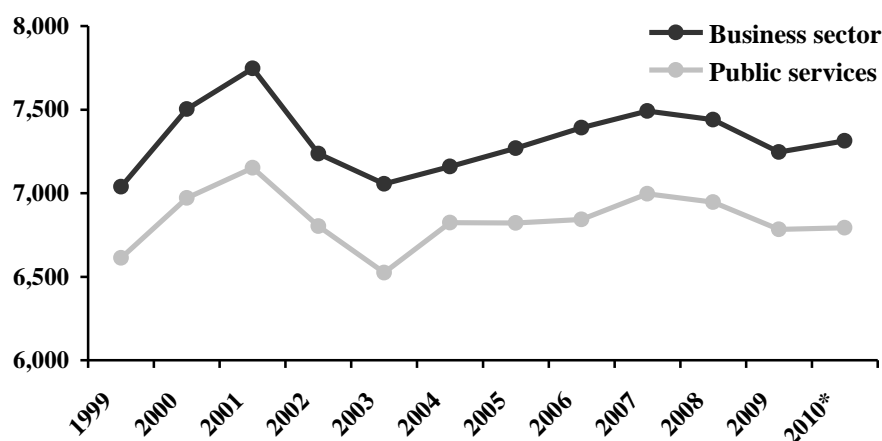
The improvement in the labor market that began in the second half of 2009 continued in the first half of 2010. The upturn took the form of a significant decrease in unemployment, to a low 6.2 percent in the second quarter, along with an increase in the participation rate, to 56.9 percent. However, it should be noted that the increase in the number of employed persons consists entirely of part-time jobs, whereas the number of full-time employees decreased in the first two quarters.

The number of non-Israeli workers rose slightly in the first half of 2010, reaching 281,000, up about 2 percent from 2009. An increase at a similar rate occurred in the number of non-Israeli workers in 2009. During the earlier part of the decade, from 2001 to 2006, the number of non-Israeli workers consistently decreased; this trend reversed in 2007, with significant increases in 2007 and 2008.

Real wages per employee position fell by 2.6 percent in 2009, due to the downturn in economic activity and the higher-than-expected inflation, further to the decrease that began in 2008 following five years of wage increases. In the first half of 2010, wages recovered slightly, particularly in the business sector, but real wages remained low compared to recent years.

Diagram 12. Real wages per employee position in the business sector and in public services

1999-2010, 2004 prices



* January-June average.

Source: Bank of Israel.

D. Capital Market

The capital market showed significant recovery in the second half of 2009 and in the first quarter of 2010. This followed steep declines in stock and corporate bond indices as well as a freeze in the issuance market during 2008, especially the latter part of the year, and in the first few months of 2009. As the Israeli economy recovered in the second half of 2009, the trend reversed, with stock indices and corporate bond indices posting sharp gains. The improvement was also reflected in an increase in the volume of corporate bond offerings. The upturn in the equity markets was checked in the second quarter of 2010, due to factors including the public debt crisis in Europe, which evoked renewed concerns over the stability of the global economic recovery. The declines in the global capital markets stopped during the last months of 2010⁹, and price gains resumed in the local equity market.

Stock Indices

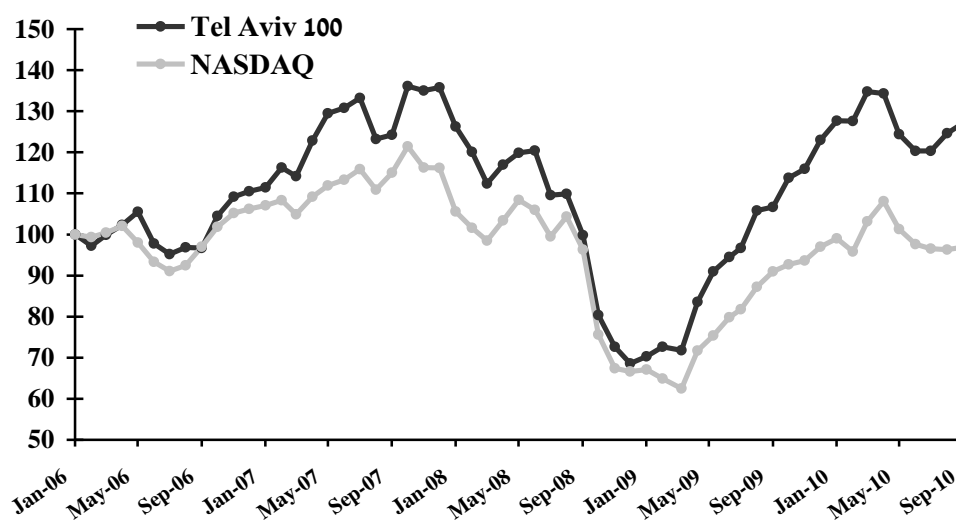
Stock indices rose sharply during the last three quarters of 2009, following the steep declines of 2008. During this period, the Tel Aviv 100 index rose by about 60 percent¹⁰, higher than the sharp gains in the developed countries (see diagram 13). The improvement in the equity market continued into the first few months of 2010, but stopped early in the second quarter, due to factors including the public debt crisis in Europe (see details in Section 3). In the third quarter of 2010, the declines halted in most key indices globally, and the Tel Aviv 100 index rose.

⁹ Capital-market data in this review are current as of September 15, 2010.

¹⁰ The end of 2009 versus the end of the first quarter of 2009.

Diagram 13. The Tel Aviv 100 index and the NASDAQ index

January 2006 - September 2010, January 2006=100



Source: TASE and Yahoo Finance.

- **Bond Indices**

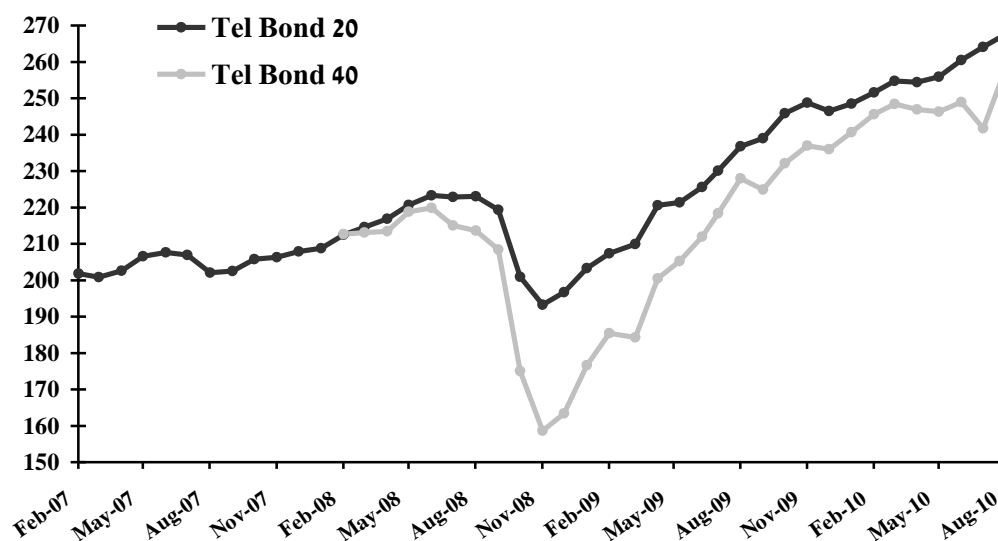
The corporate bond market experienced significant improvement during 2009. As part of this process, the Tel Bond 20 index rose by 7.1 percent in 2009 relative to 2008. The Tel Bond 40 index also posted a 5.3 percent increase. The upward trend of these indices continued in the first eight months of 2010¹¹. However, the indices slowed somewhat during the second quarter of 2010, parallel to the declines in stock indices during the same period. The decrease in yields over the last year¹² encompassed most sectors. The average yield, which reached a record 13.4 percent at the end of 2008, fell to 7.1 percent at the end of 2009 and 4.8 percent in August 2010 (the most recent available figure).

¹¹ The Tel Bond 20 index rose by 12.8 percent in the first eight months of 2010 relative to 2009. During the same period, the Tel Bond 40 index rose by 16.7 percent.

¹² This calculation refers only to tradable linked bonds, which constitute the majority of corporate bonds in Israel.

Diagram 14. Corporate bond indices

February 2007 - August 2010



Source: TASE.

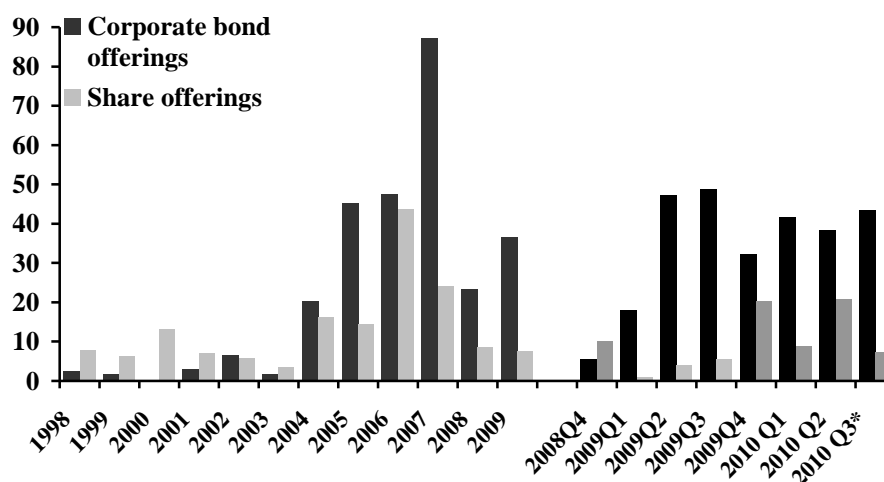
- **Securities Issuance**

The volume of offerings in the corporate bond market also improved significantly. The upturn began in the second quarter of 2009, following an almost complete freeze in the preceding two quarters. Overall in 2009, bonds issued in this market totaled NIS 36.5 billion, compared to NIS 23.4 billion in 2008¹³, an increase of 56.1 percent. Concurrently, the volume of offerings in the equity market decreased at a relatively moderate rate; offerings in this market totaled NIS 7.6 billion in 2009, versus NIS 8.5 billion in 2008, a decrease of 11.0 percent. The improvement in the volume of offerings continued in the first eight months of 2010, both in the equity market and in the corporate bond market.

