

MINISTRY OF FINANCE

**REVIEW OF ECONOMIC DEVELOPMENTS,
MACROECONOMIC FORECASTS
AND HIGHLIGHTS OF THE ECONOMIC POLICY**

APPENDIX TO THE 2008 NATIONAL BUDGET

Jerusalem
October 2007

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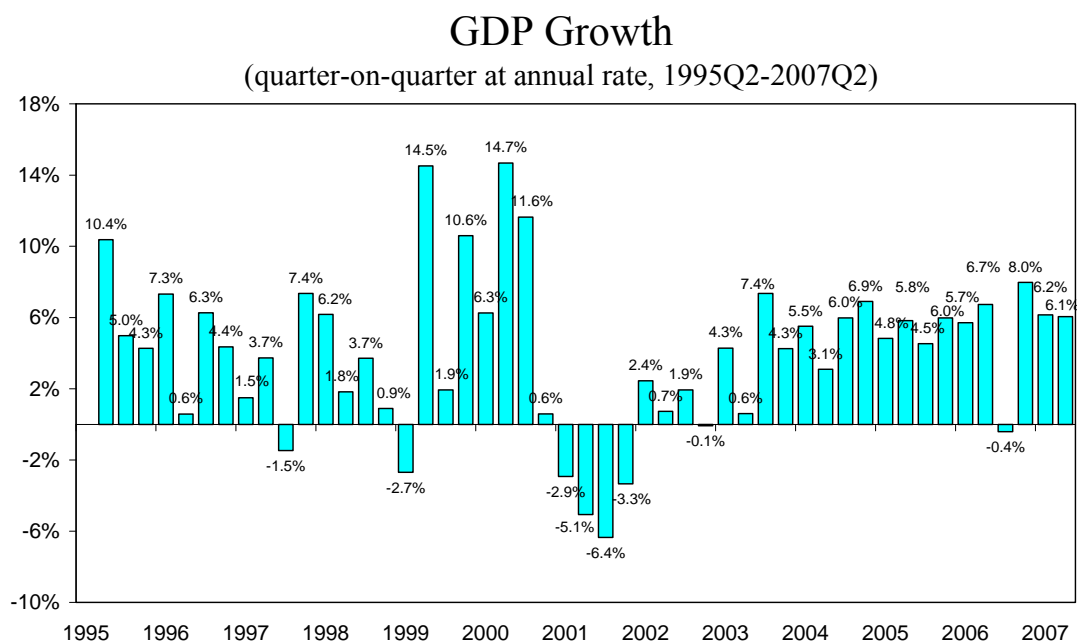
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A. Economic developments and macroeconomic forecasts¹

1. Economic developments in the first half of 2007

a. GDP and business sector GDP

The Israeli economy expanded rapidly during the first half of 2007 concurrent with a significant growth in all GDP components. In the absence of any extreme and unexpected adverse developments in the second half of 2007, this will be the fourth consecutive year in which GDP will have increased by over 5%. The growth was accompanied by an improvement in the balance-of-payments current account, a rise in employment, a decrease in unemployment and a large amount of foreign investment.



The annualized GDP growth rate in the first half of 2007 amounted to 5.1% (compared with the first half of 2006 according to original data²). The business sector GDP growth rate compared with the first half of 2006 was higher, and amounted to 5.6%.

¹ The economic analysis and the forecasts are based on information published up to September 19 2007.

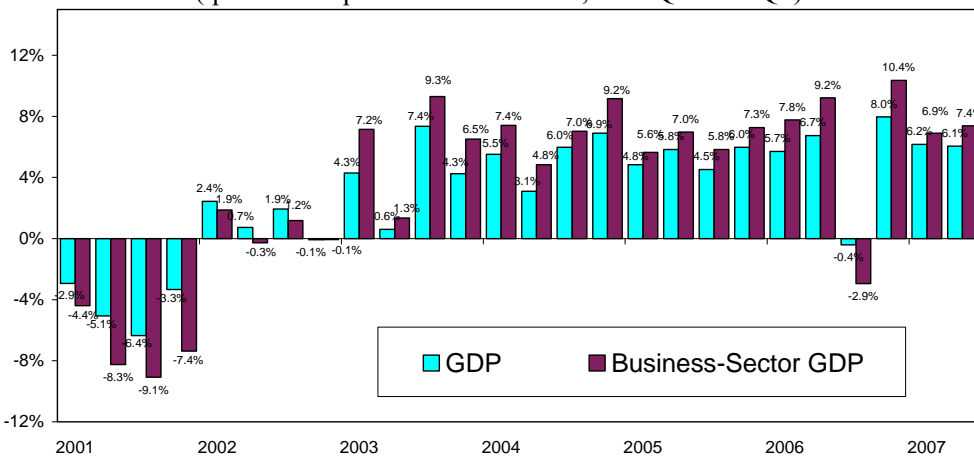
² Most of the comparisons in this part are real changes in the first half of 2007 compared with the first half of 2006 according to original data. Also presented in certain cases are annualized changes in the first half of 2007 compared with the second half of 2006 according to seasonally-adjusted data. The first half of 2007 is compared with the first half of 2006 because data for the second half of 2006 were heavily affected by the Second Lebanon War. As a result, a comparison with that half could be misleading.

Compared with the second half of 2006, GDP expanded by 6.6% (annualized, according to seasonally-adjusted data).

Per capita GDP in the first half of 2007 rose by 3.3% compared with the first half of 2006, similar to the rate of increase recorded in previous years.

The rapid growth trend that began in the second half of 2003 after the severe recession that began at the end of 2000 was thereby maintained. Growth during those years was accompanied by a significant change in the composition of GDP, which was reflected by an increase in the proportion of business sector GDP and a decrease in the proportion of government services, indicating a more rapid expansion in the business sector than in the economy as whole.

Growth of the GDP & the Business-Sector GDP
(quarter-on-quarter at annual rate, 2001Q1-2007Q2)



b. Private consumption

Private consumption grew by 6.2% during the first half of 2007, implying a per capita increase of 4.6%. The growth in private consumption resulted from the rebound in the economy, the increase in real wages³, the continued policy of reducing tax rates, and from an increase in the value of the public's asset portfolio⁴. Expenditure on private consumption reflected a large 22.8% increase in spending on consumer durables, principally purchases of private vehicles and electrical goods. This increase resulted from the strengthening of the NIS (new Israeli shekel) and the reduction of taxes on private vehicles at the beginning of January⁵ as well as from the downward reclassification of vehicle groups

³ 3.5% in the first five months of 2007 compared with the same period of 2006 (3.9% in the business sector and 2.5% in the public sector).

⁴ The public's asset portfolio expanded by 10.2% in the first half of the year.

⁵ Purchase tax on private vehicles was cut from 89% to 84% at the beginning of January.

by value (according to purchase price) in the beginning of 2007, which led to a considerable decrease in the prices of new vehicles to the consumer and to institutional customers.

c. Public consumption

Public consumption rose by 4.9% during the period reviewed, reflecting a 4.5% increase in civilian consumption and a 5.1% growth in defense consumption. The growth in defense consumption was apparent from defense imports (6.2%) and from local defense consumption (5.3%, with procurement rising by 9.9% and labor costs by 0.9%).

d. The budget deficit

The government accrued a budget surplus of NIS 7.6 billion (excluding credit extensions) during the first eight months of the year compared with NIS 5.7 billion in the same period of 2006.

Government expenditure totaled NIS 116.1 billion during the first eight months of the year compared with NIS 108.7 billion in the same period of 2006, a nominal increase of 6.8%, which was similar to the nominal increase planned in the ministerial expenditure budget in 2007 compared with 2006.

Tax revenue totaled NIS 130.1 billion in this period or 72.5% of the revenue forecast for the year in the original national budget. This was an increase of 6.5% compared with 2006 when tax revenue in the first eight months totaled NIS 122.2 billion. The growth in tax receipts derived from the expansion in business activity, the increase in wages, the growth in consumption, and from higher earnings in the capital markets during the first half of the year.

The forecast deficit for this year is 0.5% of GDP, similar to the budget deficit for 2006 (0.9% of GDP). The forecast deficit mainly reflects the impact of high growth rates that have been accompanied by a large rise in government revenue in excess of the planned increase in the original budget. However, the growth in government activity was almost the same as originally planned.

The deficit ceiling in the 2008 budget is 1.6% of GDP.

e. Investment

Concurrently, gross investment expanded by 9.3% and investment in fixed assets⁶ rose by 11.4% – investment in imported motor vehicles was up by 27.5% and investment in intangible assets increased by 29.5%. Residential construction investment rose by 2.9%, while investment in non-housing-construction fixed assets increased by 14.2%. The increased investment in fixed assets is indicative of sustained growth and an expansion in the economy's production capacity. This trend began in 2006 and differed from that in 2004 and 2005 when higher output mainly resulted from the increased utilization of existing factors of production. The growth in investment reflects *inter alia* the success of the policy

⁶ The difference reflects a lower growth in inventories.

of reducing the government's share in economic activity and the decrease in the government's domestic borrowing requirements, which has freed resources for increasing the business sector's share in investment.

f. Foreign investment

Foreign investment (direct investment in Israeli enterprises, portfolio investment, and other investment) totaled \$10.6 billion annualized during the first eight months of 2007, of which \$9.0 billion consisted of direct investment.

g. Exports

Exports rose by 6.3% during the first half of 2007. Exports of goods increased by 8.8%⁷ and exports of services remained almost unchanged, rising by 0.5%. One of the reasons for the small increase in service exports was the 20.4% decrease in tourism exports, although an annualized increase of 74% was recorded in comparison with the second half of 2006. The differences resulted from the Second Lebanon War, which severely affected tourism during the second half of 2006. Export of services excluding tourism rose by 3.5%. Agricultural exports were up by 16.9%. Contributing to the export growth was the global growth trend, as apparent from the expansion in world trade and the volume of activity in the high-tech industries worldwide.

