Country Report

Israel

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London E14 4QW
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The Economist Intelligence Unit

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London

Economist Intelligence Unit
20 Cabot Square
London
E14 4QW
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

New York

Economist Intelligence Unit
The Economist Group
750 Third Avenue
5th Floor
New York, NY 10017, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

Hong Kong

Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Geneva

Economist Intelligence Unit
Rue de l'Athénée 32
1206 Geneva
Switzerland

Tel: (41) 22 566 2470
Fax: (41) 22 346 93 47
E-mail: geneva@eiu.com

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Highlights

Editor: **Edward Bell**

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Outlook for 2013-17

- Regional upheaval, including the civil war in Syria and unrest in Egypt, poses risks for Israeli security. Israel will continue to respond cautiously to threats. A pre-emptive strike against Iran's nuclear facilities cannot be ruled out.
- The new government contains centrist elements, but is unlikely to push hard for a deal on the revived Israeli-Palestinian peace process for fear of precipitating a split. The government is unlikely to complete its four-year term.
- GDP growth will remain lacklustre in 2013-14 as Israel's export-dependent economy faces external headwinds. Growth will accelerate in 2015-17, helped by a recovery in the global economy and rising natural gas production.
- Monetary policy will be loose in 2013 as inflation remains subdued and the Bank of Israel (BOI) remains concerned over the strength of the currency. Policy will be tightened in 2014-17 as demand growth and inflation pick up.
- The fiscal deficit will stay high in 2013, despite the belated passage of tough tax and spending measures. By 2017 the deficit will have narrowed sharply.
- The New Israeli shekel will appreciate against the US dollar in 2013-17, reflecting the start of gas output and a strengthening of the external balance.
- Stronger export growth and the start of large-scale domestic natural gas production will underpin significant current-account surpluses in 2013-17.

Review

- The first round of the latest Israeli-Palestinian peace talks took place in Jerusalem on August 14th, a day after Israel released an initial batch of Palestinian prisoners as a goodwill gesture.
- Israel is preparing for a possible retaliatory attack by Syria or Hizbullah in the event that the US decides to take military action against the Syrian regime for its alleged use of chemical weapons.
- The first estimate of economic growth for the second quarter of 2013 showed GDP expanding at a higher than expected annualised rate of 5.1%, driven by strong increases in both private and public consumption.
- The consumer price index (CPI) rose by 2.2% year on year in July, near the centre of the BOI's 1 3% target range. However, the house price index, which is not part of the CPI, was 9.3% higher than a year previously.
- Reflecting its concern over an over-heated housing market, the BOI has announced fresh curbs on mortgage lending. Meanwhile, it left its key interest rate unchanged at 1.25% in September, for the fourth month in a row.
- The trade deficit increased to over US$2.2bn in July on the back of a 9% month-on-month dip in manufacturing exports.

Outlook for 2013-17

Political stability

After the election for the Knesset (parliament) on January 22nd, and a prolonged period of political manoeuvring, a new coalition government took office on March 18th. A new centrist party, Yesh Atid, headed by Yair Lapid, won 19 seats to emerge as the second-largest grouping after Likud-Beiteinu. Led by the prime minister, Binyamin Netanyahu, who remains in situ, Likud-Beiteinu is still the largest grouping in the 120-member Knesset, with 31 seats. However, it now controls 11 fewer seats than the combined total of its two constituent parties in the previous parliament, which will make it even harder for Mr Netanyahu to govern than in his previous term, particularly as Yesh Atid and an extreme-right party, Habeyit Hayehudi (Jewish Home), which controls 12 Knesset seats, have co-operated on several issues, and their combined strength equals that of Likud-Beiteinu.

Overall, the election resulted in a weakening of the right-wing parties, while the centre-left gained ground. The Labour Party won 15 seats, sufficient for it to secure third place. Altogether, the centre-left parties (Yesh Atid, Labour, Meretz, Hatnua, Kadima and the Arab parties) won 59 seats in the new Knesset, compared with the 61 seats secured by right-wing parties (Likud-Beiteinu, Jewish Home, Shas and United Torah Judaism).

Mr Netanyahu's government, which also includes Hatnua (six seats), comprises four parties and controls 68 seats, a sufficient margin to allow for individual defections but not for wider discontent. Despite the narrowness of the coalition compared with previous Israeli governments, there are significant ideological and personality clashes to be overcome. The ultra-Orthodox religious parties have been left out in the cold, which is rare for Israeli governments; a key theme of Mr Lapid's election campaign was the need for an end to the special privileges enjoyed by haredi (ultra-Orthodox) religious groups, and the coalition agreement includes a pledge to reform the current system, including a bill on the haredi military draft.

Domestic issues dominated the election campaign, with the electorate concerned over key socioeconomic issues, including the high cost of living. At the same time, a larger than anticipated fiscal deficit in 2012 has meant that that the government has been obliged to incorporate some politically unpopular tax rises and spending cuts into the delayed 2013-14 budget—which was finally approved by Congress on July 30th. Other challenges for the government will include policy on the Palestinians, Iran, bringing the ultra-Orthodox into public life and assuaging discontent over rising inequality.

Election watch

The parliamentary term is four years. Although the next general election is not due until 2017, no government has completed a full term since the 1984-88 government of national unity. In general, the country's low-threshold parliamentary system (only 2% of the national vote is needed to secure representation in the Knesset) encourages a multitude of political parties, reinforcing the difficulties of forging stable and long-lasting coalitions. The composition of the new Knesset—split almost equally between right-wing and centre-left blocs—means that the new coalition will be particularly prone to internal divisions, making it even more unlikely that the next government will last its full term.