¹³ In current prices.

Diagram 15. Offerings of corporate bonds and shares

NIS billions, in fixed prices, 1998-Q3 2010, quarterly data in annualized terms



* Q3 2010 data calculated based on July and August, in quarterly terms.

Source: TASE.

E. Fiscal Policy

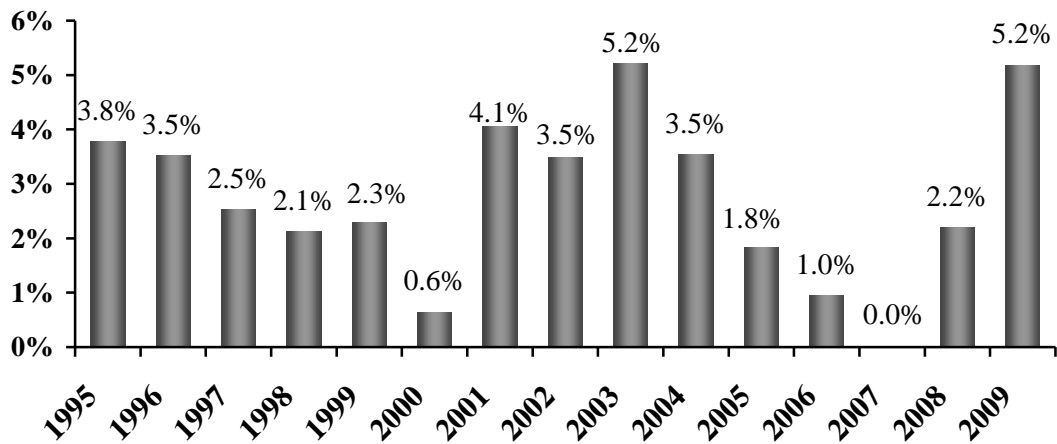
Fiscal policy in 2009 was designed to minimize the negative impact of the global economic crisis on the Israeli economy. The substantial improvement in the government's fiscal balances – the decrease in the budget deficit and in public debt – in the years leading up to the crisis enabled the government to make full use of automatic stabilizers (increasing the deficit in line with the decrease in tax revenues) while maintaining the credibility and stability of its fiscal policy, and averting the need to cut back expenses. The importance of this flexibility was highlighted by the fiscal problems confronted by many of the developed countries, which may obligate these countries to apply restraining fiscal policies as early as 2010. Such policies would take the form of a sharp cutback in expenses and an increase in taxes, and are likely to impede these countries' growth in the coming years. A key example of the importance of budgetary stability is provided by the stability of Israel's credit rating during the crisis, which prevented an increase in the government's credit financing costs (which also affect total credit costs in the economy), in contrast to the rating downgrades in many countries and the leap in those countries' debt issuance costs.

The state budget for 2009 was approved late; consequently, a biennial budget was passed, for 2009-2010. The approval of the biennial budget contributed to the stabilization of expectations during a period of uncertainty, and enabled the government to adopt a uniform, consistent policy in coping with the effects of the crisis. Some of the main actions taken by the government to address the crisis and the resulting implications include easing the criteria for eligibility for unemployment benefits, an increase of the Chief Scientist budget, support for small and mid-sized businesses, prioritization of infrastructure projects, establishment of leverage funds, provision of guarantees to banks, and more.

Government tax revenues began to fall during 2008, and the decline continued in the first half of 2009. As a result, the budget deficit in 2008 grew to 2.2 percent (following a balanced budget in 2007) and a deficit of 5.2 percent in 2009. The real increase in budgetary expenses for that year was 1.7 percent, the rate dictated by law at that time (a new rule has been put in place since then; see Box II: The Fiscal Rule) as well as a one-time increase of 1.35 percent was added for 2009-2010. This increase was necessary in order to enable the government to address nonrecurring budgetary needs stemming from the crisis. In order to prevent an increase of the deficit beyond the effect of the automatic stabilizers, indirect taxes were raised to compensate for the budgetary increase (e.g. the increase of VAT from 15.5 percent to 16.5 percent¹⁴). The 2009-2010 budget sets forth a falling deficit trajectory, to 1.0 percent of GDP by 2014. According to this trajectory, the deficit ceiling for 2011 and 2012 is 3.0 percent and 2.0 percent, respectively, while the annual increase in expenditures is 2.6 percent.

¹⁴ VAT was lowered to 16 percent in January 2010.

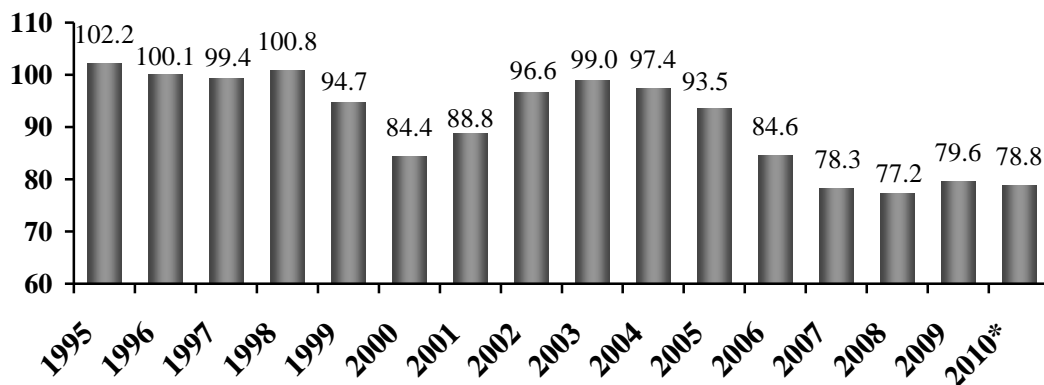
Diagram 16. Budget deficit
1995-2009, in percent of GDP



Source: Ministry of Finance.

The increase in the budget deficit halted the downward trend of the public debt-to-GDP ratio. This ratio serves as a key indicator of future budgetary stability and of the government's ability to meet its future commitments. In the years preceding the crisis, the decrease in budget deficits led to a considerable improvement in the ratio of debt to GDP, from 99 percent in 2003 to about 77 percent in 2008. The increase in the budget deficit in 2009 arrested this improvement and caused an increase in debt, to 79.6 percent of GDP. The government debt, which excludes the liabilities of local authorities, stood at 77.9 percent of GDP in 2009.

Diagram 17. Public debt
1995-2009, as percent of GDP



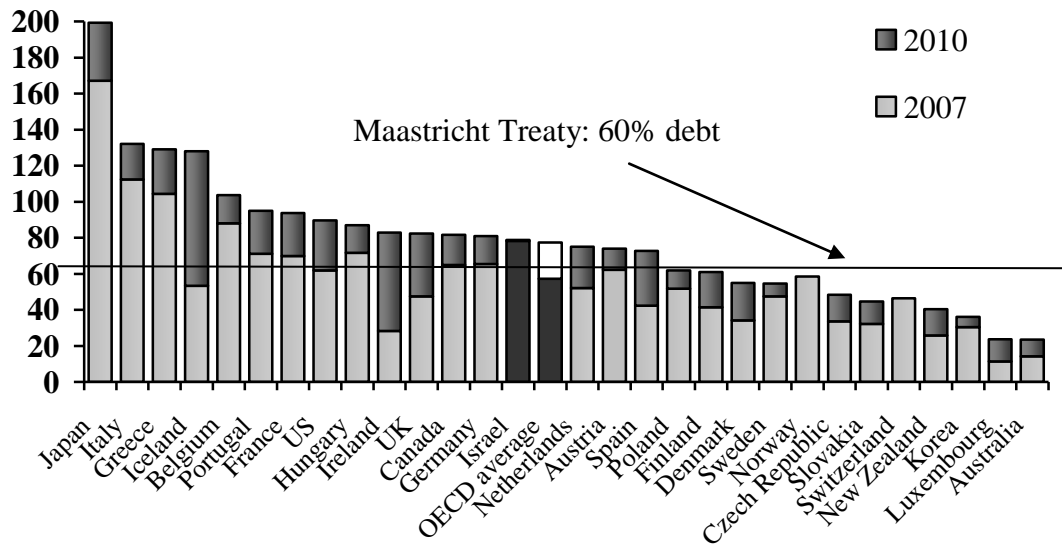
Source: Ministry of Finance.

* 2010 – estimated by the Economics and Research Division.

Israel's budgetary stability during the crisis is reflected in a comparison of the change in the debt-to-GDP ratio in Israel to the change in other countries, from 2007 (the year prior to the outbreak of the crisis) to the expected levels at the end of 2010. Whereas many countries experienced a sharp rise in debt, Israel showed almost no change. This has improved Israel's relative standing; however, the debt-to-GDP ratio in Israel remains high and is the main weakness of Israel's fiscal stability. The continued reduction of debt is essential in order to strengthen the stability of the economy and its ability to cope with global risks and with the geopolitical risks unique to Israel, as well as with the challenges facing the economy in the long term. It should be noted that Israel's geopolitical risks increase its risk premium, requiring a lower level of debt than in other developed countries. Another key benefit of debt reduction is lower interest expenses, which free budgetary resources for other activities of the government within the bounds of the existing budget.