Exports of goods (in dollar terms, excluding ships, planes and diamonds) during the first seven months of 2007 compared with the same period of 2006 rose by 12.1% to the Euro area, 5.3% to the USA and 19.6% to other countries.

h. Imports

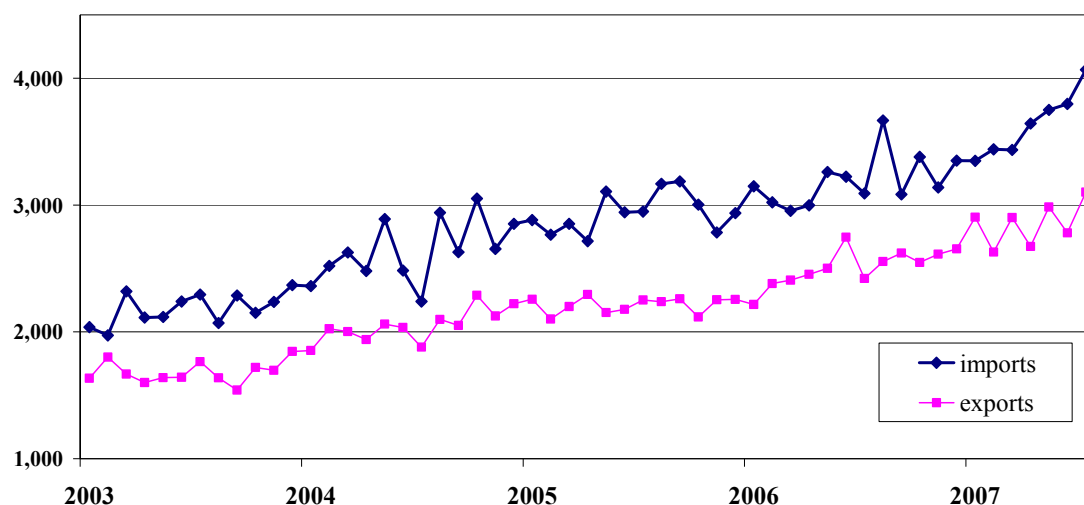
Imports expanded by 9.4% in the first half of 2007 (Imports of goods excluding defense imports, ships, planes, fuel and diamonds rose by 6.9%). The import growth derived from increases of 8.0% in imports of goods⁸ and 14.4% in service imports.

⁷ Industrial exports excluding diamonds rose by 8.4%.

⁸ Including 6.5% in imports of civilian goods excluding diamonds.

Exports and Imports of Goods

(US\$ millions per month, excl. diamonds, ships & airplanes)



Imports of goods (in dollar terms, excluding diamonds, ships and planes) during the first seven months of 2007 compared with the same period of 2006 rose by 10.8% from the Euro area, 24.3% from the USA and 17.2% from other countries.

Dollar imports of consumer goods increased by 25.8% during the first seven months of 2007 compared with the same period of 2006, while dollar imports of capital goods and raw materials increased by 17.6%. This increase is indicative of the business sector's expectations of continued growth during the coming months.

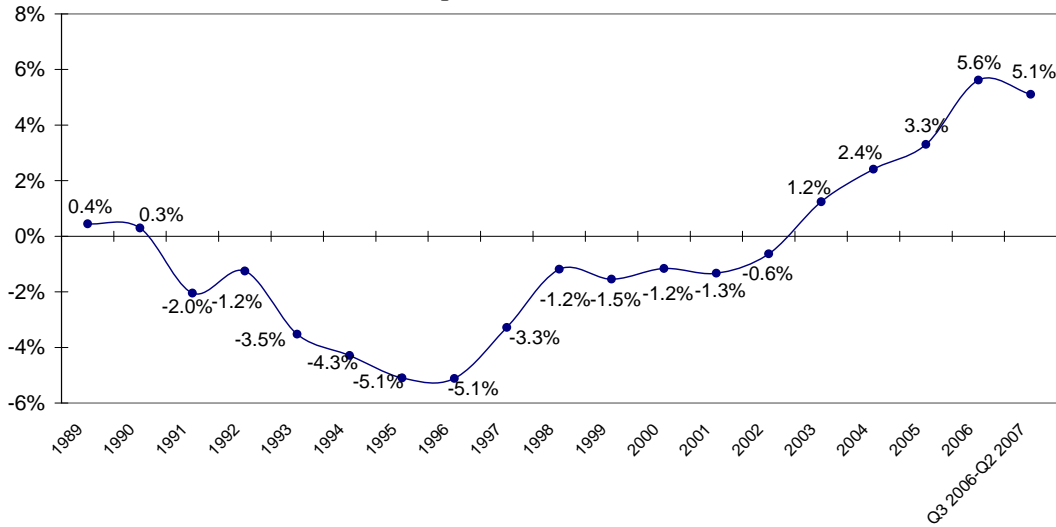
i. The balance of payments

The rapid growth in imports, which exceeded the export growth rate, led to a decrease in the balance-of-payments current account surplus during the first half of 2007. A surplus of \$3.7 billion was recorded in the current account during the first half of 2007, 4.4% less than in the same period of 2006. In GDP percentage terms, the decrease was from 5.6% in 2006 to 5.1%⁹ in 2007. This resulted from the appreciation of the NIS against the dollar and the growth in GDP.

The finance account is a mirror image of the current account, and is comprised of foreign residents' investments in the Israeli economy minus Israeli residents' investments abroad. Foreign investment in the Israeli economy totaled \$7.8 billion in the first half of 2007. During this period however, Israeli residents' investments abroad reached \$10.8 billion.

⁹ The calculation is based on the year ending in the second quarter.

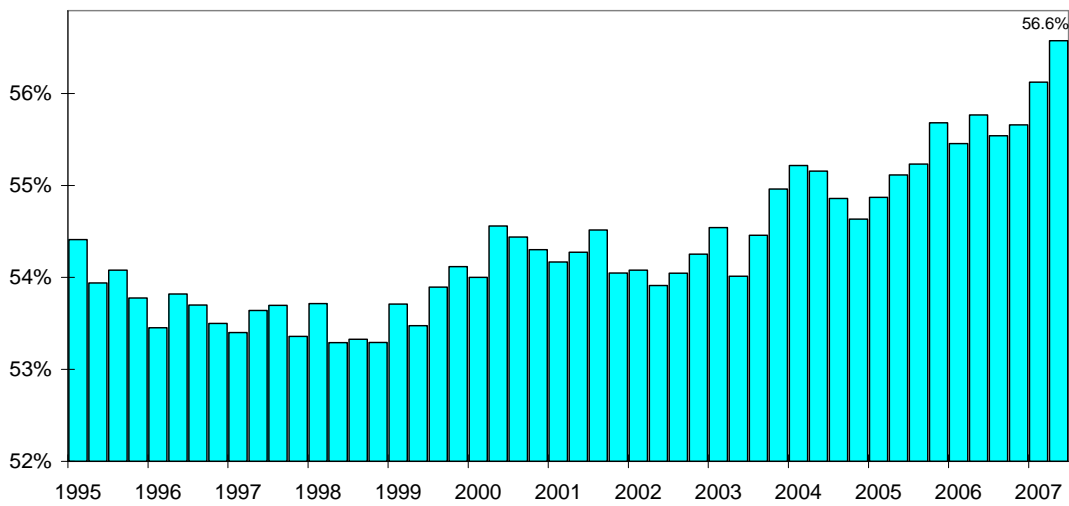
The Current Account as percent of GDP



j. The labor market

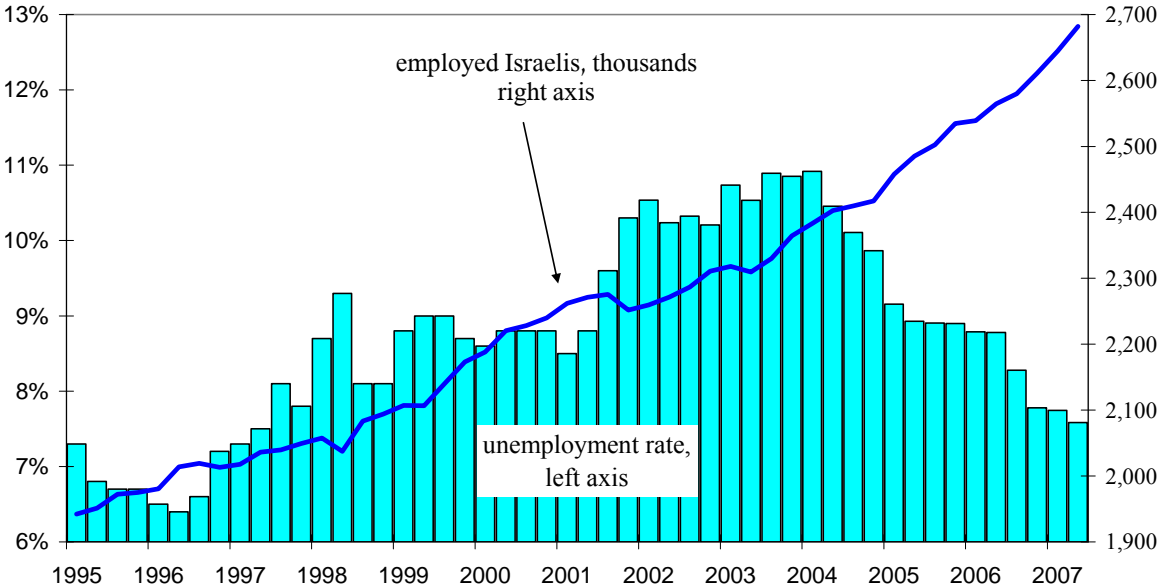
The improvement in the labor market continued in the first half of 2007. The rapid growth in business sector GDP contributed to a decline in unemployment, to an increase in the number of Israeli employed persons, and to a rise in the labor force participation rate. The rapid increase in the participation rate continued and in the second quarter of 2007 the rate reached 56.6% compared with 55.8% in 2006/Q2 and 55.1% in 2005/Q2.