International relations

The upheavals in the Arab world have alarmed many Israelis. The 1979 treaty between Israel and Egypt has secured a lengthy period of peace between the two countries. Much to Israel's relief, the Egyptian president elected in 2012, Mohammed Morsi—who represented the Muslim Brotherhood-affiliated Freedom and Justice Party—acted pragmatically in relation to Israel. However, the overthrow by the Egyptian military of Mr Morsi in early July, although probably welcomed by Israel, may produce a period of greater instability. In the meantime, the security chaos in the Sinai Peninsula, which borders southern Israel, is creating a major headache for the defence forces of both countries, although co-operation in this area is likely.

Although the centre-left parties strengthened their position in the Knesset in January, conservative elements retain a strong voice in the new coalition and remain firmly opposed to a more flexible negotiating stance on the Israeli-Palestinian peace process. After a three-year impasse, numerous visits by the US secretary of state, John Kerry, to the region finally led to a resumption of direct peace talks between the Israeli government and the Palestinian Authority in mid-August. However, given that there has been no change in the negotiating positions of both sides, substantive progress in the dialogue, even if it is sustained for some time, seems unlikely. In particular, the ability of Tzipi Livni—Israel's chief negotiator and a long-standing supporter of a peace deal with the Palestinians—to make any headway will be severely constrained by other elements in the coalition. Mr Lapid's views on the Palestinian issue do not seem to be far removed from those of Mr Netanyahu; he appears to support the maintenance of major Israeli settlements in the West Bank, as well as the retention of East Jerusalem. There are already unconfirmed reports in the media that Ms Livni is at risk of losing the support of Mr Netanyahu after offering too many concessions in the first two rounds of the talks.

Israel will be closely monitoring developments in Syria. It will seek to avoid being drawn directly into the Syrian conflict, but is preparing for possible retaliatory action by Syria, or its ally, Hizbullah, in the event that the US decides to take military action against the Syrian regime for its alleged use of chemical weapons. Most of Israel's intelligence and defence establishment is wary about the effectiveness of an Israeli strike on Iran, although Mr Netanyahu has remained outspoken in advocating the adoption of a tough position on Iran, warning against complacency from the international community following the election of a more moderate Iranian president in June.

Policy trends

Despite Mr Netanyahu's long-standing preference for tax cuts, low public spending and economic liberalisation, his previous government was obliged to increase welfare spending, following mass protests over social inequality. Concessions were also made to soften the impact on households of the higher cost of fuel and other sensitive items. In addition, the challenging fiscal situation has forced the new government to adopt some tax-raising and other austerity measures.

Faced with a rapidly expanding fiscal deficit, Mr Netanyahu has reversed some of the tax cuts made in recent years. Value-added tax (VAT) rose from 16% to 17% in September 2012, and to 18% in mid-2013. Additional tax increases have been incorporated in the budget for 2013-14. The recent appointment of a new director of the Government Companies Authority (GCA)—which is responsible for overseeing the operations of the country's 98 state-owned companies—signals Mr Netanyahu's desire to inject fresh life into the stalled privatisation programme. However, efforts to spur the sale of public-sector companies will make only modest headway, owing to stiff union resistance. A new taxation structure for the energy sector has been approved by the Knesset, based on the recommendations of the Sheshinski Committee, and will boost the government's share of hydrocarbons revenue to between 52% and 62%, from around 33% at present. The increase in revenue will help fiscal management and should also allow for a rise in government capital spending in the latter part of the forecast period, particularly once royalties and the interest income from the sovereign wealth fund that will be established to channel earnings from gas production start to flow in. A government announcement in mid-June that 60% of total gas production would be reserved for domestic use will have lifted some of the uncertainty that was impeding further development of the sector, but the gas firms are unlikely to be happy at the higher than expected allocation.

Fiscal policy

The budget deficit widened sharply in 2012, to NIS 39bn (US$10bn), more than one-third higher in nominal terms than the previous year. However, following a recent upward revision of GDP, the 2012 fiscal shortfall is now reported at 3.9% of GDP, down from a previously-estimated 4.2%. The delayed 2013–14 budget, which was finally approved by the Knesset at the end of July, incorporates a number of additional tax rises and spending cuts, including a politically-unpopular reduction in child allowances. In addition to a graduated rise in personal income tax rates, corporate income tax will rise from 25% this year to 26.5% in 2014. The government forecasts a rise in the budget deficit to 4.7% of GDP this year, followed by a decline to 3% of GDP in 2014. However, helped by a combination of higher tax revenue and expenditure constraint (monthly spending was limited to one-twelfth of the previous year's programmed level until the Knesset approved the new budget), the budget deficit in the first seven months of 2013 was lower than in the same period of last year. As a result, The Economist Intelligence Unit expects the fiscal deficit to amount to around 3.7% of GDP in the whole of this year, 1 percentage point below the official target. The fiscal gap will narrow steadily in 2014-16, moving into balance by 2017. The improvement will reflect an expected rebound in tax revenue, helped by a steady recovery in the global economy and mounting income from hydrocarbons royalties.