Diagram 18. Debt to GDP ratio, 2007 and 2010

Percent



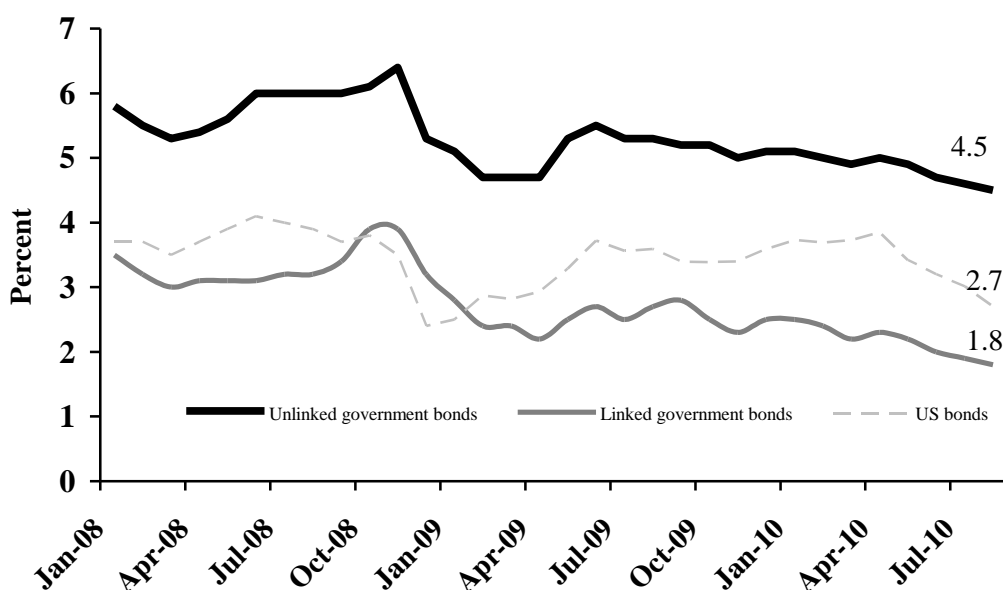
Source: OECD, June 2010. Israel –Ministry of Finance estimates.

- **Government bond yields and developments in Israel's risk premium**

In early 2009, at the height of the global financial crisis, the downward trend in ten-year government bond yields that began in late 2008 continued. During this decrease, yields of unlinked government bonds (“Shahar”) and linked government bonds (“Galil”) reached 4.7 percent and 2.2 percent, respectively. The decrease in yields resulted from the redirection of demand to safer assets (the “flight to quality”), due to the uncertainty in the financial markets and the pessimism regarding the direction taken by the local and global economy. Government bond yields rose during May and June 2009, due to the improvement in conditions in the markets and the increase in yields of government bonds globally, which resulted from an unprecedented volume of issues, especially in the United States. Yields began falling in July 2009, in a trend that continued in the first eight months of 2010. In August 2010, the yield of Shahar bonds was 4.5 percent, and the yield of Galil bonds, which serves as an indicator of the real interest rate, was 1.8 percent – a historical low.

Diagram 19. Ten-year government bond yields

January 2008 - August 2010



Source: Bank of Israel; US Department of Treasury.

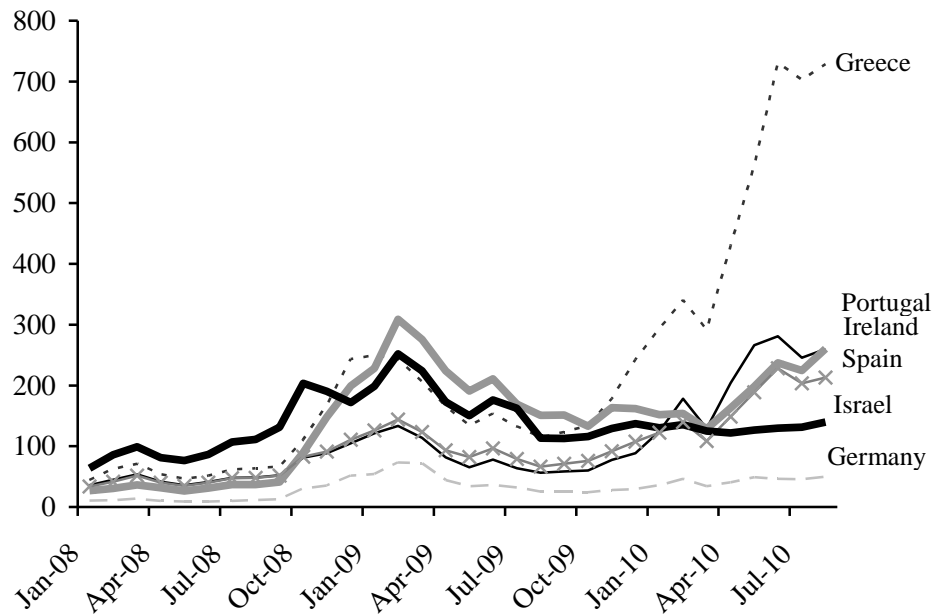
During 2009, CDS¹⁵ spreads narrowed in most countries, including Israel, reflecting expectations of the markets' recovery from the global financial crisis. In late 2009, as worries over the development of a debt crisis in Europe mounted, CDS spreads of the problematic countries (PIIGS¹⁶) began to rise sharply, expressing concerns over default by one or more of these countries (especially Greece). CDS of Israeli government bonds were not affected by the rise in CDS spreads of the PIIGS countries; the markets appeared to estimate that the probability of debt crisis "contagion" in Israel was very low.

¹⁵ CDS (credit default swap) transactions are agreements allowing the credit risk of a third party to be transferred from one party to another. These transactions essentially constitute the sale of insurance against bankruptcy. CDS spreads are customarily treated as an indication of the borrower's default risk.

¹⁶ Portugal, Iceland, Ireland, Greece, and Spain. For further details regarding the debt crisis in Europe, see Section 4.

Diagram 20. CDS spreads on ten-year government bonds

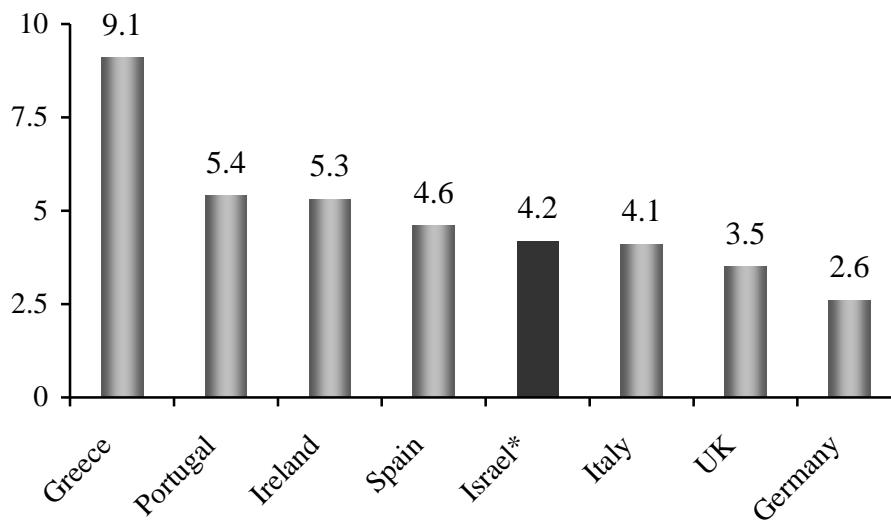
January 2008 - August 2010, monthly averages



Source: Bloomberg.

Diagram 21. Ten-year government bond yields, international comparison

June 2010 average



* Euro-linked bonds. Source: Bloomberg.

Deriving more detailed information regarding the relationship between CDS spreads of Israel and of the countries in the above chart requires a statistical analysis of correlation coefficients. The question is, which European countries are correlated with Israel during the period under review – which, as noted, includes the latter part of the financial crisis and the beginning of the European debt crisis. The following table shows a calculation of the correlations between CDS spreads in selected European countries and in Israel. The data indicate that during the period reviewed, the CDS spread on Israeli government bonds was strongly correlated with countries considered to be stable, i.e. Germany and the UK, and weakly correlated with the PIIGS countries (except Ireland).