Labor Participation Rate (ages 15+)



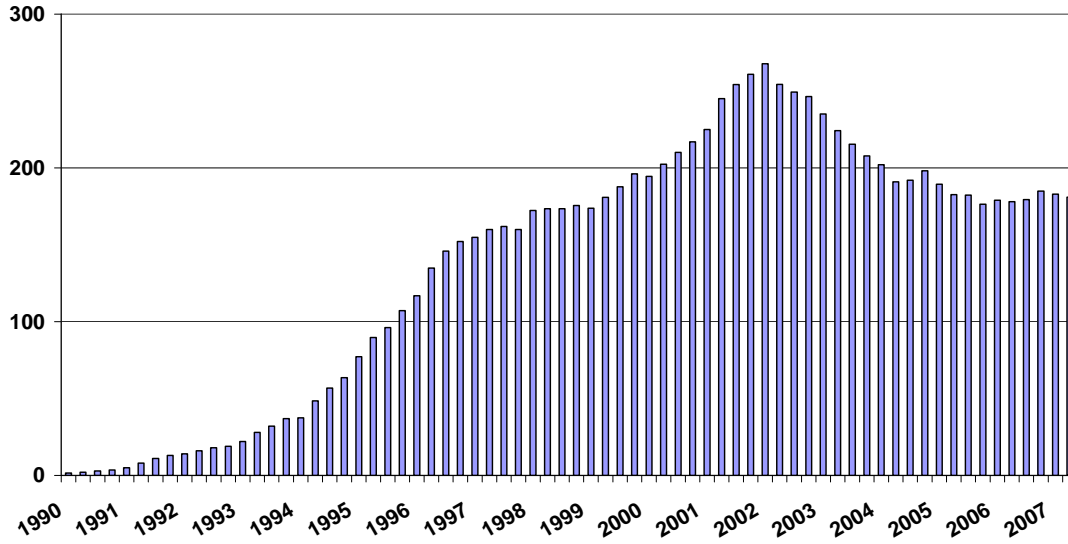
During the past year (2007/Q2 compared with 2006/Q2) the number of employed persons rose by 117 thousand or 4.6%, most of them as full time employees. The unemployment rate continued to fall despite the rapid growth in the participation rate, and reached 7.6% in 2007/Q2 compared with 8.8% in 2006/Q2.

The Unemployment Rate and Employed Israelis



The number of foreign workers in the economy has remained stable since mid-2004, in contrast to the downtrend during the previous two years. In the second quarter of 2007, the number of foreign workers amounted to 181.0 thousand, 87 thousand less than the peak number recorded at the beginning of 2002. In addition to foreign workers, 47 thousand Palestinian workers were employed in the second quarter of 2007. The decrease in the number of foreign workers from the beginning of 2002 to 2004 reflected the successful implementation of the government's policy of reducing the number of these workers. This policy was intended to increase the number of Israeli employed persons, and to improve the wages of Israelis who are employed in similar sectors of the economy.

Foreign Workers (Thousands)

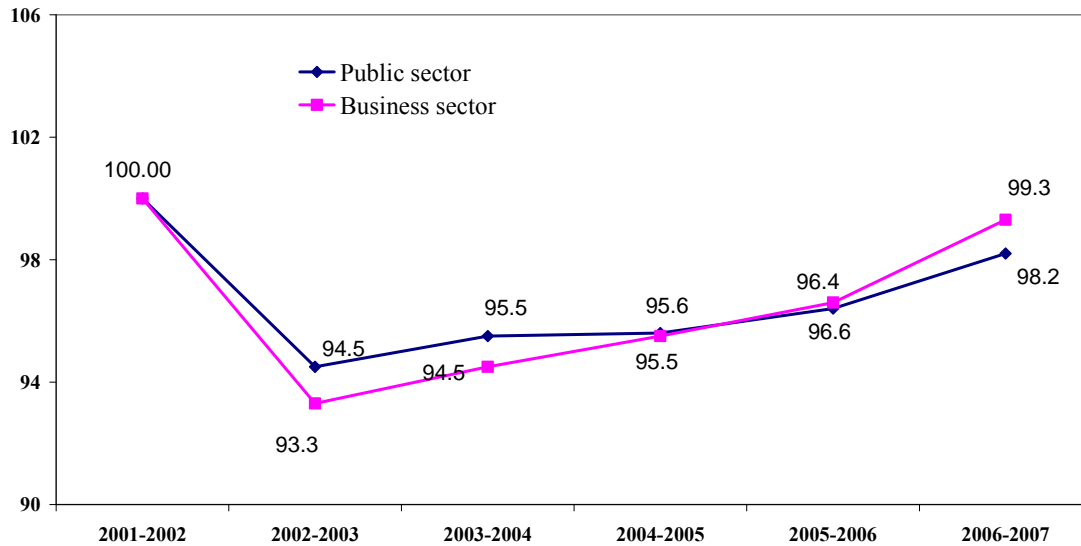


The average real wage in the economy rose by 3.5% in the first five months of 2007 compared with the same period of 2006 (3.9% in the business sector and 2.5% in the public sector), following an increase of 1.3% in 2006 (1.7% in the business sector and 0.3% in the public sector).

Real Wages (CPI-adjusted)

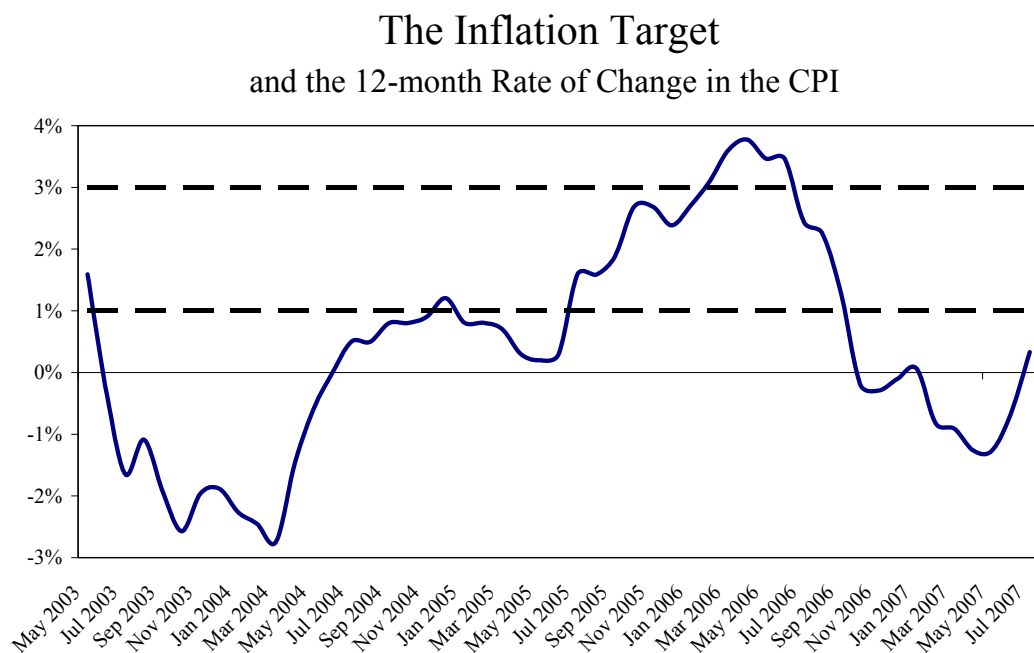
Years Ending May

Index 2001-2002 = 100



k. Inflation and monetary policy

Inflation in the past year was significantly lower than the government's inflation target. During the last two years inflation has been affected by two opposing trends: growth, which has the effect of increasing inflation; while the current account surplus and the inflow of foreign capital led to an appreciation of the NIS and to a decrease in inflationary pressures. The downward deviation from the inflation target of 1.0%-3.0% mainly resulted from the weakening of the dollar, which had a major impact on the CPI via housing prices, which are mostly dollar-denominated, and via import prices. During the 12 months from July 2006 to July 2007 the CPI rose by 0.3%¹⁰, while relatively high indexes were recorded in recent months. Notable among the index components were a 3.5% increase in prices of fruit and vegetables and a 0.5% decrease in housing prices (which were affected by the volatility in the dollar as stated).

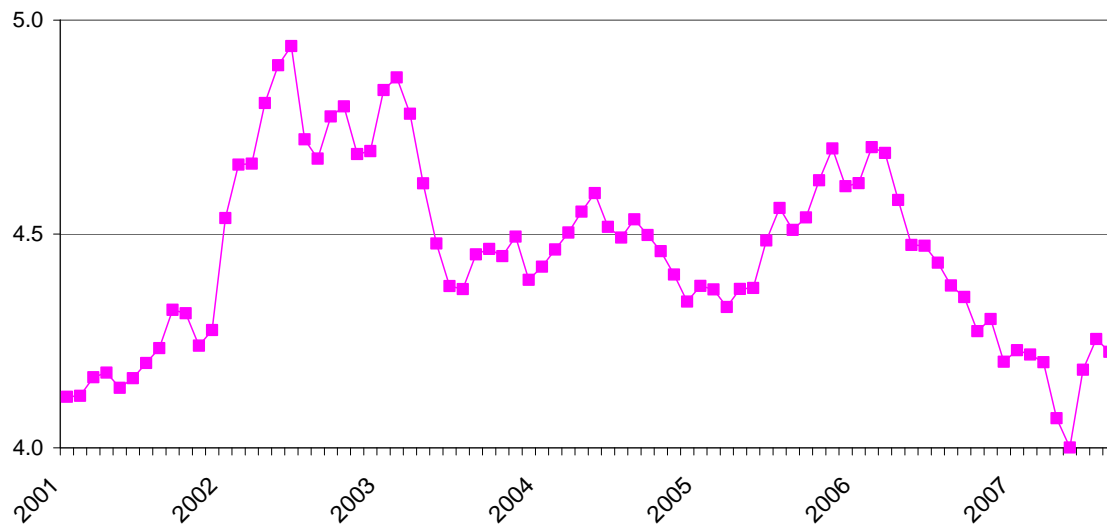


The Bank of Israel interest rate, which amounted to 4.5% at the beginning of 2006, was gradually raised to 5.5% in September 2006 mostly due to the weakening of the dollar at the beginning of the year, the rise in fuel prices in the first half of the year and the central bank's concern that the war in the north would undermine financial stability. From November 2006, as a result of the weakening of the dollar and the decline in fuel prices which reduced inflationary pressures, the interest rate was cut continually to 3.5% in June 2007. The interest rate for July 2007 was left unchanged. The central bank raised the interest rate by 0.25 percentage point in August and September to a level of 4.0%. This rate hike was intended to bring inflation to the center of the targeted range during 2008. The interest rate was raised in August and September for the following reasons:

¹⁰ The monthly CPI rose by an average of 0.7% in the first seven months of 2007 compared with the same period of 2006.