Monetary policy

Since the Bank of Israel (BOI, the central bank) started its easing cycle in September 2011 in response to a deteriorating global economic outlook, rates have been reduced by a cumulative 200 basis points, taking the policy rate to 1.25%, following two interest-rate cuts in May. The monetary easing cycle may have further to run given the subdued near-term outlook for inflation, lacklustre economic growth and the imposition of greater fiscal austerity, and the central bank's concern over the New Israeli shekel's strength. The currency's strength has prompted the central bank to announce a new programme of foreign-currency purchases to neutralise the impact of gas revenue on the external accounts, starting with US$2.1bn in purchases in 2013. The BOI also announced additional curbs on mortgage lending in August, in response to rapidly rising house prices. Monetary policy will remain loose in the second half of 2013, before the central bank begins to tighten policy in 2014, in response to accelerating economic growth and a gradual pick-up in inflation. The base rate will climb to around 4% in 2016-17. The eventual appointment of a new BOI governor to replace the acting central bank head, Karnit Flug, (who took over following the departure of Stanley Fischer at the end of June), should not lead to a dramatic shift in policy, particularly with a monetary policy committee firmly in place.

International assumptions

	2012	2013	2014	2015	2016	2017
Economic growth (%)						
US GDP	2.8	1.6	2.6	2.4	2.5	2.4
OECD GDP	1.5	1.2	2.1	2.1	2.2	2.2
World GDP	2.2	2.0	2.7	2.8	2.8	2.8
World trade	2.4	3.7	5.2	5.4	5.5	5.6
Inflation indicators (% unless otherwise indicated)						
US CPI	2.1	1.5	2.2	2.2	2.3	2.3
OECD CPI	2.2	1.6	2.1	2.2	2.3	2.1
Manufactures (measured in US$)	-0.6	-3.8	-0.1	1.2	1.8	1.9
Oil (Brent; US$/b)	112.0	107.0	104.8	107.3	103.8	97.0
Non-oil commodities (measured in US$)	-10.7	-6.7	-1.3	0.7	1.4	3.0
Financial variables						
US$ 3-month commercial paper rate (av; %)	0.2	0.1	0.2	0.3	1.2	2.2
Exchange rate NIS:US$ (av)	3.9	3.7	3.6	3.5	3.4	3.4
Exchange rate US$:€ (av)	1.29	1.30	1.27	1.26	1.26	1.27

Economic growth

Real GDP growth slackened to 3.3% in 2012, the weakest performance since 2009, albeit still respectable by developed-economy standards. Exports are continuing to struggle in the face of the weakness in Israel's main overseas markets, especially Europe. The first official estimate of growth for the first half of 2013 showed GDP expanding at an annualised rate of 3.4% (with a surprisingly high 5.1% expansion in the second quarter). The recent spurt in growth is partly explained by consumers bringing forward purchases before planned tax rises, as well as the start of gas production at the Tamar field. Although consumer spending is likely to moderate in the second half of this year, we now expect real GDP to expand by 3% in the whole of 2013, compared with our previous forecast of 2.7%. Given an increasing tax burden, domestic demand will be constrained in 2014, although relatively low unemployment will ensure that private consumption continues to expand. Rising gas output, and its mitigation of energy import needs, will also provide a boost to growth over the forecast period.

Although the level of investment will remain sensitive to international developments, the exploitation of large gas deposits in the Mediterranean (the Tamar field came on stream in April)—which will require significant investment in pipelines, terminals and associated infrastructure—will provide a fillip over the medium term, although it will also draw in imports. Israel's dynamic high-tech sector will also be a key investment driver. In addition, residential construction will grow, albeit at more modest rates, helped by government initiatives to expand the housing stock.

With exports accounting for around 40% of GDP, foreign demand will remain a critical determinant of overall growth. Export performance in 2013 will be held back by a further contraction in Europe; the US and Europe, in combination, absorb nearly three-fifths of Israel's merchandise exports. However, Israel has developed export markets in the more robust emerging economies, including China—which, even taking into accounting a recent slowdown in growth, will continue as a group to outperform developed economies. The external contribution to GDP will increase towards the end of the forecast period as an increase in the domestic supply of natural gas leads to a reduction in the net energy import bill, and exports of liquefied natural gas are tentatively set to begin from 2017 (although this will depend on market conditions and the construction of expensive infrastructure). Overall, we expect GDP to expand by an average of 4.5% a year in 2014-17, with particularly strong growth in 2016-17.

Economic growth

%	2012[a]	2013[b]	2014[b]	2015[b]	2016[b]	2017[b]
GDP	3.3	3.0	3.2	4.1	4.9	6.0
Private consumption	3.2	3.1	3.2	3.9	4.0	3.8
Government consumption	3.0	2.6	2.2	2.1	2.1	1.9
Gross fixed investment	3.5	-2.5	5.5	7.0	8.8	8.0
Exports of goods & services	1.0	-1.2	5.5	6.9	8.1	10.7
Imports of goods & services	2.3	-3.0	6.1	6.8	6.9	5.9
Domestic demand	3.7	2.4	3.3	4.1	4.5	4.3
Agriculture	2.2[c]	2.0	2.1	2.1	2.0	1.9
Industry	4.0[c]	5.5	5.0	5.7	6.7	8.0
Services	3.0[c]	1.9	2.3	3.4	4.1	5.1

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Economist Intelligence Unit estimates.

Inflation

Sluggish economic growth will help to contain demand-side pressures on inflation in the short term. Together with some moderation in house price growth—helped by a further recent tightening in mortgage lending criteria—and subdued global commodity prices, we expect inflation to average 1.9% in 2013, near the mid-point of the central bank's target range of 1-3%, despite an increase in purchase taxes in mid-2013, which has pushed up price growth mid-year. Inflationary pressures will pick up from 2014 onwards as domestic demand starts to grow more strongly. However, a progressive tightening in monetary policy, together with an appreciation in the shekel, will help to keep inflation within the target range. Persistent overheating of the housing market remains a risk and may require further macroprudential measures.