Table 5. Correlation of CDS spreads in 2009 and H1 2010

	UK	Germany	Ireland	Italy	Spain	Portugal	Greece	Israel
UK	1							
Germany	0.94	1						
Ireland	0.85	0.87	1					
Italy	0.79	0.87	0.76	1				
Spain	0.41	0.54	0.42	0.85	1			
Portugal	0.25	0.43	0.24	0.75	0.97	1		
Greece	0.16	0.31	0.18	0.69	0.96	0.98	1	
Israel	0.89	0.82	0.87	0.54	0.09	-0.09	-0.18	1

Box II: The Fiscal Rule

The need to ensure a continued decrease in the ratio of debt to GDP in Israel, as well as the considerable decrease in public expenditures and in the tax burden in Israel, from a relatively high level at the beginning of the last decade to a level similar to the OECD average, prompted the government and the Knesset to approve a new fiscal rule. The new rule links the rate of increase of budgetary expenditures to the level of debt relative to the target and the long-term growth of the economy, in contrast to the previous rule, which established a limit on real expenditure growth regardless of the growth rate and the developments in the debt-to-GDP ratio. In addition, a deficit limit applies, as in the past. The increase in the budget is established according to the effective limit. Under the new rule, as the actual ratio of debt to GDP approaches the medium-term target of 60 percent, the permitted increase in expenditures will approach the long-term growth rate of the economy. Consequently, convergence with the debt target will allow an increase in the budget such as to significantly moderate the decrease in the weight of public expenditures within GDP, alongside further improvement of budgetary stability. It was further established that the budget deficit ceiling would continue to fall gradually, to 1.0 percent of GDP by 2014, as resolved in the budget for 2009-2010. Based on the rule, the permitted real increase in the budget for 2011 is limited to 2.6 percent, according to the following calculation:

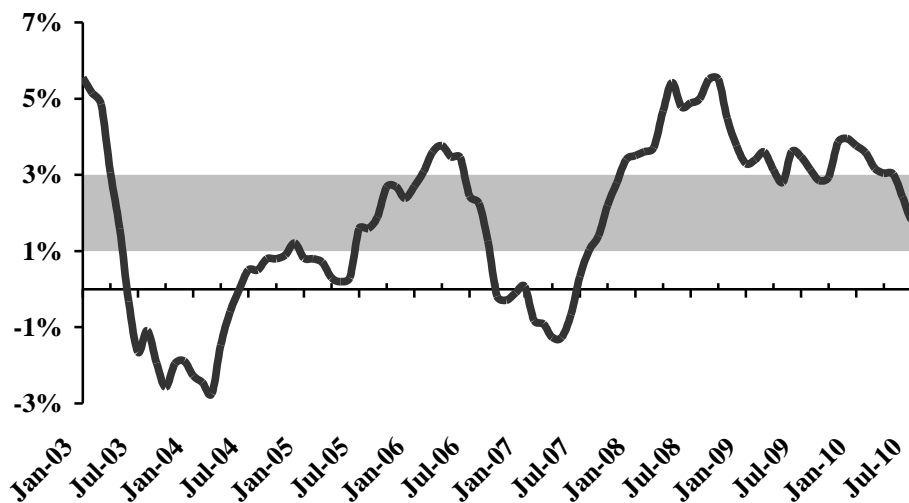
$$\frac{\text{Medium term debt to GDP ratio target}}{\text{Current debt to GDP ratio}} \times \text{Average growth rate in the last decade} = \frac{60\%}{80\%} \times 3.5\% = 2.6\%$$

F. Inflation and Monetary Policy

In 2009, the consumer price index rose by 3.9 percent (year end to year end). The increase in the CPI was influenced by a sharp rise in housing prices, as well as the nonrecurring effects of increases in indirect taxes such as VAT.

Diagram 22. Rate of inflation and inflation targets

2003 - August 2010



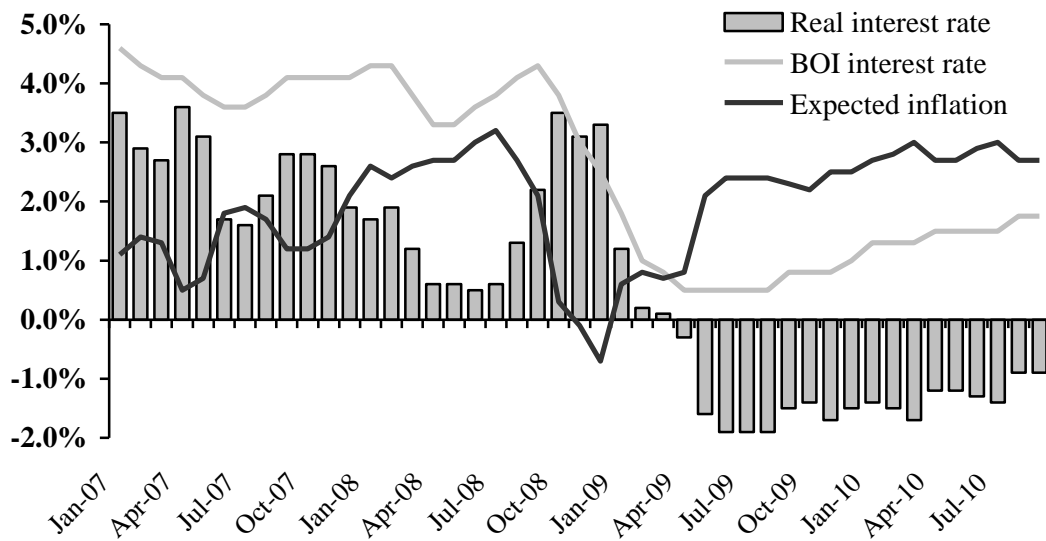
Source: Central Bureau of Statistics and Bank of Israel.

Monetary policy in 2009 was marked by an unprecedented expansion, similar to the monetary policies applied in the developed countries in response to the crisis. The Bank of Israel interest rate fell to a historical record low of 0.5 percent. The BOI also applied additional expansive measures, such as purchasing government bonds on the secondary market in order to reduce the long-term interest rate, and extensive purchasing of foreign currency in order to increase the bank's reserves (starting 2008 as well) and prevent significant appreciation of the shekel. In the second half of 2009, as the signs of rapid economic improvement strengthened, the Bank of Israel began to raise the interest rate gradually. Note that the current BOI interest rate of 1.75 percent (in August 2010) still represents a negative real interest rate, indicating monetary expansion, which may create upward pressure on prices over time. It is therefore likely that the continuation of the economic growth trend will lead to a continued policy of rising interest rates, towards a more neutral environment. The expansive

monetary policy implemented by the BOI brought the quantity of means of payment to a record level in November 2009. The rapid increase in the quantity of means of payment has halted in the last few months.

Diagram 23. Bank of Israel interest rate, inflation expectations, and real interest rate

2007 - August 2010



Source: Bank of Israel.

2. *Highlights of Forecasts for 2010, 2011, and 2012*¹⁷

Macro-economic developments in Israel are strongly influenced by worldwide growth rates and compositions, both positively and negatively, due to Israel's status as a small and open economy. This effect was reflected in the years of rapid growth prior to the crisis, during which global developments provided a tailwind for growth in Israel, and conversely during the recent crisis, when the Israeli economy was harmed by the steep decline in global demand. Thus far, the recovery of the global economy has been faster than was expected at the start of the crisis, as evidenced by the upward revision of global growth forecasts¹⁸. The forecasts presented in this section are based on the assumption that the rebound of the global economy will continue in the coming years, but growth rates in developed countries will be lower than in the years leading up to the crisis. At the same time, the level of uncertainty regarding the continuation and the extent of the global economic recovery is still high. The debt crisis in Europe serves as a reminder of the fragility of the global recovery. Thus a more negative scenario for the global economy, which would also affect developments in the Israeli economy, should be taken into consideration (for further details, see the section on developments in the global economy). Accordingly, we expect growth in Israel to recover in the next three years, but remain lower than the growth rates of 2004-2007.

- **Key Assumptions**

As noted above, the key assumption on which the macro-economic forecasts for 2010-2012 are based is that the global economic recovery that began in late 2009 will continue. This recovery is expected to be reflected in a relatively rapid increase in the volume of global trade. In addition, we assume that the American economy will grow at a rate of approximately 3 percent in 2010, and that the U.S GDP growth will slow in 2011-2012, in line with the forecasts by the International Monetary Fund.

Following the labor-market developments in the second half of 2009, we assume that the pace of the increase in the number of employed persons will be greater than the

¹⁷ These forecasts were prepared on May 13, 2010, based on the data available at that time. Data obtained recently provide similar indications. These forecasts were used in the construction of the budget.

¹⁸ Global growth forecasts by the International Monetary Fund from April 2010 are at 4.2 percent, one percentage point higher than the IMF's forecasts from October 2009.

growth rate of the working-age population, as a result of the closure of part of the output gap that formed during the crisis. As a consequence, the unemployment rate is expected to continue to fall gradually, with a moderate increase in the workforce participation rate. Concurrently, we expect a gradual increase in real wages per employee position.

Equity markets in Israel and globally continued to post strong gains in the early months of 2010, but stopped in the second quarter. We assume that capital-market indices will experience moderate gains during 2011 and 2012. A similar assumption applies to oil prices. Following the significant increase that has already occurred, we assume a slight additional rise later this year and relative stability in the following two years.

Forecast Highlights

The budget for 2011-2012 is based on a growth forecast of 3.6 percent in 2010, 3.8 percent in 2011, and 4.0 percent in 2012. This growth will be led by the business sector, with business GDP to rise by 4.5 percent in 2011-2011 and 4.7 percent in 2012. These forecasts reflect growth in all GDP components. In particular, significant growth in private consumption is expected in 2010, as well as significant growth in exports during the coming three years.

Exports of goods and services are expected to grow by 9.2 percent in 2010, 6.1 percent in 2011, and 7.5 percent in 2012, mainly as a result of the expected increase in the volume of global trade and GDP growth in the United States. The currency appreciation of the last few months is expected to somewhat temper the increase in exports.

Imports of goods and services are expected to grow by 7.9 percent in 2010, 4.0 percent in 2011, and 5.3 percent in 2012. The more significant increase in 2010 is influenced by factors including the increase in oil prices earlier this year as well as the capital-market gains, which reflect an increase in the public's wealth, and therefore in demand for consumer goods (some of which are imported).

Private consumption is expected to grow at a high rate of 4.5 percent in 2010, compensating somewhat for the growth rate of private consumption in 2009, which

was lower than the rate of population growth. The growth rate is expected to be more moderate in 2011 and 2012, at 3.0 percent and 3.2 percent, respectively. The increase in all three years will be influenced by a gradual rise in the number of employed persons and in real wages.