- Inflation that was higher than the forecast average (0.7% in June and 1.1% in July).
- The publication of indicators showing that the rapid growth in the economy is continuing.
- A slight strengthening of the dollar.
- An increase in the average wage per employee post in all principal industries, and the slower growth in labor productivity resulting from the decrease in the output gap.
- The decline in unemployment.
- Growing expectations of a rise in the global inflation rate, especially in the prices of oil and basic food products.
- The expansion in the means of payment.

The NIS Dollar Exchange Rate



2. Initial economic developments in the third quarter of 2007

Initial data on economic developments in the third quarter show continued rapid growth. The indicators include a further rapid expansion in government revenue from tax receipts and levies in July and August, a 7.9% increase in imports of goods (excluding ships, planes and diamonds), a 21.4% rise in imports¹¹ of capital goods, and a continued positive inflow of foreign residents' direct investments in Israel amounting to \$550 million in July. The Bank of Israel's composite index for July rose by 1.1% due to a substantial increase in the commerce and services revenue index and in the goods exports and imports indexes. However, decreases were recorded in the industrial production and service exports indexes. The continued improvement in the labor market is expected to have a favorable effect on private consumption, although uncertainty in the financial markets could offset this effect.

¹¹ Import and export data for July are as compared with June 2007 (seasonally-adjusted).

The risks deriving from short-term global developments

The negative effects on the short-term growth rate could derive mainly from external sources. Firstly, it is still difficult to assess the impact on short-term macro developments of the subprime crisis¹² in the USA and the uncertainty in the financial markets. The European Central Bank and the Federal Reserve injected large amounts of credit into the markets in order to prevent the development of a global financial crisis as the result of a liquidity crisis. However, a further deterioration in the American real-estate market, with its resulting impact on the banks and the hedge funds, and also possibly on private consumption in the USA, cannot be ruled out. Although the US economy expanded by 4.0% in the second quarter, the growth rate compared with the same quarter of 2006 remained below 2%. Moreover, GDP in the second quarter reflects a growth in inventories while the increase in private consumption was moderate, vehicle sales fell to their lowest level for the past nine years, and the construction industry is in a slump. In the Euro area, second quarter growth was lower than in the first quarter – 1.2% annualized – but amounted to 2.5% compared with 2006/Q2. As a result, the export growth rate is very likely to lag behind the import growth rate in the second half of the year.

3. Macroeconomic forecasts for the end of 2007 and for 2008

General

Data for the first half of 2007 and figures published for July-August 2007 show that the rapid growth trend continued in the third quarter of 2007. We estimate that the global economic environment and domestic demand will make it possible to achieve a growth rate of 5.4% in 2007. The increase in real wages, the growth in employment, the decline in unemployment and a relatively low real interest rate are supporting domestic demand. The growth rate forecast for 2007 is similar to the actual growth rate in 2006, but lower than the potential growth rate that would have prevailed in 2006 were it not for the impact of the Second Lebanon War. This gap mainly reflects the effect of the slowdown in world markets in 2007 compared with 2006.

The growth rate forecast for 2008 is 4.2%. This rate of growth is higher than that in the majority of developed countries and the average growth rate in Israel in the last decade, but lower than in 2007, mainly due to:

- The strength of the NIS. The expansionary effect of the real depreciation during the years 2000-2004 has exhausted itself while the moderating effect of the real appreciation during 2006 will impact with a year's lag, and will thereby be mainly apparent at the end of 2007 and during 2008.
- The decrease in the output gap as apparent from low unemployment rates and from the higher utilization of capital, among other factors.

¹² Mortgage credit granted to customers who defaulted on repayment in the past, or to customers with another type of economically problematic background.

1. Main assumptions behind the growth forecasts for 2007 and 2008

The rate of growth in the economy in the short term is dependent on a number of factors that will affect domestic demand and exports. The principal factors in this respect are:

- The global growth rate and the composition of this growth. According to the consensus forecast, the growth rates currently forecast for 2007 are 2.0% in the USA and 2.7% in the eurozone. The growth rates forecast for 2008 are 2.6% in the USA and 2.3% in the Euro area. The weighted average growth rate of the developed countries according to their weightings in Israeli exports has fallen from 3.1% in 2006, to 2.5% in 2007 and 2.6% in 2008. The present forecast, especially in the USA, is subject to major risks deriving from the imbalance in the American economy (a high budget deficit and households' negative saving), as apparent from the large balance-of-payments current account deficit, among other factors. In addition, the American economy is affected by the weakness in the real-estate market, as partly reflected by the subprime crisis, which is expected to impact private consumption. However, most analysts are forecasting a soft landing for the American economy.
- A growth in world trade¹³.
- The management of a responsible fiscal policy. One of the key assumptions is that the government will maintain its policy of adherence to the expenditure and deficit targets.
- The extent of restraint in monetary policy.
- The security situation. A main working assumption is that there will be no major deterioration in the security situation in 2007 and 2008.

The principal macro risks which the economy will face during the coming years are the resumption of a troubled security situation and a significant slowdown in the global economy. The Israeli economy will obviously suffer in the event of a full or partial materialization of these scenarios.

2. Main elements of forecasts for 2007

a. Inflation

Adherence to the inflation target towards the end of the year. Recent months' price indexes were heavily affected by exchange rate adjustments. Assuming that the effect of the appreciation of the NIS has largely exhausted itself and domestic demand leads to increased inflationary pressures during the year, we estimate that inflation in 2007 (December 2007 compared with December 2006) will amount to 2.4% and that average annual inflation will amount to 0.3%.

¹³ The IMF expects world trade to expand by 7.0% in 2007 and 7.4% in 2008.

b. The participation rate

A continued increase in the participation rate. The participation rate is expected to increase from an average of 55.6% in 2006 to 56.5% in 2007 as a result of the sustained growth in the economy, the increase in wages, the continued process of postponement of the retirement age and changes in the composition of the working-age population (the younger population entering the labor market are more skilled than the elderly population leaving the market).

c. Employment

The growth in employment will continue. Employment will increase by 4.2%, while the unemployment rate will average 7.5%. The increase in the number of non-Israeli employed persons reflects a decrease in 2007 but an average increase because of end effects, meaning relatively high figures for the fourth quarter of 2006. The decrease in the number of foreign workers has resulted from government policy aimed at reducing the unemployment rate and improving the wages of the weak sectors of the population.

d. The public debt

A continued decline in the ratio of the public debt to GDP. The public debt ratio is expected to fall from a level 86.7% of GDP at the end of 2006 to 81.7% at the end of 2007 (including proceeds from the privatization of the Oil Refineries)¹⁴. Despite the decrease, the public debt ratio in Israel is still considerably higher than in the majority of developed countries. The average debt-GDP ratio in the OECD countries in 2005 amounted to 58.8%.

e. Private consumption

Private consumption is expected to grow by 5.2% in 2007 due to the increase in real wages, continued tax reforms, the rise in the number of employed persons, the decline in unemployment, and the increase in the value of the public's asset portfolio.

f. Public consumption

Public consumption is expected to expand by 3.7% in 2007. Taken into account in this respect were the legally prescribed expenditure growth pattern of 1.7% and a non-recurring increment of 1.6% resulting from the Second Lebanon War (a total of 3.3%¹⁵).

g. Investment in fixed assets

Investment in fixed assets will grow appreciably following the increase in 2006. Investment in fixed assets is expected to expand by 9.1%. This increase mainly reflects sustained growth, continued

¹⁴ Assuming a growth rate of 5.4% for 2007 and a budget deficit of 0.5% of GDP.

¹⁵ Excluding finance for the expenses involved in the disengagement from the Gaza Strip.

corporate profitability, the decrease in long-term real interest rates, and increased imports of capital goods and raw materials. A continuation of the global growth trend will support this assessment. Investment in residential construction will also expand but at a lower rate, in view of the expected growth in demand (mainly in the Tel Aviv and central regions) and the decrease in stocks of vacant apartments.

h. Exports

Exports of goods and services will expand by 6.7% (exports excluding diamonds will increase by 6.6%). This increase reflects expectations of a further growth in world trade, sustained global growth, the continued expansion of high-tech industries and the rebound in the tourism industry, which will lead to an improvement in service exports. However, the real appreciation of the NIS in 2006 and the slower global growth rate in 2007 compared with 2006 are likely to offset this effect to some extent.

i. Imports

Imports of goods and services are expected to increase by 7.9%. This increase reflects an expected growth in imports of raw materials and capital goods due to the consolidation of the growth rate and the strengthening of the NIS against other currencies. The strengthening of the NIS will also lead to higher imports of consumer goods.

3. Main elements of forecasts for 2008

The assessments for 2008 are mainly based on medium-term forecasts whereby GDP is expected to grow by an annual average of 4.0% (2.3% per capita) in the medium-term (the next five years), while business sector GDP will expand by 4.2%. These growth rates will be supported by a 6.0% annual increase in exports, matching the forecast growth in world trade.