Exchange rates

In an attempt to reduce upward pressure on the shekel, the authorities have introduced a number of measures aimed at curbing the influx of "hot money" in recent years, with modest success. However, the relative robustness of Israel's economy and the expectation of gas output (which began in April) have prompted a renewed strengthening of the currency and led the central bank to intervene directly in April with US dollar purchases for the first time since mid‑2011 and in May to announce a programme to neutralise the impact of the gas revenue on the external position through foreign-currency purchases. Nevertheless, the currency will still appreciate in 2013 and beyond as rising domestic gas production benefits the external position, although the authorities may attempt further dollar purchases and other measures to curb upward pressure on the currency.

External sector

Despite a sluggish recovery in demand in Israel's main export markets, reduced import costs resulting from weak domestic demand, lower commodity prices and the flow of domestic gas supplies will push down the merchandise trade deficit in 2013. Business services exports will expand, as will the tourism sector; the number of arrivals reached a new high in the first half of this year. We expect the current account to return more significant surpluses from 2014 as the recovery in export growth accelerates and import costs are held down by a steady increase in domestic gas supplies. The external balance will continue to benefit from more robust growth in goods and services exports and lower energy imports over the remainder of the forecast period, with exports of gas making an increasing contribution from 2016-17 onwards. Despite a widening of the primary income deficit, reflecting rising dividend payments to international energy firms with stakes in the offshore gas sector, we expect the current-account surplus to reach 5.8% of GDP in 2017.

Forecast summary

Forecast summary
(% unless otherwise indicated)

	2012[a]	2013[b]	2014[b]	2015[b]	2016[b]	2017[b]
Real GDP growth	3.3	3.0	3.2	4.1	4.9	6.0
Industrial production growth	3.7	4.6	6.0	7.7	9.2	10.4
Gross agricultural production growth	2.2[c]	2.0	2.1	2.1	2.0	1.9
Unemployment rate (av)	6.9	7.3	7.2	7.1	6.6	6.4
Consumer price inflation (av)	1.7	1.9	2.3	2.6	2.4	2.1
Consumer price inflation (end-period)	1.6	2.1	2.3	2.3	2.2	2.0
Lending rate	5.2	4.3	5.0	6.0	6.0	6.3
Government balance (% of GDP)	-3.9	-3.7	-2.9	-1.8	-0.6	0.1
Exports of goods fob (US$ bn)	62.3	59.5	64.2	71.4	81.4	95.7
Imports of goods fob (US$ bn)	71.7	65.4	67.9	73.6	81.0	87.3
Current-account balance (US$ bn)	0.6	5.8	8.3	11.0	14.6	23.3
Current-account balance (% of GDP)	0.2	2.0	2.7	3.3	4.0	5.8
External debt (end-period; US$ bn)	93.9	96.2	97.0	98.1	99.8	101.4
Exchange rate NIS:US$ (av)	3.86	3.65	3.63	3.49	3.43	3.36
Exchange rate NIS:US$ (end-period)	3.73	3.64	3.55	3.45	3.41	3.33
Exchange rate NIS:€ (av)	4.96	4.74	4.61	4.40	4.32	4.26
Exchange rate NIS:¥100 (av)	4.83	3.72	3.56	3.39	3.36	3.33

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Economist Intelligence Unit estimates.

Data and charts

Annual data and forecast

	2008[a]	2009[a]	2010[a]	2011[a]	2012[a]	2013[b]	2014[b]
GDP							
Nominal GDP (US$ bn)	213.1	205.8	232.0	258.2	257.6	285.3	313.4
Nominal GDP (NIS bn)	765	809	866	924	993	1,042	1,137
Real GDP growth (%)	5.2	1.1	3.9	4.6	3.3	3.0	3.2
Expenditure on GDP (% real change)							
Private consumption	1.6	2.1	5.1	3.8	3.2	3.1	3.2
Government consumption	2.5	2.5	3.6	2.5	3.0	2.6	2.2
Gross fixed investment	9.7	-5.2	9.6	15.7	3.5	-2.5	5.5
Exports of goods & services	6.2	-11.0	14.0	7.3	1.0	-1.2	5.5
Imports of goods & services	2.3	-13.7	15.3	10.5	2.3	-3.0	6.1
Origin of GDP (% real change)							
Agriculture	0.8[c]	9.5[c]	0.0[c]	2.0[c]	2.2[c]	2.0	2.1
Industry	4.4[c]	-3.5[c]	5.7[c]	4.4[c]	4.0[c]	5.5	5.0
Services	5.7[c]	3.0[c]	3.2[c]	4.8[c]	3.0[c]	1.9	2.3
Population and income							
Population (m)	7.4	7.5	7.6	7.8	7.9	8.0	8.2
GDP per head (US$ at PPP)	29,247[c]	29,316[c]	30,336[c]	31,793[c]	32,823[c]	33,685	34,663
Recorded unemployment (av; %)	7.6	9.4	8.3	7.0	6.9	7.3	7.2
Fiscal indicators (% of GDP)							
General government revenue	28.1	25.0	25.5	25.6	24.7	25.2	24.7
General government expenditure	30.2	30.0	29.0	28.7	28.6	28.9	27.5
General government balance	-2.1	-4.9	-3.5	-3.1	-3.9	-3.7	-2.9
Public debt	71.5	73.8	70.0	68.5	66.9	67.2	64.7
Prices and financial indicators							
Exchange rate NIS:US$ (end-period)	3.80	3.78	3.55	3.82	3.73	3.64	3.55
Exchange rate NIS:€ (end-period)	5.29	5.44	4.74	4.94	4.89	4.65	4.47
Consumer prices (av; %)	4.6	3.3	2.7	3.5	1.7	1.9	2.3
Stock of money M1 (% change)	14.2	50.8	12.1	4.0	5.0	9.8	9.9
Stock of money M2 (% change)	9.8	17.7	3.9	9.6	8.4	7.7	11.1
Lending interest rate (av; %)	6.1	3.7	4.5	5.5	5.2	4.3	5.0
Current account (US$ m)							
Trade balance	-6,410	733	-1,954	-8,188	-9,346	-5,820	-3,654
Goods: exports fob	58,012	46,806	56,414	64,294	62,321	59,545	64,214
Goods: imports fob	-64,422	-46,073	-58,368	-72,482	-71,667	-65,365	-67,868
Services balance	4,965	4,994	5,996	6,872	9,838	11,311	12,310
Primary income balance	-4,021	-5,114	-5,152	-4,350	-8,020	-7,830	-8,240
Secondary income balance	8,482	7,402	8,425	8,732	8,137	8,155	7,906
Current-account balance	3,016	8,015	7,315	3,066	609	5,817	8,321
External debt (US$ m)							
Debt stock	88,392	94,639	107,814	104,532	93,939	96,180	96,968
Debt service paid	11,763	9,951	10,522	16,361[c]	17,989[c]	12,322	13,673
Principal repayments	5,600	4,590	4,857	9,735[c]	11,557[c]	6,531	8,042
Interest	6,163	5,361	5,665	6,626[c]	6,432[c]	5,791	5,630
International reserves (US$ m)							
Total international reserves	42,513	60,611	70,907	74,874	75,908	79,160	83,213