Fixed-asset investments will show no significant change (0.7 percent growth) in 2010, but are expected to expand by 1.8 percent in 2011 and 3.6 percent in 2012. The gradual increase predicted in the investments component over the three-year period is accounted for by the relationship between investments and the GDP. During slowdowns, surplus production capacity reduces the need for new investments, while during the emergence from a recession the need for investments is renewed. The investments item recovers later and less strongly relative to the overall recovery of GDP. In addition, this item is positively affected by increases in the capital market and negatively affected by the expected increases in the Bank of Israel interest rate.

Public consumption is expected to grow by 1.8 percent¹⁹ in 2010, 1.7 percent in 2011, and 1.8 percent in 2012. This increase is based on assumptions regarding the labor market.

Inflation

We estimate that inflation will not deviate from the target range within the next three years. Inflation is expected to reach 2.2 percent in 2010 (December 2010 versus December 2009) and 2.0 percent in 2011 and 2012. Average annual inflation is expected to remain within the target range set by the government.

Employment

We assume that the number of employed persons will grow at an annual rate of approximately 2.0 percent in 2010-2012. In addition, we expect the participation rate to stand at 56.8 percent in 2010, rising slightly in 2011 and 2012. As a result, the unemployment rate is expected to fall gradually, from 7.6 percent in 2009 to 6.3 percent in 2010, 6.0 percent in 2011, and 5.9 percent in 2012.

¹⁹ The public consumption items are different from the budgetary expenditure and therefore grow at different rates.

Table 6. Growth rate of real GDP and GDP components

2006-2010

	2006	2007	2008	2009	2010	2011	2012
	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast
Real growth rates (percent)							
Gross domestic product	5.7	5.3	4.2	0.8	3.6	3.8	4.0
Private consumption	4.3	6.3	3.0	1.7	4.5	3.0	3.2
Public consumption	3.1	3.1	2.6	2.5	1.8	1.7	1.8
Gross investment	7.3	11.3	2.4	-8.9	2.2	4.6	4.1
Of which: Fixed-asset investments	13.6	14.7	3.9	-5.8	0.7	1.8	3.6
Exports	5.9	9.3	5.9	-12.5	9.2	6.1	7.5
Exports of goods, excluding diamonds	12.0	11.8	10.6	-9.7	12.2	4.8	6.9
Exports of services	7.0	7.7	11.4	-11.9	10.7	6.4	7.6
Imports of goods and services	3.2	11.9	2.4	14.1-	7.9	4.0	5.3
Defense imports	11.8	-4.1	1.0	-22.8	8.8	8.8	8.8
Business GDP	7.0	5.9	4.7	0.1	4.5	4.5	4.7
GDP per capita	3.8	3.4	2.4	1.1-	1.9	2.1	2.3

Forecasts prepared on May 13, 2010.

Table 7. The consumer price index and the labor market

2005-2010

	2006	2007	2008	2009	2010	2011	2012
	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast
Consumer price index							
Index (2008=100)	95.1	95.6	100.0	103.3	105.8	107.9	110.0
Change (annual average vs. annual average)	2.1	0.5	4.6	3.3	2.4	2.0	2.2
Change (December vs. December, in percent)	-0.1	3.4	3.8	3.9	2.2	2.0	2.0
Wages							
Average wages in current prices	7,467	7,628	7,921	7,973	8,279	8,584	8,942
Annual change in current prices	3.4	2.2	3.8	0.7	4.0	3.7	4.0
Annual change in fixed prices	1.3	1.6	-0.7	-2.6	1.5	1.6	1.8
Employed Israelis							
Number of employed persons (thousands)	2,575	2,684	2,777	2,786	2,886	2,958	3,018
Annual change (percent)	3.2	4.3	3.4	0.3	3.6	2.5	2.0
Unemployed persons							
Unemployed persons (thousands)	236	212	182	230	192	187	190
Percent of workforce	8.4	7.3	6.1	7.6	6.3	6.0	5.9
Participation rate (percent)	55.6	56.3	56.5	56.6	56.8	57.0	57.1

Forecasts prepared on May 13, 2010.

Table 8. Real GDP and nominal GDP²⁰

2006-2010

	2006	2007	2008	2009	2010	2011	2012
	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast
GDP in fixed prices (2005 prices)	634.3	667.3	694.0	698.9	724.2	751.9	782.0
Rate of change in real GDP (percent)	5.3	5.2	4.0	0.7	3.6	3.8	4.0
GDP in current prices (NIS billions)	649.9	686.0	725.1	765.9	810.1	864.1	918.6
Rate of change in nominal GDP (percent)	7.9	5.6	5.7	5.6	5.8	6.7	6.3

Forecasts prepared on May 13, 2010.

²⁰ According to the most recent update by the Central Bureau of Statistics, GDP in 2009 totaled NIS 768.3 billion. Values for earlier years are current as of May 2010, when the forecasts were prepared; slight disparities therefore exist between Table 3 and the rest of this document, which presents more current data. The data in this table served as the basis for the preparation of the budget.

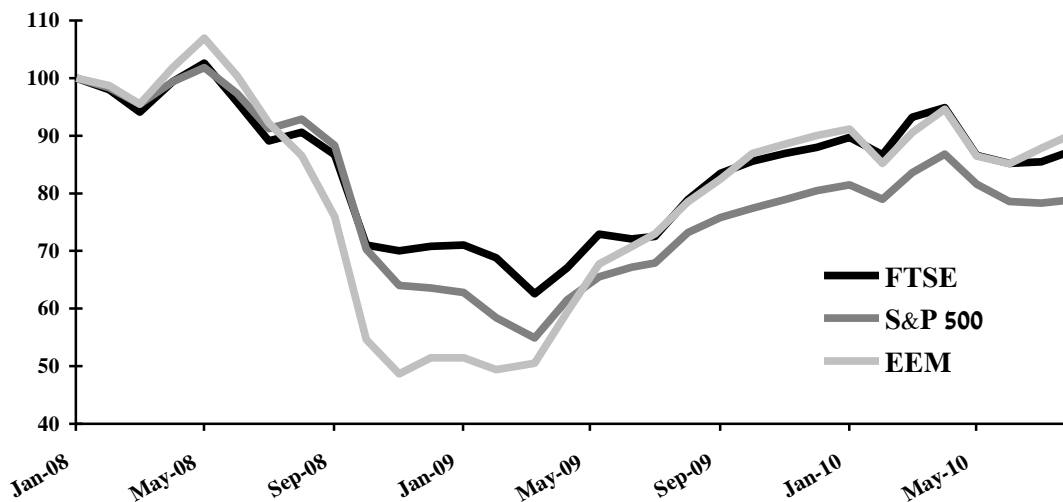
3. *Developments in the Global Economy and Threats to the Recovery*

Background

The global financial downturn escalated in late 2008, leading to the most severe crisis in the global economy since the 1930s. The crisis caused steep drops in the financial markets, GDP declines in many countries, a sharp fall in the volume of global trade, and serious damage to labor markets. An economic rebound began in the second quarter of 2009 and gained strength during the year. The recovery, which was based to a great extent on expansive fiscal and monetary policies, was reflected in an increase in GDP, sharp gains in the financial markets (see diagram below), and stabilization of the labor market. However, the steep increases of 2009 did not continue in the first half of 2010. Fiscal conditions worsened, especially in Europe, while the volume of public-sector support for real activity decreased. As a result, the pace of the recovery lessened and concerns over the economic developments of the coming years mounted.

Diagram 24. Notable global stock indices

2008-August 2010, January 2008=100



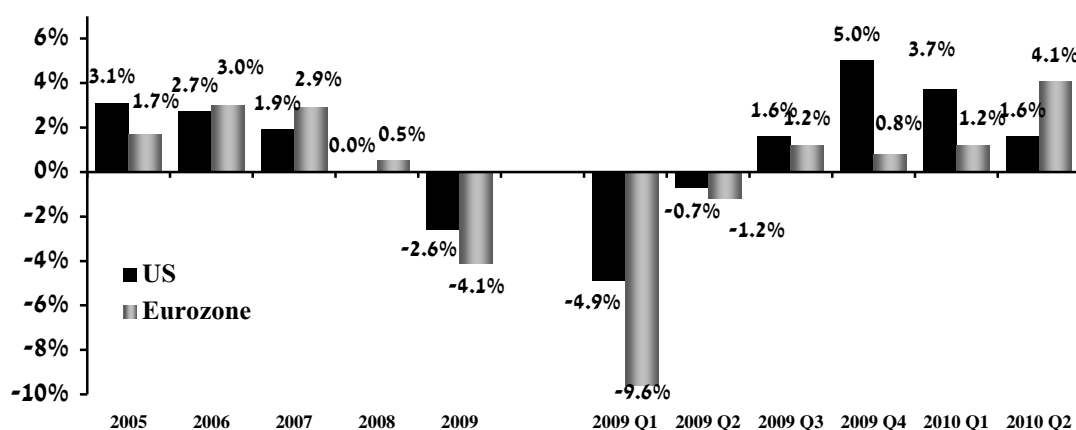
Source: Yahoo Finance.

Global Developments in 2009 and 1H 2010

Most of the developed economies experienced negative growth rates in 2009. However, growth improved substantially starting in the second quarter of 2009, as growth rates in developed economies were still negative but more moderate than in the preceding two quarters. In the third quarter, many developed economies, including the United States and the eurozone, showed positive growth rates (see diagram below). In the US, the growth rate in the fourth quarter of 2009 was the highest quarterly rate in about four years. The growth rate in the US slowed in the second quarter of 2010, whereas the leading European economies had high growth rates.