As previously mentioned, the reasons for the lower growth forecast in 2008 compared with 2007 are:

- A decrease in the output gap and the resulting increase in supply restrictions. The decrease in the output gap was reflected by lower unemployment rates in the first half of 2007 compared with the average rates for the years 2004-2006, and by a substantial increase in investments in fixed assets in 2006 compared with the moderate expansion in 2004-2005.
- A lower export growth rate resulting from the delayed effects of the real appreciation in the second half of 2006 and in the initial months of 2007.

Risk factors in 2008 as well are a deterioration in the security situation and a more serious than expected global slowdown. However, if these risk factors do not materialize and providing that the economy's growth potential is exploited, the potential for higher than forecast growth rates exists. Realization of the growth potential is dependent on the implementation of a responsible

and resolute fiscal policy that will favorably affect economic growth in 2008 and the following years. The growth potential can be realized in a number of areas:

- **A moderate increase in government spending** in accordance with the expenditure restriction will make it possible to further reduce the tax rates on individuals and companies (and thereby increase disposable income and private consumption), and to continue reducing the public debt as a percentage of GDP.
- **A stable fiscal policy supporting price stability**, monetary expansion and a reduction in the economy's risk premium.
- **The continued privatization of government companies** will increase these companies' efficiency and lead to the more efficient allocation of sources in the economy.
- **Continued investment in utilities, education, R&D and national projects** will form a basis for the continued development of business activity in the economy.
- **The implementation of active labor market policies** will facilitate a continued reduction in unemployment, an increase in the participation rate and an improvement in the standard of living of the weak sectors of the population.
- **An increase in public sector efficiency in order to assure a high level of services for the country's citizens.**
- **Structural changes in the principal industries that will increase competition and productivity.**
- **An increase in the efficiency of regulatory systems.**

We estimate that 2008 will be notable for the following developments:

- **Continued growth in the economy.** The GDP growth rate will amount to 4.2%.
- The private consumption growth rate will amount to 4.3%, and will be impacted by the same factors that affected the 2007 forecast (see the previously mentioned details).
- Public consumption will increase by 2.0%. Government spending will rise by 1.7% in real terms in accordance with the planned pattern. Non-recurring increments of 1.0% in respect of the Second Lebanon War and 0.5% for completing the disengagement program from the Gaza Strip will be added.
- Investment in fixed assets will increase by 5.5%, less than in 2007 when the forecast growth in investment will reflect the consolidation of the growth rate and will compensate for the low rates of growth in fixed asset investment in 2003-2005.

- Exports will rise by 4.7%. This is less than the rate of increase in 2007, and mainly reflects the end to the impact of the real depreciation during 2000-2004 and the delayed impact of the real appreciation during 2006 and 2007. As stated, global growth forecasts for 2008 are 2.6% in the USA, higher than the 2.0% growth forecast for 2007, and 2.3% in the eurozone, less than the 2.7% growth forecast for 2007. The weighted growth forecast for the developed countries according to their weighting in Israeli exports amounts to 2.6% for 2008, almost the same as that for 2007 (2.5%).
- Imports will rise by 4.6%. This is a lower rate of growth than in 2007 and derives from the slightly lower assessment of GDP and export growth for 2008 compared with 2007.
- **Price stability will be maintained.** Annual inflation will average 2.2% (2.0% from December 2007 to December 2008).
- **A continued positive trend in the labor market.** Unemployment will fall to 7.2%. The number of employed will increase by 2.8% and the participation rate will climb to 57.2%. The number of foreign workers will decrease by 2.0%.
- **A continued decline in the public debt to GDP ratio.** The public debt will fall to 80% of GDP.

Table 1 - Real GDP growth rates and the components of GDP, 2003-2008

	2003	2004	2005	2006	2007	2008
	Actual	Actual	Actual	Actual	Forecast	Forecast
Real growth rates (in %)						
Gross domestic product	2.3	5.2	5.3	5.2	5.4	4.2
Private consumption	1.2	5.6	4.0	4.5	5.2	4.3
Of which: by Israeli households	1.3	5.7	4.0	4.5	5.2	4.3
Public consumption	-2.3	-2.5	2.9	2.3	3.7	2.0
Gross investment	-6.0	3.1	11.1	5.3	10.9	7.1
Of which: Investment in fixed assets	-5.6	-0.4	2.3	10.1	9.1	5.5
Of which: Investment in fixed assets excl. residential construction	-6.1	-0.4	2.5	11.6	11.6	5.9
Exports	8.0	18.1	4.3	5.9	6.7	4.7
Exports excluding diamonds	8.2	19.8	6.6	10.1	6.6	5.6
Goods exports	5.5	16.0	3.4	5.6	8.9	3.8
Industrial exports excluding diamonds	5.0	17.9	6.4	12.5	9.3	5.0
Service exports	13.7	23.0	6.4	6.7	1.6	6.6
Service exports excl. tourism services and consumption by nonresidents	16.9	25.3	5.2	8.8	1.6	6.0
Exports of tourism services and consumption by nonresidents	-1.0	11.1	13.3	-4.6	1.6	10.2
Imports	-1.3	11.8	3.5	3.3	7.9	4.6
Goods imports	-2.1	11.0	2.7	2.8	6.9	4.0
Service imports	1.1	14.2	5.9	5.1	11.0	6.4
Business sector GDP	3.2	7.2	6.5	6.5	6.2	4.9
Per capita GDP	0.4	3.4	3.5	3.4	3.6	2.5

Table 2 - The consumer price index and the labor market, 2003-2008

	2003	2004	2005	2006	2007	2008
	Actual	Actual	Actual	Actual	Forecast	Forecast
Consumer price index						
Index (2006=100)	97.1	96.7	97.9	100.0	100.3	102.5
Change (annual average-annual average)	0.7	-0.4	1.3	2.1	0.3	2.2
Change (December-December in %)	1.9	1.2	2.4	-0.1	2.4	2.0
Wages						
Average wage at current prices	6,908	7,050	7,219	7,491	7,701	8,009
Annual change at current prices	-2.3	2.1	2.4	3.8	2.8	4.2
Annual change at fixed prices	-2.7	1.0	1.5	1.8	2.5	2.0
Employed persons						
Number of employed persons (th.)	2,590	2,634	2,723	2,801	2,918	2,999
Annual change (in %)	0.8	1.7	3.4	2.9	4.2	2.8
Israeli employed persons						
Number of employed persons (th.)	2,330	2,401	2,494	2,574	2,688	2,774
Annual change (in %)	2.0	3.0	3.9	3.2	4.4	3.2
Non-Israeli employed persons						
Number of employed persons (th.)	260	233	229	227	230	225
Annual change (in %)	-8.9	-10.1	-1.8	-0.7	1.1	-2.2
Unemployed persons						
Unemployed (th.)	280	278	246	236	219	215
Percentage of labor force	10.7	10.4	9.0	8.4	7.5	7.2
Participation rate (in %)	54.5	54.9	55.2	55.6	56.5	57.2

Table 3 - Real GDP and nominal GDP, 2003-2008

	2003	2004	2005	2006	2007	2008
	Actual	Actual	Actual	Actual	Forecast	Forecast
GDP at fixed prices (2005 prices)	531.7	559.4	589.0	619.7	653.2	680.6
Rate of change in real GDP (in %)	2.3	5.2	5.3	5.2	5.4	4.2
GDP at current prices (NIS billion)	527.0	554.1	589.0	633.1	670.6	715.6
Rate of change in nominal GDP (in %)	1.7	5.1	6.3	7.5	5.9	6.7

B. Highlights of the economic policy for 2008

1. Fiscal policy

The economic policy proposed in the budget proposal for 2008 and the Arrangements Law is consistent with the fiscal policy adopted in previous years. This policy consists of the continued implementation of reforms in the economy, a restriction on the growth in government spending, and the continued policy of reducing the tax burden concurrent with the debt-GDP ratio. The economic policy proposed in the budget for 2008 is based on a real expansion of 1.7% in the budget base and the retention of a deficit target of 1.6% of GDP.

Restriction on the growth in government spending and the size of the budget deficit

Under the economic policy determined for 2004, a decision was taken to amend the Law for the Reduction of the Deficit, prohibiting an increase in government spending of more than 1% a year in real terms in each of the years 2005-2010, and a budget deficit of over 3% of GDP. Following the formation of a new government, it was decided to change the expenditure growth restriction to 1.7% and to impose a deficit ceiling of no more than 1.0% from 2009. The law was amended as a result of the implementation of the Gaza disengagement program and the Second Lebanon War, and the government was permitted additional non-recurring expenses that are not included in the budget base. Since these non-recurring expenses are exceptional and do not affect the course of development of government spending and the deficit in the medium-term, the budget base for 2008 will expand by 1.7% in real terms, concurrent with non-recurring increments of 1.0% for financing the Second Lebanon War and strengthening of the north of the country and 0.5% for completing the disengagement program. Any additional expenditure that will be required will be financed from within the framework of the existing budget.

The economic policy for 2008 includes *inter alia measures* for improving the socio-economic situation, upgrading the army's capabilities and enhancing the educational system.

Socio-economic enhancement

One of the main emphases in the economic policy for 2008 is the enhancement of the situation of the weak sectors of the population while maintaining an export-oriented economic policy. Accordingly, the policy for 2008 includes the implementation of negative income tax, increased budgets for day centers and the promotion of a compulsory pension. In addition, the government has adopted the socio-economic agenda that was published by the Economic Council, which operates under the auspices of the Prime Minister's Office. Following the adoption of this agenda, an inter-ministerial committee headed by the Director-general of the Finance Ministry and comprised of various teams was established. These teams are defining objectives for enhancing the socio-economic situation, creating new tools, monitoring the application of these tools and the manner in which their efficiency is measured. One of the teams is concerned with the matter of foreign workers. As a result of the

committee's work, the government adopted two objectives for medium-term socio-economic policy. The first objective is employment – increasing the rate of employment among the 25-64 age group from 69.1% to 71.7% by the year 2010. The second objective is a poverty reduction target, whereby the income of the lower quintile will increase by 10% more than the per capita GDP growth rate during the years 2008-2010 and that quintile's share of income from labor in total income will increase from 43% to 45%.