[a] Actual. [b] Economist Intelligence Unit forecasts. [c] Economist Intelligence Unit estimates.
Source: IMF, International Financial Statistics.

Quarterly data

	2011 3 Qtr	4 Qtr	2012 1 Qtr	2 Qtr	3 Qtr	4 Qtr	2013 1 Qtr	2 Qtr
Output								
GDP at constant 2005 prices (NIS bn)	230.6	230.6	229.9	230.2	237.9	237.7	236.5	241.2
Real GDP (% change, year on year)	5.9	3.7	4.0	2.9	3.2	3.1	2.9	4.8
State of economy index (% change, year on year)[a]	6.0	40.6	2.8	-22.6	37.0	-22.9	-23.1	1.8
Revenue (2004=100)[a]	100.4	99.5	100.5	101.0	116.5	101.0	103.0	104.4
Index of goods exports (2005=100)[a]	96.3	100.8	87.9	83.4	119.8	84.8	92.5	91.1
Employment and prices								
Industrial employment (2000=100)	108	108	109	109	108	109	108	n/a
Employment ('000)	3,257	3,269	3,307	3,352	3,394	3,383	3,417	3,434
Unemployment rate (% of the labour force)	7.6	6.8	6.7	6.6	7.0	7.1	6.5	6.2
Consumer prices incl VAT (2006=100)	98.8	98.9	99.0	100.0	100.6	100.5	100.4	101.2
Consumer prices incl VAT (% change, year on year)	3.3	2.5	1.8	1.6	1.8	1.6	1.4	1.2
Wholesale prices, manufacturing output (2005=100)	96.3	96.9	98.4	99.6	100.2	101.8	101.6	99.7
Wholesale prices, manufacturing output (% change, year on year)	8.6	7.5	4.8	3.5	4.0	5.0	3.3	0.0
Financial indicators								
Exchange rate NIS:US$ (av)	3.548	3.722	3.771	3.824	3.988	3.841	3.708	3.626
Exchange rate NIS:US$ (end-period)	3.712	3.821	3.715	3.923	3.912	3.733	3.648	3.618
Deposit rate (av; %)	2.8	2.6	2.4	2.3	2.2	2.0	1.8	n/a
Lending rate (av; %)	5.8	5.6	5.3	5.3	5.1	4.9	4.5	n/a
Treasury bill rate, 1 year (av; %)	3.2	2.7	2.5	2.4	2.1	2.0	1.7	1.5
M1 (end-period; NIS bn)[b]	115.4	114.9	114.2	120.3	124.9	125.5	128.7	132.7
M1 (% change, year on year)	1.8	1.6	-0.4	3.1	8.3	9.2	12.7	10.3
M2 (end-period; NIS bn)[b]	476.5	486.2	494.9	500.1	515.7	522.9	528.9	n/a
M2 (% change, year on year)	11.7	12.0	9.5	8.5	8.2	7.6	6.9	n/a
Tel Aviv 100 stockmarket index (end-period; Jan1st 1992=100)	969.8	978.5	1,032.5	969.9	1,054.6	1,049.1	1,100.0	1,069.6
Sectoral trends								
Mining production (2004=100)	111.4	110.3	77.6	96.6	104.0	88.3	96.1	129.4
Manufacturing production (2004=100)	99.9	101.6	100.5	105.1	107.2	106.1	102.3	101.9
Tourist arrivals ('000)	691.0	732.8	637.2	807.2	724.5	716.8	602.4	824.9
Construction completed ('000 sq metres)	2,297	2,355	2,320	2,516	2,284	2,300	2,383	n/a
Residential ('000 sq metres)	1,628	1,679	1,732	1,846	1,770	1,905	1,807	n/a
Foreign trade (US$ m)								
Exports fob	14,605	13,647	13,891	13,719	13,094	13,265	14,318	14,574
Diamonds, polished	2,607	2,091	2,581	2,300	1,559	1,922	2,430	n/a
Imports cif	-18,529	-17,828	-19,120	-18,373	-17,345	-17,432	-17,126	-17,746
Trade balance	-3,925	-4,182	-5,229	-4,654	-4,252	-4,168	-2,808	-3,172
Foreign payments (US$ m)								
Merchandise trade balance fob-fob	-1,992	-2,802	-3,724	-1,740	-1,926	-1,956	-1,393	n/a
Services balance	702	2,254	1,958	3,025	1,567	3,288	2,996	n/a
Primary income balance	-848	-1,005	-1,590	-2,325	-2,024	-2,081	-1,835	n/a
Net transfer payments	2,157	2,220	2,337	1,982	2,109	1,949	2,053	n/a
Current-account balance	20	666	-1,019	942	-274	1,201	1,822	n/a
Reserves excl gold (end-period)	76,327	74,874	76,997	75,119	76,225	75,908	76,967	78,221

[a] Seasonally adjusted. [b] Bank of Israel, average of end-month data.