Diagram 25. GDP growth, US and eurozone

In percent, 2005-Q2 2010

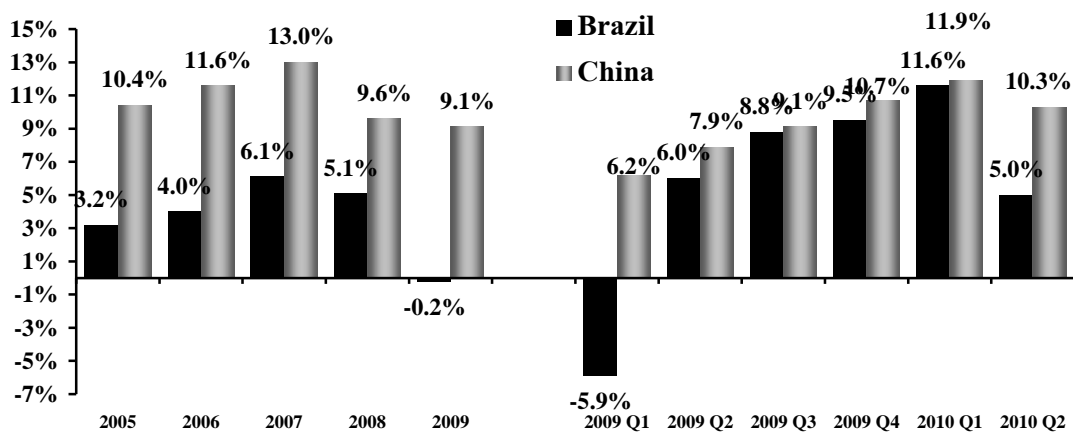


Source: BEA, Eurostat.

As positive GDP growth rates returned to the developed countries over recent quarters, the emerging economies experienced steep improvement. These markets, which include China, Brazil, Russia, and India, had already returned to high growth in the second quarter of 2009. The rapid rebound in these countries played an important role in the recovery of the global economy.

Diagram 26. GDP growth in China²¹ and Brazil

In percent, 2003-2009



Source: NBSC, IBGE, The Economist.

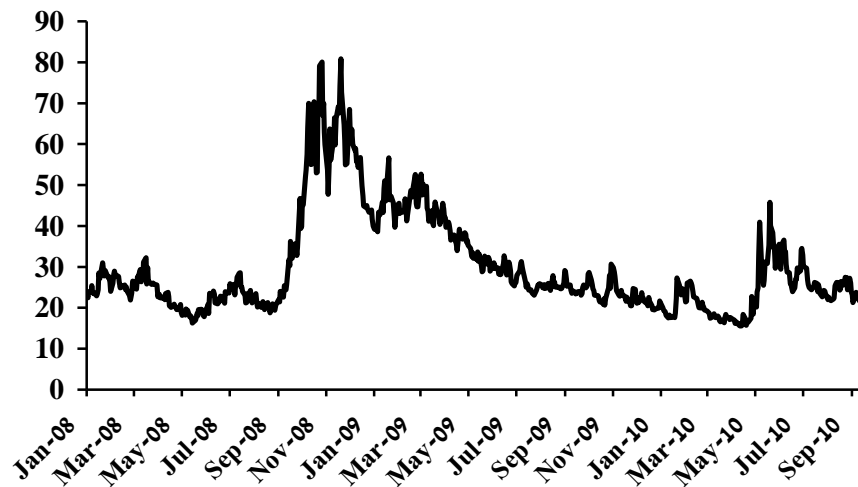
Another important development occurred in the financial sector: following many months of grave worries over this sector’s stability, positive signs have emerged since the second quarter of 2009 and these concerns have lessened sharply. The stabilization of the financial sector largely relied on public bailouts on an unprecedented scale, mainly in the United States and Europe. An expression of the decrease in concerns over the stability of the financial sector can be found in the VIX index²², also known as the “fear index.” This index, which reached about 80 points at the apex of the crisis, fell to approximately 20 points in the second half of 2009, similar to the level prior to the escalation of the economic crisis in September 2008. Risk indices in the financial sector worsened somewhat during 2010, due to the fiscal developments in Europe in the second quarter (see details below).

²¹ Quarterly national accounting data in China are calculated in comparison to the same quarter in the preceding year.

²² The index reflects investors’ expectations regarding the degree of volatility of the S&P 500 index in the next 30 days, as expressed in options trading. An increase in this index indicates an increase in the risk level in the markets.

Diagram 27. VIX index

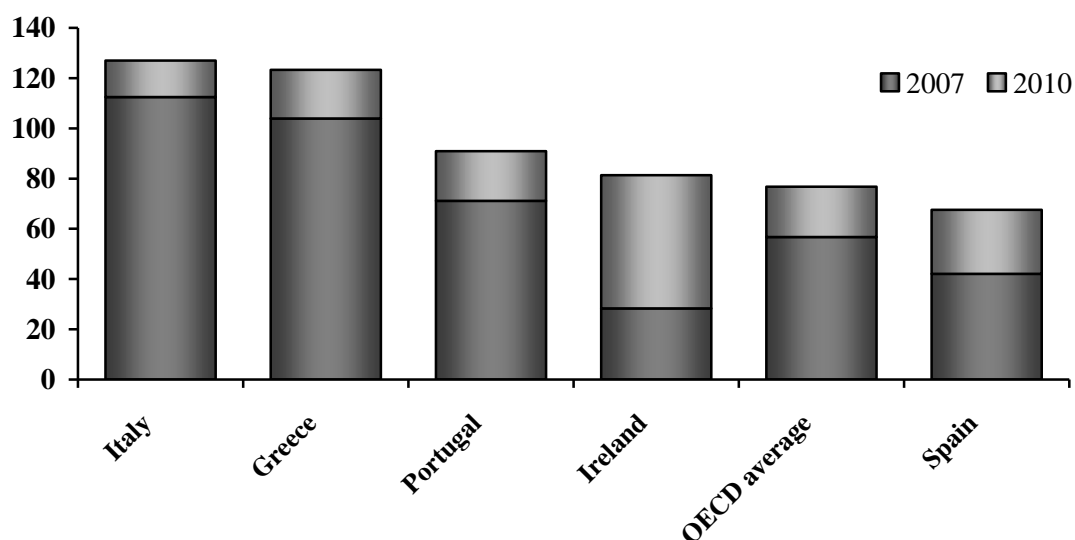
January 2008 - September 2010



Source: Yahoo Finance.

The European public-debt sector experienced a severe downturn in late April 2010. S&P downgraded its ratings of Greece, Spain, and Portugal (three of the PIIGS countries, which are considered to be the problematic European economies, with Italy and Ireland), leading to a steep increase in investors' nervousness and a significant risk of insolvency in Greece, and to a lesser extent in Spain and Portugal. This scenario could potentially have caused "contagion" in other countries experiencing serious fiscal problems and severe damage to the financial sector in Europe. The European Union, in collaboration with the International Monetary Fund, therefore found it necessary to announce two aid programs for countries in fiscal difficulties, at an unprecedented aggregate volume of EUR 890 billion. Meanwhile, the European Central Bank announced additional support measures. In addition, many European countries, including Greece, Spain, Portugal, the UK, and Germany, declared budget cuts and tax hikes aimed at coping with their large public debts.

Diagram 28. Public debt in PIIGS countries in 2007 and 2010, in percent of GDP



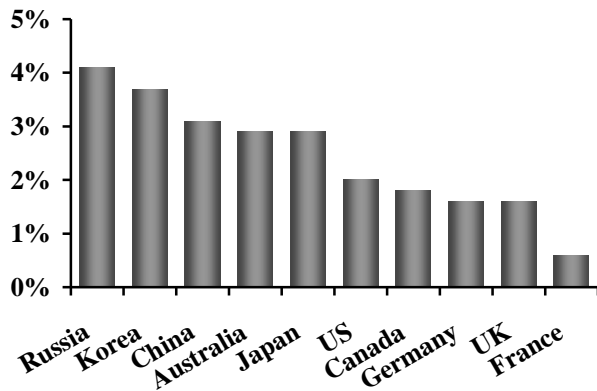
Source: OECD.

The policy measures applied in recent months led to some degree of calm in the markets, but the risk attributed to public debts in Europe remained high; in some of the countries, risk indices continued to rise in the last few months (see Diagram 20). The high risk still attributed to European public debts stems from factors including the fact that despite the unprecedented scale of the aid packages, they do not necessarily address the continued existence of structural problems in some EU countries. There are also concerns over the ability of the struggling states to apply policies that will lead to the reduction of deficit and debt rates to sustainable levels in the coming years.

The Key to Recovery in 2009-2010: Fiscal and Monetary Policy

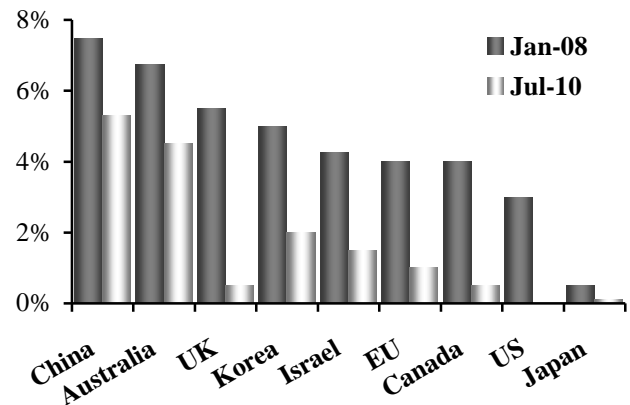
The improvement in the rate of GDP growth, as well as in other key indices, starting in the second quarter of 2009 resulted to a considerable extent from the unprecedented scale and creativity of policy measures in the areas of both fiscal and monetary policy. Governments applied aggressive fiscal expansion and granted large-scale sectoral aid, especially to the financial sector, while cutting taxes. In the area of monetary policy, central banks lowered interest rates sharply, alongside other policy tools such as purchases of government bonds. A decrease in public-sector support for real economic activity during the recent period was one of the main causes of the lower growth rates seen in 2010.