Enhancing the educational system

A key objective in economic policy for 2008 is an improvement in the educational system. In the long term, an improvement in the educational system enhances the economic situation of the weak sectors and also contributes to growth in the economy. A consistent improvement in the system has the effect of reducing economic gaps and increasing social mobility. The impact of education is reflected by the close relationship between the number of years of education and the labor force participation rate, the extent of unemployment and the level of wages. In 2006 the participation rate of those with 16+ years of schooling amounted to 77.1%, compared with 54.6% among those with 11-12 years of the schooling and 23.0% among those with up to 8 years of schooling. The unemployment rate among these groups amounted to 4.0%, 11.2% and 16.0% respectively¹⁶. Investment in human capital also leads to a growth in productivity per employee and as a result, to higher wages. In 2005 the wages of male full time salaried employees with 16+ years of schooling were nearly twice (94%) the wages of those with 11-12 years of schooling and almost triple (186%) the wages of those with up to 8 years of schooling. Among women the situation was similar: The wages of female employees with 16+ years of schooling were 70% higher than the wages of those with 11-12 years of schooling and 144% higher than the wages of those with up to 8 years of schooling¹⁷. A growth in employment together with an increase in wages leads to a rise in the standard of living for the working-age population, as well as to increased savings and income after leaving the labor market, which are two objectives of the economic policy.

An expansion in human capital, which increases productivity, also has a major impact on long-term growth, competitiveness and the challenges facing the Israeli economy in the future. In addition, the benefit to society of education exceeds the benefit to the individual. This is because education leads to more rapid technological innovation and development¹⁸, enables workers to learn from it, contributes to a reduction in crime, and reduces dependency on the welfare system.

Enhancement of the educational system is a central component of the budget policy for 2008. In this respect, it was decided to implement a reform in education from 2008, to be staggered over a period of six years at an overall budgetary cost of NIS 5 billion. The reform is intended to increase the quality of teaching staff and the level of teaching. The reform includes an increase and a structural change in teachers' working week, the creation of a system of wage incentives, and managerial flexibility at the level of the individual school. Concurrently, a reform in higher education is planned on the basis of the

¹⁶ See the Bank of Israel Annual Report for 2006.

¹⁷ Economics and Research Department calculations from the Income Survey for 2005. FTE – 35+ work hours.

¹⁸ If the adoption of new technologies is facilitated by a skilled labor force.

Shohat Committee's conclusions regarding an improvement in the level of research and instruction at universities and colleges and increased access to higher education.

Strengthening the IDF

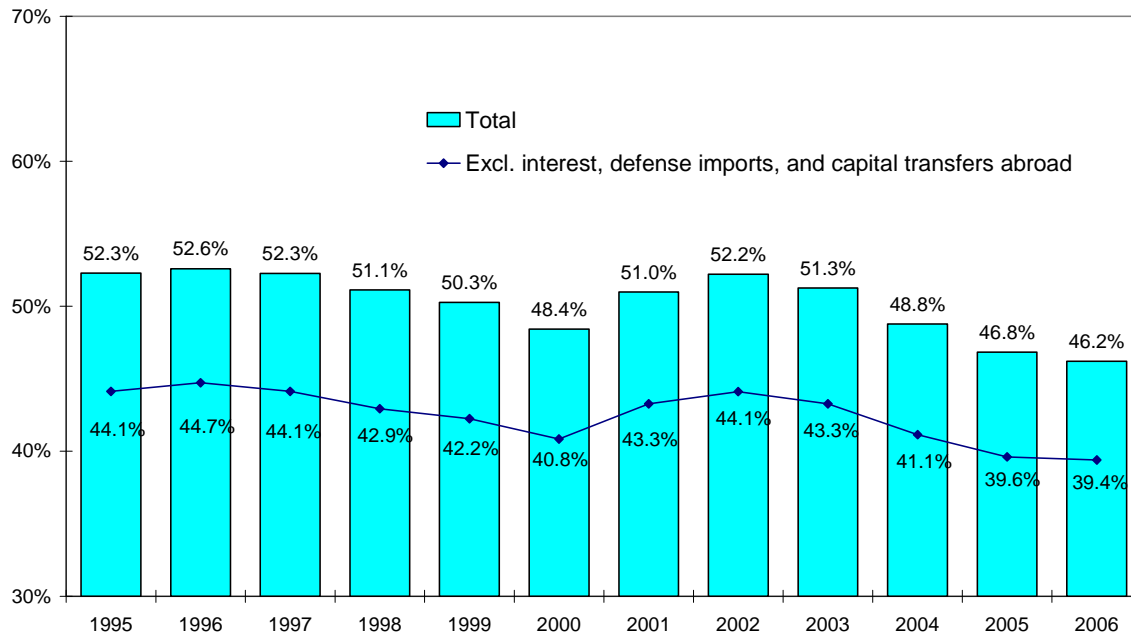
Following the Second Lebanon War, the Brodet Committee was established in order to examine the IDF's medium and long-term requirements. The government adopted the committee's recommendation to increase the defense budget for the years 2008-2017 by NIS 100 billion. Out of the overall increment, NIS 46 billion will come from the national budget, NIS 30 billion from more efficient usage of the existing budget and NIS 24 billion from increased defense aid from the USA. It should be noted in this respect that a new agreement was signed on US defense aid to Israel for the years 2009-2018, as a continuation of the existing agreement which expires in 2008. Under the new agreement, the aid during those years will total \$30 billion (\$3 billion a year on an ascending scale). 74% of the aid will be used for procurement from the USA.

2. Trends in public expenditure and in the development of the public debt

Public expenditure

During the years 1995-2000 public expenditure fell from 52.3% of GDP in 1995 to 48.4% in 2000. Due to the severe recession in the Israeli economy which began at the end of 2000, the growth in defense spending resulting from the confrontation with the Palestinians and the policy of monetary restraint, public spending as a percentage of GDP rose appreciably in the years 2001 and 2002 – principally in the defense, wages and transfer payments items. As a result of the decline in GDP and the rise in public spending during those years, public spending surged to 52.2% of GDP in 2002. The measures taken to restrict the growth in public spending since 2003 together with the rapid growth in GDP since 2004 reduced public expenditure to 46.2% of GDP in 2006.

General Government Expenditure (as percent of GDP)

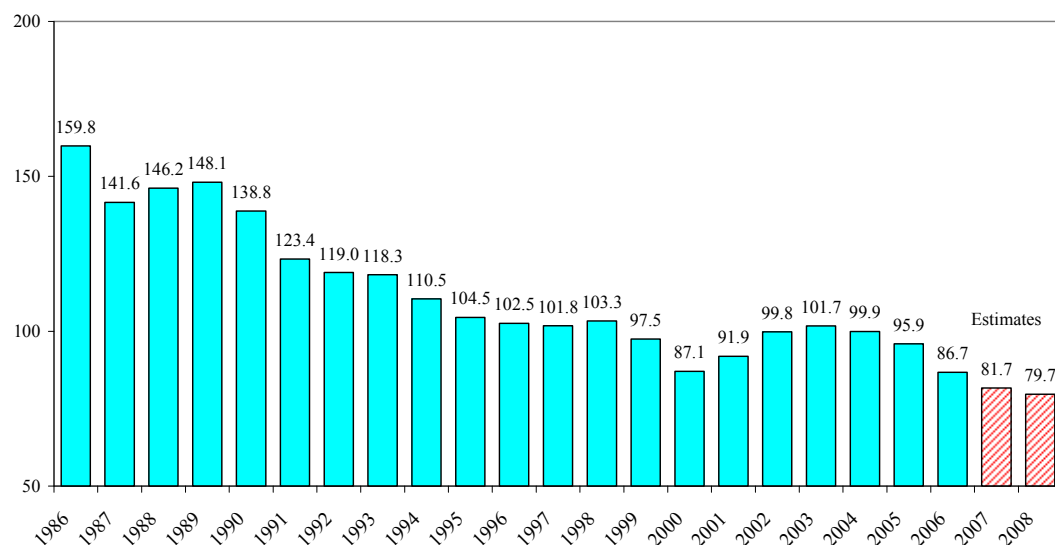


The public debt

The public debt fell appreciably from a level of 159.8% of GDP in 1986 following the stabilization program to 87.1% of GDP in 2000. During the years 2001-2003 however, as a result of the slowdown in economic activity and the decrease in tax revenue coupled with the difficulty in reducing government spending due to increased defense requirements, the debt-GDP ratio increased to 101.7% in 2003. Following the rebound in the economy and the adherence to the budget deficit targets, the public debt fell to 86.7% of GDP at the end of 2006.

The high level of the public debt constitutes an economic burden for the coming generations. The larger is the debt, the greater will be the future tax burden required for financing interest payments and repayment of the debt. The debt-GDP ratio is also one of the indicators of stability in the economy, and a large debt necessitates a higher level of government borrowing. These factors increase the interest costs to the economy, and adversely affect the level of investment in the economy and business sector GDP growth rates. A continued decline in the public debt will reduce the Israeli economy's vulnerability in a recession period, and will make it possible to adopt an anti-cyclical fiscal policy.