Sources: Bank of Israel; IMF, International Financial Statistics; Israel Central Bureau of Statistics, Monthly Bulletin of Statistics.

Monthly data

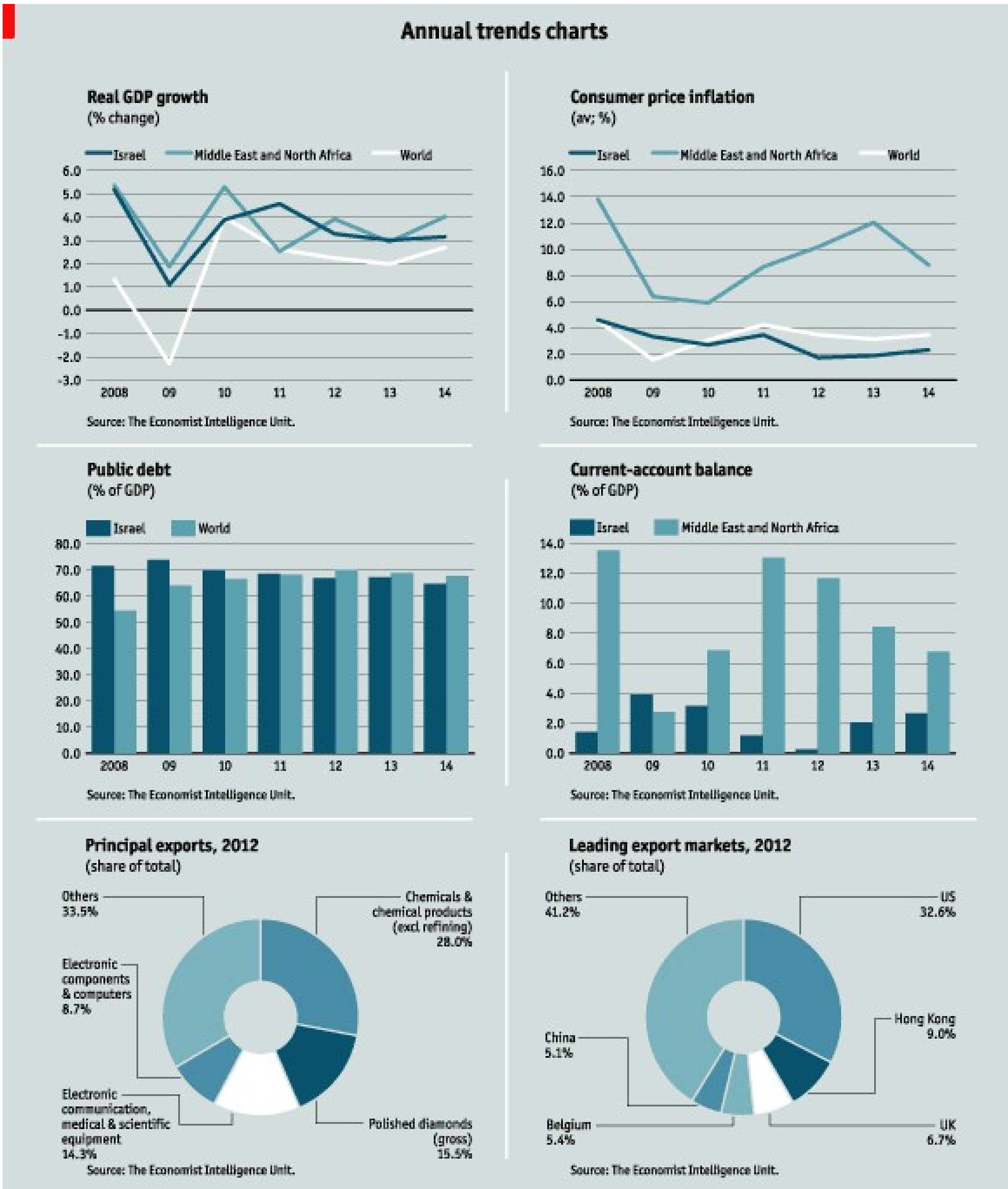
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate NIS:US$ (av)												
2011	3.58	3.66	3.56	3.43	3.47	3.42	3.42	3.54	3.68	3.67	3.73	3.77
2012	3.81	3.74	3.76	3.75	3.83	3.89	3.99	4.02	3.96	3.85	3.89	3.78
2013	3.74	3.69	3.70	3.62	3.63	3.63	3.61	n/a	n/a	n/a	n/a	n/a
Exchange rate NIS:€ (av)												
2011	4.79	4.99	4.99	4.97	4.98	4.92	4.88	5.09	5.09	5.03	5.05	4.97
2012	4.92	4.95	4.97	4.94	4.90	4.88	4.91	4.98	5.07	5.00	5.00	4.96
2013	4.97	4.94	4.79	4.71	4.72	4.79	4.72	n/a	n/a	n/a	n/a	n/a
Real effective exchange rate (2000=100; CPI-basis)												