Diagram 29. Volume of stimulus packages in 2009 in percent of GDP



Source: IMF, OECD

Diagram 30: Central bank interest rates

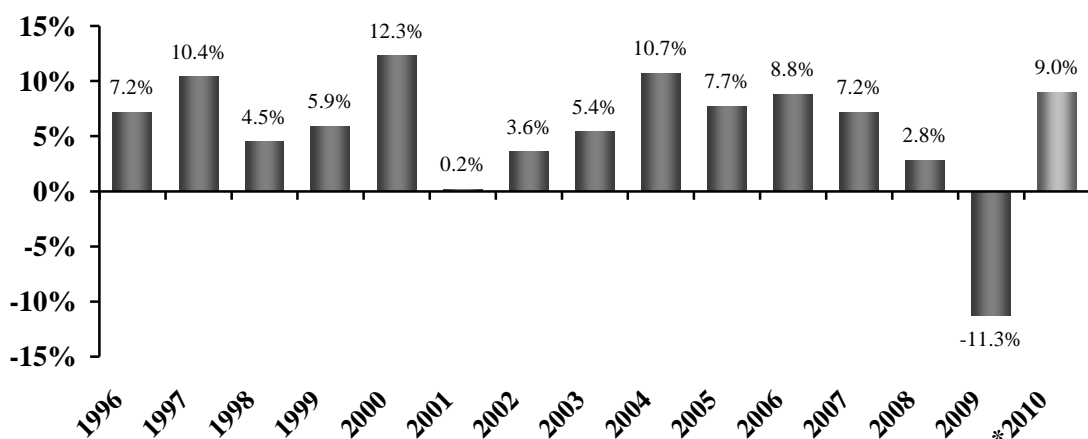


Source: FXstreet.com.

Volume of World Trade

The global economic crisis led to a significant slowdown in the volume of global trade in 2008, and a sharp decline in 2009 (see diagram below). However, the improvement in the global economy in the latter quarters of 2009 caused IMF economists to estimate that the volume of world trade would rise again in 2010.

Diagram 31. Volume of international trade
Rates of change, 1996-2010



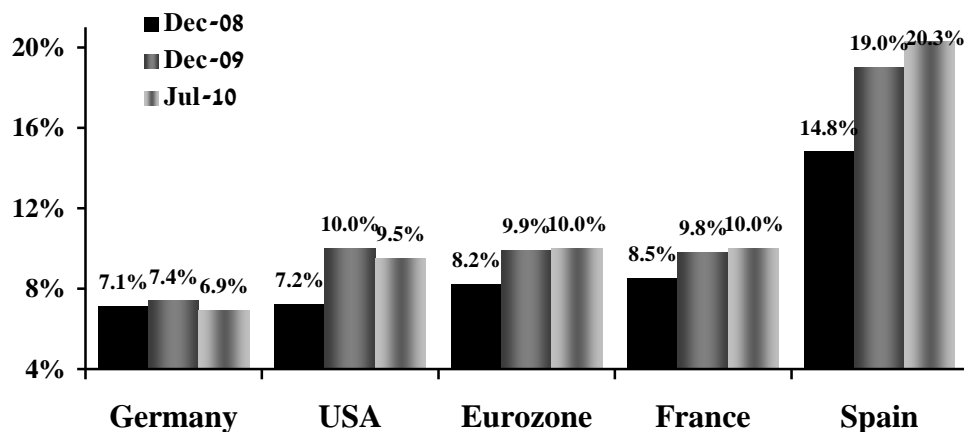
Source: International Monetary Fund.

* Estimated.

Labor Market Developments

Despite the improvement in the final quarters of 2009, the effects of the global economic crisis are still apparent in many areas. For example, the labor market, which exhibits a delayed reaction to economic developments, experienced high unemployment rates at the end of July 2010 (see diagram below).

Diagram 32. Unemployment rates in selected countries



Source: Eurostat.

Threats to the Global Economic Recovery

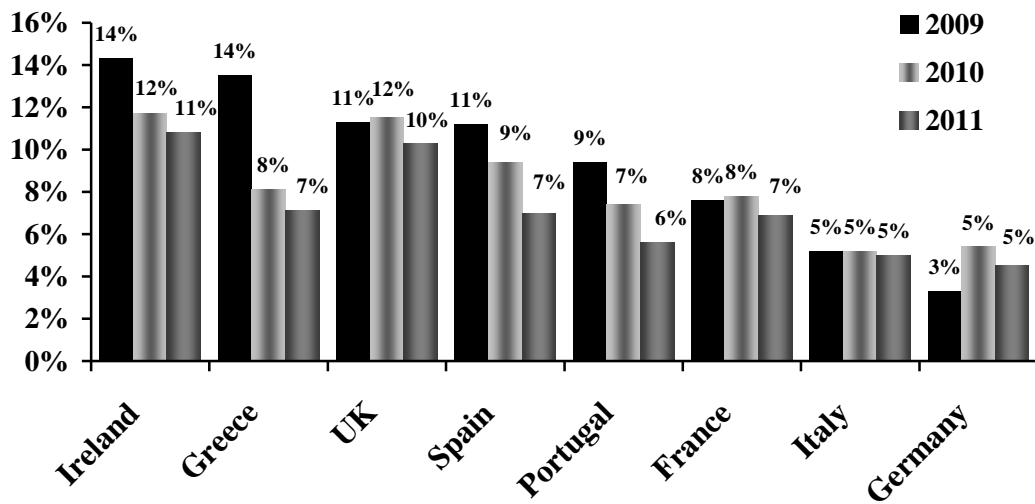
Although a rebound has occurred in the last few months, there are still threats to the global economic system. As a small, open economy, Israel will be influenced by the developments in the world economy. Challenges confronting the global economy in the coming years are likely to slow growth and significantly amplify uncertainty. The key risks to the economic recovery are detailed below.

- **Risk of insolvency of states**

Worries over the fiscal stability of several countries, including Greece, Spain, and Portugal, mounted during the second quarter of 2010. Despite the announcement of aid packages and the fiscal restraint measures being applied in many countries, several states are still at genuine risk of insolvency, due to the rates of public debt and deficits expected in the coming few years (see diagram below). Insolvency of the public sector in a developed country could have substantial negative implications for the global economy.

Diagram 33. Broad government deficit in selected European countries, 2009-2011

In percent of GDP



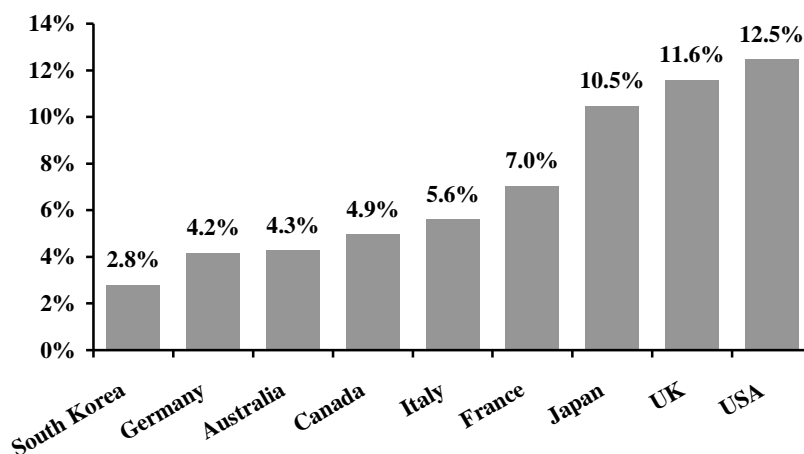
Source: OECD.

- **Reduction of supportive public policies**

The economic recovery of the last few quarters stemmed to a great extent from the sharp increase in public expenditures and from fiscal deficits, which led to an increase in public debt. The high levels of debt will obligate many countries to apply restraining fiscal policies, which will involve the termination of the stimulus packages, reduction of public spending, and increased taxes. These policies will lower demand and impede growth in these countries in the coming few years.

Diagram 34. Broad government deficit in 2009, international comparison

In percent of GDP



Source: IMF.

In addition, since the escalation of the global economic crisis in late 2008, central banks around the world have applied highly expansive monetary policies. Thus, interest rates are now at historical lows; additional policy measures unprecedented in nature and scale are also being applied. This has left limited maneuvering space for monetary policies. Moreover, the anticipated increase in interest rates in the coming years (in order to prevent inflationary pressures and the development of price bubbles) will serve to moderate the effect of many of the existing stimulus measures within monetary policy.

- **Concerns over the financial system**

In recent years, the financial sector was a key growth driver for many economies, especially for developed countries, contributing to the development of price bubbles. It is now clear that comparable growth rates will not be seen in the financial sector in the next few years, due to more conservative positions of the financial organizations, the damage to the public's confidence in the financial sector following the crisis, and undiscovered toxic assets still remaining within the system. According to IMF estimates, the volume of toxic assets not yet written off of banks' balance sheets is USD 0.8 trillion. Regulatory reforms leading to tighter supervision of the activity of the financial sector may also reduce growth rates. The slowdown in the financial sector and the move to more conservative policies are likely to reduce the supply of credit. These developments, which may be essential to the improvement of stability, can also limit the growth potential of the developed economies. Finally, insolvency of one of the PIIGS countries could have significant negative implications for the financial system in Europe.