Gross Public Debt (as percent of GDP), 1986-2008



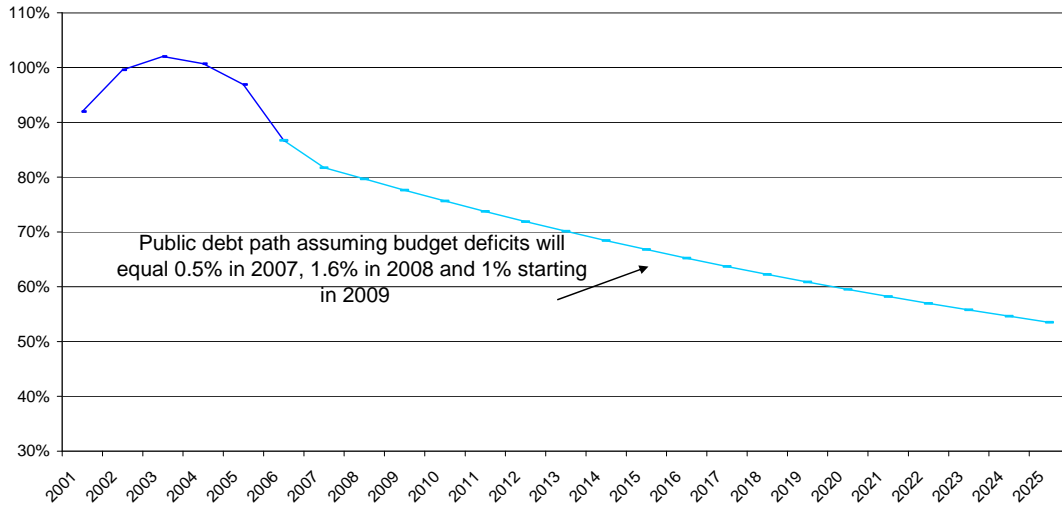
Forecast for the coming years

Assuming growth of 5.4%, a deficit of 0.5% and inflation of 0.3% in 2007 followed by growth of 4.2%, a deficit of 1.6% and inflation of 2.2% in 2008, the public debt can be expected to contract to 81.7% of GDP at the end of 2007 and to 79.7% at the end of 2008.

Under a simulation assuming growth of 4.0%, a budget deficit of 1.0% and inflation of 2.0% from 2009 onwards, the public debt will reach 60% of GDP in 2020, similar to the European Union's target in accordance with the Maastricht Treaty.

Public Debt (as percent of GDP)

Simulation assumption: GDP growth rate of 5.4% during 2007, 4.2% during 2008 and 4.0% during 2009-2025. Inflation rate of 0.3% during 2007, 2.2% during 2008 and 2.0% starting 2009



3. Tax revenue forecast for 2008

Tax revenue¹⁹ of NIS of 190.0 billion²⁰ is forecast for 2008, broken-down as follows: NIS 103.0 billion from direct taxes, NIS 82.0 billion from indirect taxes and NIS 5.0 billion from levies²¹. The revenue forecast for 2008 assumes a real increase of 4.2% in gross domestic product (GDP), a rise of 2.4% in GDP prices and an estimated net tax reduction of NIS 6.8 billion resulting from legislative changes. Exclusive of the legislative changes, a 2.8% real increase in tax receipts is expected in 2008 compared with 2007. This rate is less than the forecast GDP growth rate because of non-recurring revenue of NIS 2.5 billion charged in 2007 due to the sale of mutual fund and provident fund management companies, and to an exceptional increase in the realization of capital gains. Exclusive of the non-recurring component and the effect of legislative changes, tax revenue will increase by 4.2% in real terms in 2008 compared with 2007, similar to the GDP growth rate.

¹⁹ This part discusses the government's tax revenue (including foreign currency revenue) charged by the Tax Authority as well as revenue in the form of levies, which are charged by government ministries. The income in this part does not include VAT on defense imports. Neither does this part discuss the revenue of other public sector bodies, which also charge taxes and compulsory payments: the National Insurance Institute, the local authorities and the authorities that operate in accordance with special legislation, such as the Ports Authority.

²⁰ All the data are at current prices unless otherwise stated. Under the assumptions employed in the budget for 2008, the CPI will amount to an average of 106.2 points (on the basis of 2002=100), implying an increase of 2.2% compared with the price index forecast for 2007.

²¹ In 2004 the Income Tax and Land Taxation Department, and the Customs and VAT Department were amalgamated into the Israel Tax Authority. In this part we will refer to the two former departments as "direct taxes" and as "indirect taxes" respectively.

Percentage change in tax revenue compared with previous year ¹				
	2005	2006	2007	2008
Original data	5.2	7.9	5.0	-0.7
Receipts exclusive of effect of legislative changes	7.9	10.5	7.2	2.8
Receipts exclusive of effect of legislative changes and non-recurring revenue	7.9	8.1	8.0	4.2
¹ Nominal change exclusive of the change in the CPI.				

At the end of 2000 the Israeli economy entered a severe recession due *inter alia* to the security situation and the global economic slowdown. GDP fell in each of the years 2001 and 2002, and the conjunction of the recession with the military conflict led to a real decrease in tax revenue of 1% in 2001 and 5% in 2002. The contraction in economic activity ceased in 2003, and since 2004 the economy has been expanding by 5% a year. A positive turnaround was recorded in tax revenue as well during 2003, and in the years 2004-2006 tax receipts (exclusive of the effect of the legislative changes and non-recurring revenue) increased by 8% a year in real terms. Despite the war in the summer of that year, the growth in the economy and rate of increase in tax receipts continued during 2006. The revenue estimate for 2007, which was compiled on the basis of actual receipts up to June and a forecast until the end of the year, amounts to NIS 187.0 billion, which is NIS 7.5 billion more than the original budget forecast. As stated, NIS 2.5 billion of the receipts surplus derives from non-recurring transactions.

In 2008 the Finance Ministry will maintain a double-targeted fiscal policy of encouraging growth and maintaining fiscal discipline. This will be reflected by a further reduction in taxes on labor and firms and the expectation, based on a multi-year tax program, of larger tax cuts in the years 2009 and 2010 with the aim of encouraging work and entrepreneurship. At the end of the process, the maximum marginal rate of tax on individuals (income tax, national insurance fees and health tax) will amount to 44% and corporation tax to 25%. In addition, payroll tax and sales tax will be abolished in 2008, and the purchase tax on an individual apartment will be reduced to the extent that 80% of apartment-buyers will be exempt from payment of the tax. These reductions are possible as a result of an expansion in the tax base, the cancellation of exemptions, and the restraint imposed on public spending.

The net effect of legislative changes on the tax burden will amount to a reduction of 1.0% of GDP in 2008. That year will fall within an eight year period (2003-2010) when legislative changes will have had the effect of reducing the tax burden by a cumulative rate of 4.3% of GDP. Since the national insurance burden will be reduced by 0.4% of GDP in those years, the concurrent legislative changes will reduce the overall tax burden by 4.7% of GDP.

Exclusive of the effect of legislative changes, tax revenue will increase by 5.2% in nominal terms during 2008 (exclusive of the effect of the change in the CPI, revenue will rise by 2.8%). This rate of increase will be less than the nominal GDP growth rate of 6.7%, because non-recurring revenue of NIS 2.5 billion was charged in 2007 as stated.

To conclude, the tax burden, which is the ratio of total government tax revenue to GDP, will amount to 26.9% in 2008, a decrease of 1.4% of GDP compared with 2007 and 2.7% of GDP compared with the record year of 2000²².

4. Government wage and personnel policy

On December 31 2001, a collective agreement for the years 1999-2001 was signed with the New General Federation of Labor (the New Histadrut) concerning a wage increment of 3.6% for the represented employees with effect from January 1 2001, as well as the payment of a one-time bonus of NIS 1,250 in respect of the years 1999 and 2000. It was also agreed to continue negotiations on the final rate of the previously mentioned increment and on the matter of the "employment structure" in the government sector. During 2001 and the first half of 2002, intermittent and inconclusive negotiations were held with the New Histadrut against the background of a deterioration in the country's security situation and economic situation.

On December 18 2001, an agreement for the years 1999-2001 was signed with the Teachers Federation and the Post Elementary School Teachers Organization which matched the framework agreement with the New Histadrut for those years.

The wages of senior officials that are indexed to the average wage in economy were frozen for the years 2002-2005. An attempt to reach an agreement on a general wage freeze in the economy (with the exception of already signed agreements) failed.

The agreement for the move from a budgetary pension to an accrual pension for new government employees went into effect in April 2002 (at the local authorities and other bodies where the budgetary pension was practiced, the agreement went into effect in November 2001). The main purpose of the agreement is to prevent a persistent increase in the government's actuarial liability in respect of the budgetary pension, and to reduce the budgetary pension payments burden in the national budget in the future. For professional grades who have not signed an agreement for the move to an accrual pension, the move was applied by means of a law applicable from September 1 2002.

A cost-of-living agreement for 2002 in the business sector was signed in November 2002, following which the Minister of Labor and Welfare signed an extension order for the entire economy. Under the agreement, new employees received a one-time bonus of 2.1% in December 2002, a cost-of-living increment at a rate of 2.1% up to the level of the minimum-wage in January 2003, and a cost of living increment of 2.1% up to a ceiling of NIS 7,700 in the entire economy – except for the civil service – in January 2004.

On May 22 2003, a collective agreement for encouraging growth in the economy was signed by the government and other public service employees, and by the New Histadrut for the period from July 1 2003 to June 30 2005. The agreement covered a temporary reduction in wages, that is a postponement

²² As stated, this is the government tax burden only. The tax burden including the taxes imposed by the National Insurance Institute and the local authorities will amount to 36% of GDP in 2008.

of the date for adjusting the cost of living increment and postponement of the dates for the payment of vacation allowance and seniority bonuses. As a result of the agreement, the application of this postponement of the payments in question to employees who are not represented by the New Histadrut as well as to other public service entities that were not signed on the agreement was anchored in legislation. The total saving in the national budget from the application of the agreement reached NIS 2 billion a year for those years.

On December 12 2004 another agreement was signed with the New Histadrut, stipulating that the wage reduction was to end on the appointed date and that the payment of vacation allowance for 2004 would be brought forward to December 2004 instead of the beginning of 2005. In addition, the second date for the payment of a cost-of-living increment for 2002 in the civil service was postponed to June 2006 under the agreement for the encouragement of growth and the agreement of December 12 2004. In July 2005, the salary reduction stipulated in the collective agreement signed on the matter with the New Histadrut ended.

In January 2006 the salaries of senior officials that were indexed to the average wage since 2001 were adjusted. The basic salary of senior officials that were indexed to the salaries of deputy ministers was adjusted by the entire increase in the index during the years 2001-2006.