2011	90.43	88.04	89.15	91.03	90.03	91.30	90.60	87.21	86.04	87.09	85.93	85.91
2012	85.53	85.77	85.63	86.22	85.39	84.69	82.62	81.88	81.69	83.44	82.81	84.61
2013	85.54	86.73	88.19	89.85	89.67	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (end-period; NIS bn)												
2011	656.4	660.9	663.9	670.4	674.3	678.9	683.9	687.6	690.4	696.2	697.8	700.8
2012	705.5	707.3	706.2	707.7	711.3	715.8	720.0	720.1	722.5	730.6	732.5	735.9
2013	739.7	742.3	744.9	747.6	748.2	749.8	n/a	n/a	n/a	n/a	n/a	n/a
Budget revenue (NIS bn)												
2011	21.1	18.7	25.8	20.3	21.2	17.2	21.3	17.9	20.6	21.2	19.1	20.4
2012	24.1	17.6	22.1	22.4	21.2	18.2	22.1	19.2	23.4	21.1	18.6	21.6
2013	22.3	17.8	24.4	21.5	23.9	21.2	25.5	n/a	n/a	n/a	n/a	n/a
Budget expenditure (NIS bn)												
2011	16.5	20.5	25.9	21.1	21.3	21.0	20.6	20.8	21.8	25.1	19.7	33.2
2012	17.5	20.5	26.2	24.8	22.1	23.5	23.5	23.4	25.5	23.7	21.4	34.1
2013	19.2	21.9	26.9	24.2	22.5	24.3	25.6	n/a	n/a	n/a	n/a	n/a
Budget balance (NIS bn)												
2011	4.6	-1.8	-0.1	-0.9	-0.1	-3.8	0.7	-2.9	-1.3	-3.9	-0.6	-12.8
2012	6.6	-2.9	-4.1	-2.4	-0.9	-5.2	-1.4	-4.3	-2.1	-2.6	-2.7	-12.5
2013	3.0	-4.1	-2.5	-2.6	1.3	-3.1	-0.1	n/a	n/a	n/a	n/a	n/a
M1 (end-period; % change, year on year)												
2011	8.6	8.1	4.9	4.8	3.9	7.6	0.7	4.2	0.6	0.8	2.3	1.6
2012	-1.9	0.0	0.6	4.5	3.0	1.8	6.9	6.8	11.2	10.3	8.7	8.7
2013	10.6	12.2	15.2	8.8	10.9	11.4	14.3	n/a	n/a	n/a	n/a	n/a
M2 (end-period; % change, year on year)												
2011	5.5	6.9	7.5	6.3	8.4	9.3	9.2	12.5	13.3	14.0	11.6	10.5
2012	10.6	8.8	8.9	10.6	6.9	7.9	9.3	8.2	7.2	6.2	8.3	8.2
2013	6.0	6.8	7.8	6.6	8.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Manufacturing production index (% change, year on year)												
2011	7.4	5.7	8.8	-10.3	-1.4	-6.3	-2.5	2.9	18.2	-1.4	5.2	3.9
2012	3.0	0.3	-6.0	14.2	7.4	4.9	10.2	10.3	1.3	7.1	6.1	0.3
2013	2.4	5.1	-1.8	0.6	-7.0	-2.3	n/a	n/a	n/a	n/a	n/a	n/a
Domestic trade & services index (seasonally adjusted; % change, year on year)												
2011	4.2	3.2	2.0	3.1	5.7	3.7	6.1	-0.7	-1.7	-3.0	-0.2	-2.0
2012	-0.1	0.0	-1.8	0.6	1.3	-2.6	0.7	2.1	0.3	4.2	0.0	0.5
2013	0.8	3.4	3.1	4.5	2.0	3.7	n/a	n/a	n/a	n/a	n/a	n/a
Average monthly wages (% change, year on year)												
2011	0.5	-1.1	-0.1	1.6	-0.1	-0.8	0.1	-0.9	2.4	1.8	0.6	1.1
2012	-0.2	1.5	-0.8	0.1	3.2	2.2	1.9	1.8	-0.4	1.3	1.3	3.2
2013	1.5	1.5	1.8	2.8	0.5	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Deposit interest rate (%)												
2011	1.9	2.1	2.2	2.5	2.6	2.8	2.8	2.8	2.9	2.6	2.6	2.5
2012	2.5	2.3	2.3	2.3	2.3	2.3	2.2	2.1	2.2	2.1	2.0	1.9
2013	1.8	1.7	1.8	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Money market rate (end-period; %)												
2011	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.2	0.3	0.4	0.4
2012	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2
2013	0.2	0.2	0.2	0.2	0.1	0.1	n/a	n/a	n/a	n/a	n/a	n/a
Long-term bond yield (av; %)												
2011	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
2012	n/a	n/a	1.2	1.1	1.1	1.0	0.7	0.5	0.6	0.4	0.4	0.4
2013	0.4	0.4	0.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Tel Aviv-100 stockmarket index (end-period; Dec 1991=100)												
2011	1,204	1,190	1,208	1,195	1,152	1,113	1,118	1,013	970	1,021	984	978
2012	1,014	990	1,032	1,066	981	970	997	1,000	1,055	1,076	1,090	1,049
2013	1,047	1,091	1,100	1,083	1,108	1,070	1,094	n/a	n/a	n/a	n/a	n/a
Consumer prices (av; % change, year on year)												
2011	3.6	4.2	4.3	4.0	4.1	4.2	3.4	3.4	2.9	2.7	2.6	2.2
2012	2.0	1.7	1.9	2.1	1.6	1.0	1.4	1.9	2.1	1.8	1.4	1.6
2013	1.5	1.5	1.3	0.8	0.9	2.0	2.2	n/a	n/a	n/a	n/a	n/a
Core consumer prices (av; % change, year on year; excl housing, fruit & vegetables)												
2011	2.3	2.9	3.3	3.0	3.1	3.5	2.8	2.9	2.9	2.6	2.3	1.6
2012	1.3	1.0	1.1	1.5	1.0	0.4	0.5	1.2	1.3	1.3	1.0	1.3
2013	1.0	1.1	0.8	0.0	0.3	1.4	1.7	n/a	n/a	n/a	n/a	n/a
Wholesale prices (av; % change, year on year)												