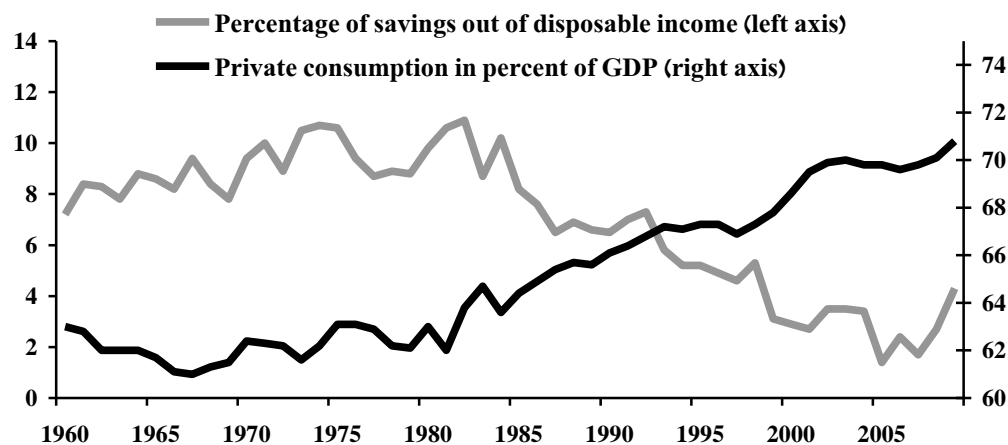
- **Imbalance in the global economic system**

As in other Western countries, the American economy has seen the formation of liquidity surpluses in recent years, due to a deficit in the balance of payments (financed, among other means, by cheap Chinese credit supported by the fixed low exchange rate of the yuan), in addition to expansive monetary policies. The liquidity surpluses and cheap credit encouraged increasing leveraging of economic activity (including in the real-estate sector), causing a large volume of debts, while also strengthening the incentive to develop complex financial instruments generating high

returns. These countries accumulated debts to lender countries such as China, Japan, and Germany, which rely on exports, and to countries reliant on exports of raw materials, such as the Gulf states and Russia. In order to balance the global system, it will be necessary to increase savings and reduce imports and consumption in many of the developed countries, including the United States, and to increase domestic demand in economies such as China, Japan, and Germany. This is not a simple process, for economic and cultural reasons, and may cause a slowdown in the global economy, at least initially.

Diagram 35. Private savings and consumption in the US

In percent, 1960-2009



Source: BEA.

- **Risk of protective policies**

The economic crisis could heighten the tendency towards protectionist policies, in which local industries are supported and protective customs tariffs or various non-customs restrictions are applied. Such protective policies, if they are implemented in numerous countries, will lead to a reduction of the volume of international trade and lower global growth rates. A similar dynamic impaired international trade during the Great Depression of the 1930s, exacerbating the crisis.

- **Long-term damage to the labor market**

The economic crisis led to a significant increase in unemployment rates in the world economy. This damage to the labor market is expected to have an impact in the

medium term (the labor market shows a delayed reaction to real developments), mainly on private consumption. In addition, if the unemployment is prolonged, there are likely to be long-term effects on the rate of growth (a ratchet effect, in which people who are unemployed for a long period lose job skills and may not succeed in returning to work).

- **The end of inventory renewals**

One of the reasons for the recovery in the GDP growth rate during the last quarters of 2009 was the process of inventory replenishment. In the period leading into the crisis, many firms reduced purchases, causing a decrease in their inventories. At a certain point, this created a need to increase purchasing in order to replenish depleted inventories. This growth driver is expected to have only a secondary impact in 2010.

4. *Financing the Deficit*²³

The deficit in the state budget is mostly financed through capital raising in the local market. A smaller share of the deficit is financed in foreign markets and through the privatization of government assets.

Financing of the budget deficit through capital raising focused on the local market may push business entities out of the market and raise long-term interest rates, causing damage to the volume of investments and to growth rates. Reducing the government's financing needs facilitates credit financing by the business sector.

Trends in 1995-2004

In the period from 1995 to 2004, the deficit was primarily financed through the issuance of bonds in the domestic market. Following the pension-fund reform, the rate of funding through nontradable ("designated") bonds fell sharply. During this decade, the government issued bonds in foreign markets for the first time, in the United States, Europe, and Japan. The funding in the US during 2002-2004 was largely based on the second guarantee plan provided by the US government.

Trends in 2005-2007

From 2005 to 2007, two parallel processes took place: the proportion of privatization revenues in deficit financing increased, and the volume of the budget deficit as a percentage of GDP decreased. In 2005, the deficit stood at approximately 1.6 percent of GDP; in 2006 it was 1 percent, and in 2007 the budget was balanced. Due to the smaller financing needs, it was not necessary to issue bonds backed by US government guarantees, and foreign-currency loans were based on independent offerings in the Euro and Global markets and on issuance by the State of Israel Bonds organization²⁴. Most of the offerings of domestic debt were based on the tradable market.

²³ This section was prepared by the Debt Management Unit of the Accountant General Division.

²⁴ In 2005, an independent offering of EUR 750 million was performed on the Euro market. In 2006, an independent offering of USD 1 billion was performed on the Global market. No independent offerings were performed overseas during 2007.

Trends in 2008-2010 and Forecast for 2011-2012

From 2008 to late 2009, Israel was influenced by the global crisis. The main effect of the crisis was a reduction in tax revenue, which obliged the government to perform relatively large-scale funding. The deficit in 2008 and 2009 was 2.1 percent and 5.15 percent of GDP respectively, primarily financed by tradable funding in the domestic market. Despite the financing needs and the global crisis, the government chose not to use US government guarantees to back bond offerings; foreign-currency loans were based on independent issuance in the Euro and Global markets and on issues by the State of Israel Bonds organization²⁵. In 2010, the world began to emerge from the crisis, and tax revenues were higher than expected as a result. In addition to funding in the domestic market and foreign-currency loans²⁶, part of the deficit in 2010 was financed through the privatization of Discount Bank.

Assuming that the financial crisis does not resume, the trends described above are expected to continue in 2011 and 2012: financing needs are expected to be similar, financing will be based mostly on the domestic tradable market, and foreign-currency funding will be based on independent offerings in foreign markets.

²⁵ No independent offerings were performed overseas during 2008. In 2009, an independent offering of USD 1.5 billion was performed on the Global market.

²⁶ An independent offering of EUR 1.5 billion was performed on the Euro market in 2010.

5. *Capital Market Policy*²⁷

The rapid recovery displayed by the Israeli capital market in 2009 and early 2010 was a key element of the Israeli economy's relatively strong ability to cope with the global economic crisis. The recovery took the form of an increase in the market value of stock indices, reduction of spreads in the corporate bond market, an increase in the volume of trade on the secondary market to pre-crisis levels, and an increase in the number and volume of capital and bond offerings.

Beyond the sense of stability restored to the various economic players, the capital-market recovery helped the business sector raise financing sources and boosted the expansion of economic activity. For example, although the volume of activity in the primary market did not return to the level seen in 2007, the change in trend was reflected in a 73% increase in the volume of bond offerings in 2009 relative to 2008, and an additional 8% increase in the first half of 2010 as compared to the same period last year. Furthermore, access to the capital market improved for a large number of companies representing diverse activity and risk characteristics.

In the credit sector, the recovery in the non-bank credit market reduced the volume and proportion of bank credit in financing the activity of the business sector, to the level typical of the Israeli economy during the period preceding the crisis. This process allows for a more balanced distribution of business credit and greater diversification of credit risk in the economy. Another characteristic of the non-bank credit market recovery is the increase in the share of mutual funds in this market. While the volume of institutional entities' corporate bond holdings grew by 17% from December 2008 to May 2010, mutual funds' corporate bond holdings increased by 184%. This development reflects the partial recovery of the non-bank credit market, as institutional entities (provident funds, pension funds, and insurance companies) have not yet returned to their past levels of activity in the non-bank credit market.

The volatility in the capital markets, the weakness of the financial sector during the crisis, and the high importance of the capital markets for the proper functioning of the global economy led governments, regulators, economists, and international financial

²⁷ This section was prepared by the Capital Market, Insurance and Savings Division.

organizations such as the World Bank and the IMF to reexamine the necessary regulation and supervision of the capital markets and financial entities. The initial results of this examination include changes in supervision and regulation structures in various countries, and the expansion of the authority of regulators into new areas of activity. This policy underlines the awareness that the complexity of the capital markets and their impact on the real markets necessitate a broad, systemic view of the financial markets, as well as wider supervision and regulation of these markets.

As part of the lessons learned from the crisis, and the understanding of the importance of the congruence of local regulation with global regulation, the ordering of the insurance market in Israel has continued, in line with the process underway in the global insurance markets. Thus, along with the adoption of the Basel II guidelines by the banking system, insurance companies in Israel continue to prepare for the adoption of the Solvency II guidelines, on a schedule similar to the timeline for the adoption of these guidelines in Europe. In particular, Pillar I of these guidelines reinforces the capital structure and base of Israeli insurance companies. Concurrently, guidelines have been established, based on the conclusions of the Hodek Committee, for the management of corporate bond portfolios by institutional entities, which administer NIS 800 billion in pension savings. The guidelines are designed to formalize information gathering, analysis, and investment processes regarding corporate bonds, which comprise a growing share of the pension savings portfolio, parallel to the rapid expansion of the non-bank credit market.

The increased regulation of world capital markets and the reinforcement of the capital structure of financial institutions are aimed at reducing uncertainty in the capital markets in the long term and enabling the global economy to return to rapid growth. However, the high costs of rescuing the global economy from the financial crisis, the persisting weakness of the financial sector in the United States and Europe, and the uncertainty regarding the debt repayment capability of several European governments are burdens weighing down the global economy. These worries regarding the global economic recovery have spawned similar concerns regarding the rate of recovery of the Israeli economy, which is export-oriented, and consequently of the capital markets as well.