In June 2006 public sector employees were paid the second part of the cost-of-living increments in respect of 2002, at a rate of 2.1% of salary exceeding the minimum wage. No upper limit for payment of the cost-of-living increment was determined for employees in the grades covered by collective agreements. For other employees, a limit based on an average wage of NIS 7,856 was determined.

In April 2006 the legal minimum wage was adjusted in accordance with the increase in the average wage in the economy, to NIS 3,456.58 a month. In July 2006 the minimum wage was adjusted again in accordance with the coalition agreement reached for forming a government, to NIS 3,585.18 for June 2006, and to NIS 3,710.18 in April 2007. According to the coalition agreement, the minimum-wage is to be increased to NIS 3,835.18 in December 2007. The government decided to postpone the latest adjustment date by half a year, subject to approval by the Knesset and a legislative amendment in the matter.

The signing of a collective salary agreement between health employers (the government, the General Health Services and the Hadassah Medical Organization), and the Israel Medical Federation, the trade union representing doctors, is currently subject to arbitration. Involved is an alternative mechanism for settling disputes between the parties by means of compulsory arbitration. This is because the parties have failed to reach negotiated agreements. The government has raised a number of demands within the framework of the arbitration process. The main demand is for doctors to record their presence at work by clocking-in/out. Currently, doctors are the only public service employees who report their presence on a monthly form rather than clocking-in/out for work.

On August 12 2007 a memorandum of understanding was signed in the matter of a reform and a new salary agreement following the declaration of principles that was signed on May 16 2007 between the State of Israel and the Teachers Federation. On September 10 2007 a temporary collective agreement

was signed for the implementation of a reform in elementary schools and pre-high schools. Under the declaration of principles and the temporary agreement, the reform will be applied to elementary schools and pre-high schools in a graded manner over six years. Concurrently, negotiations are being held with the Post Elementary School Teachers Federation (which announced that it is not prepared to implement the reform in accordance with the declaration of principles and the temporary agreement) regarding the salary agreement that expired on December 31 2001.

In addition, the teachers were paid compensation in respect of salary erosion for the years 1999-2006. This followed the arbitration ruling that was given on May 22 2007 regarding the rate of erosion of the years 1999-2001. The teachers' salary table was adjusted by 4.75% with effect from January 1 2007. A non-recurring payment of 108% of a one month salary will also be paid for the years 1999-2001, no later than salaries for January 2008.

In July 2007, following negotiations between the government and public service employers, and the New Histadrut, a **framework agreement** was formulated which provides salary increments for public-sector employees represented by the Histadrut, as follows: January 2008 – a salary increment of 1.5%, December 2008 – supplementing the salary increment to a rate of 3%, December 2009 – supplementing the salary increment to a rate of 5%. In the near future negotiations will be held with all the trade unions belonging to the Histadrut regarding the manner of apportioning the salary agreement covered by the framework agreement to all of the grades in question.

The average wage in the public sector rose by 2.5% in 2006. The average real wage in the public sector increased by 0.3%.

Enforcement of the Budget Basics Law and the supervision of budgeted entities

As a result of the serious findings emerging from the Salary Commissioner's annual report, in July 1997 the government decided to establish a mechanism for enforcing Paragraph 29 of the Budget Basics Law (a paragraph stipulating that budgeted entities may not change their employees' salary or retirement conditions beyond the accepted level for all government employees).

Following this decision, an Enforcement Unit was established in the Salaries Department at the Ministry of Finance for the purpose of collating the activities necessary for the enforcement of the Budget Basics Law, including claims on behalf of the State in all matters relating to the cancellation of agreements, arrangements, salary excesses and the prosecution of those responsible for them. In cooperation with the State Prosecutor's Office, the Enforcement Unit is operating and using its authorities to increase the supervision of budgeted entities (and local government in particular) and to prevent salary excesses.

The Enforcement Unit is currently involved in dealing with salary excesses in local government, at the Israel Electric Corporation, at the Bank of Israel, at the universities, and at other public-sector supported and budgeted entities. In the course of seven years of enforcement, over 2,500 decisions were made at the Salaries and Work Agreements Department concerning the salary and retirement conditions of thousands of public sector employees, leading to a cumulative saving of over a billion

NIS and on an actuarial basis, of over NIS 2.5 billion. The enforcement activities have served as deterrent among public-sector entities, especially at municipalities and local authorities. This form of deterrence is leading to savings estimated at hundreds of millions of NIS.

Plans for the future

1. The Salary Commissioner intends to initiate legislative amendments on the following matters:
 - The prohibition of strikes in essential services and the determination of a mechanism for resolving differences of opinion in the area of labor relations. This is in view of the numerous strikes and lost work days, which have seriously affected the Israeli economy.
 - Resumption of the efforts at promoting legislation for the purpose of determining the maximum salary in the public sector.
2. The Salaries and Wage Agreements Department and the Civil Service Commission have formulated a program for the encouragement of retirement (the “Oranim Program”), the main elements of which are:
 - a. Incentives for employees – A proposal for a number of retirement tracks, capital and budgetary (and not only a capital track as practiced until now).
 - b. Motivating managers – At units and ministries that adhere to the terms of the retirement program (a reduction of 5% and more in the personnel of the ministries/subordinate units), the ministry will retain part of the saving incurred in order to provide salary increments to the remaining employees.

The Ministry of Finance has not yet formulated a position on the matter.

5. Financing of the deficit

The budget deficit is mainly financed by domestic borrowing and overseas borrowing, as well as by receipts from the privatization of government assets and reducing the government's balances at the Bank of Israel.

Although financing the deficit by means of domestic borrowing contributes to the development of the capital market, large-scale domestic borrowing can deter business firms from entering the market and lead to a rise in the long-term interest rates, which adversely affects investment and growth rates. Deficit finance by means of overseas borrowing and independent public offerings in particular supplies the government's foreign currency requirements, expands the basis for those investing in Israel Government bonds, and creates a benchmark for issues abroad by Israeli companies.

Trends in the financing of the deficit

As a result of the reform of the pension funds, issues of non-marketable capital have decreased considerably. During the years 1995-2007, the deficit was largely financed by means of marketable domestic borrowing instruments. From 2008, issues by the pension funds are expected to increase gradually, and to constitute a more significant source for financing the deficit.

In 1995 the government issued own-guaranteed bonds in overseas markets for the first time – the USA, Europe and Japan – and in the years 2003-2004 issued bonds guaranteed by the United States government as part of the second guarantees program.

Since 2005 privatization receipts have constituted a major source for financing the deficit, and have thereby helped to reduce the debt-GDP ratio.

6. Policy in the capital market

The process of increasing the efficiency of the capital market received a major boost during recent years as a result of the reforms in the markets, and especially the implementation of the recommendations of the "Bachar Committee" and the extensive legislation resulting from these recommendations. The measures taken in this respect were of major importance for the Israeli economy as a whole and for each individual citizen and consumer of financial services.

The changes implemented in the capital market were intended to provide a more competitive structural base for the market by reducing the concentration for which the market is noted and the structured conflicts of interest inherent in the activity of the entities operating in the market. As a result, in 2006 a large proportion of the banks' holdings in provident funds and mutual funds was sold to non-banking organizations, part of them to foreign institutions which are new players in the domestic capital market and whose entry to Israel is to be encouraged. The ratio of the banks' holdings in total provident fund assets fell from 56% in December 2006 to 29% in June 2007²³. This process has the potential for creating alternatives to the financial institutions operating in the capital markets, for reducing the banks' dominance in the market, and for increasing the competition for the management of customers' assets while strengthening the status of consumers in the financial markets as whole and in the savings and pension market in particular.

The Bachar reform and the continuation of the positive trend in the capital market have had the effect of reducing the proportion of credit from the banking system to total credit in the economy. In the past, the banking system was notable for its control of credit sources and for high concentration. The concentration was apparent from the large banking groups' control of financial activity. This control restricted the range of credit sources available and delayed the development of alternative sources for raising capital, principally capital issues in Israel and abroad and credit provided by institutional investors (provident funds, insurance companies and pension funds).

²³ In December 2006 the banks' rate of holding in the mutual funds amounted to 1%.

Institutional investors' entry into credit extension activity is a welcome development, and has the potential for increasing the competition in this area and for diversifying institutional investors' portfolios. As a result, the proportion of credit (loans and corporate bonds) to the total assets of long-term saving organizations (provident funds, the new pension funds and the insurance companies' profit-sharing portfolios) rose from 32% in December 2006 to 36% in June 2007. Since credit activity requires specific expertise and a suitable organizational infrastructure, regulatory procedures were determined in order to reduce the risk inherent in the credit portfolios managed by institutional investors.

Several of the strategic measures aimed at liberalizing the regulations covering the activity of institutional investors yielded results during recent years. These results involved the lifting of restrictions and the standardization of investment regulations. The measures involved are intended to lead to increased competition for members' savings. Concurrently, the barriers imposed on investment in foreign assets were reduced in order to encourage supervised entities to increase their rates of investment in overseas markets. As a result, pension saving institutions' rate of holding in assets abroad increased from 11% in December 2006 to 13% in June 2007. The increased exposure to overseas markets is intended to reduce financial risk by geographically diversifying the investment portfolio and to reduce the exposure of institutional investors (and their members) to fluctuations in the local capital market and the performance of the Israeli economy. The global financial approach that is taking hold in Israel is reflected by the adoption of international accounting standards (IFRS), and by the emphasis on increasing the Israeli economy's attractiveness in the eyes of foreign investors.

Apart from the previously mentioned changes, measures were taken to increase the competition between the pension institutions by launching a site ("Pensiya Net") that provides tools for comparing the pension funds' performance. Together with "Gemel Net", this site enables the public to choose a saving supplier in a sophisticated manner while increasing the competition for savers' funds. This competition is expected to increase during the coming years in view of the publication of draft regulations covering the transfer of money between long-term saving products.