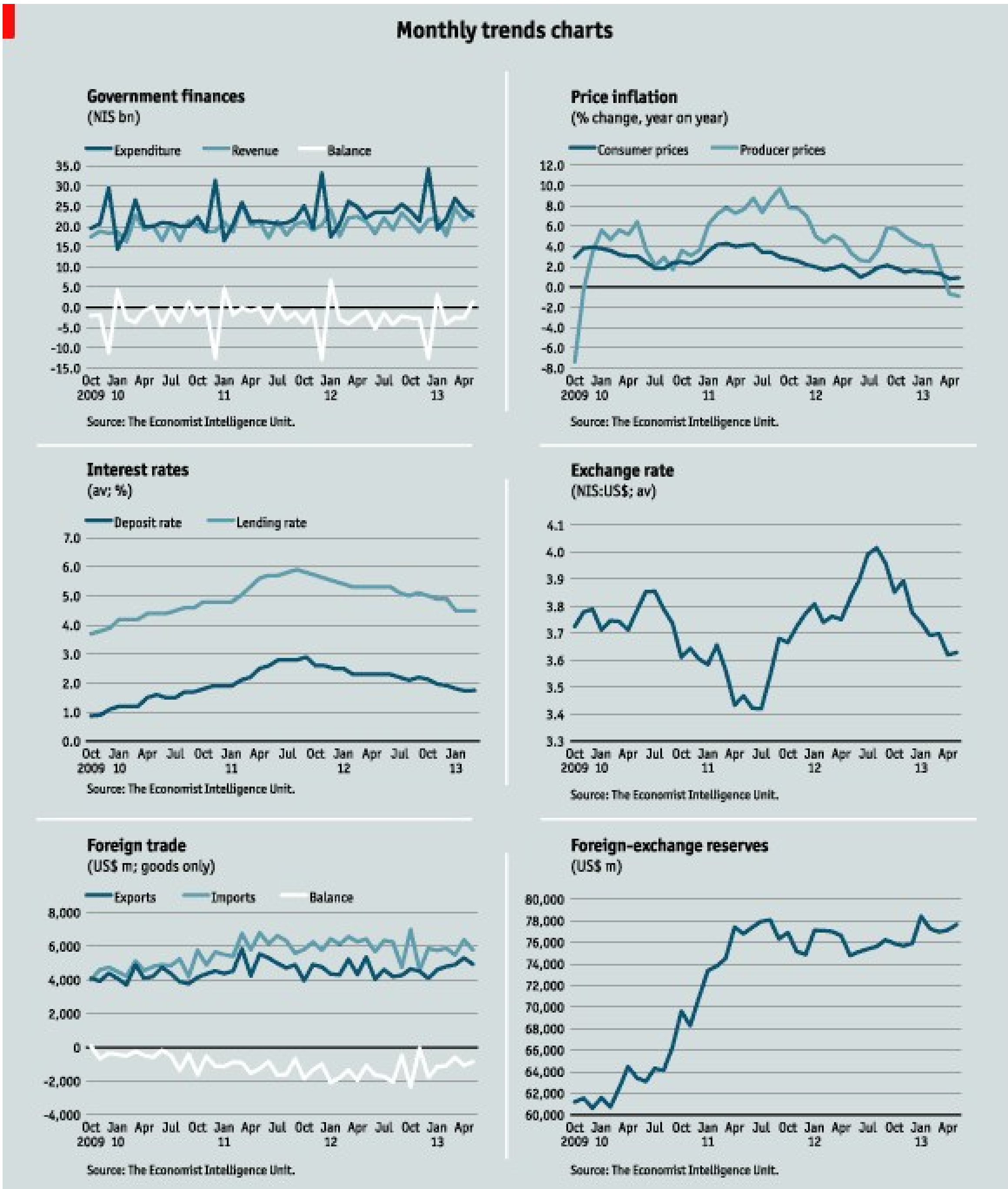
2011	6.2	7.2	7.8	7.3	7.7	8.7	7.3	8.7	9.7	7.8	7.8	7.0
2012	5.0	4.4	5.0	4.6	3.3	2.6	2.5	3.6	5.9	5.7	4.9	4.4
2013	4.0	4.1	1.7	-0.7	-0.9	1.7	2.7	n/a	n/a	n/a	n/a	n/a
Total exports fob (US$ m)												
2011	4,377	4,530	5,848	4,252	5,539	5,307	4,989	4,712	4,905	3,964	4,911	4,772
2012	4,354	4,310	5,228	4,322	5,351	4,045	4,617	4,198	4,278	4,653	4,523	4,088
2013	4,614	4,799	4,905	5,305	4,938	4,331	4,433	n/a	n/a	n/a	n/a	n/a
Total imports cif (US$ m)												
2011	5,507	5,396	6,753	5,792	6,794	6,148	6,628	6,316	5,586	5,816	6,252	5,761
2012	6,439	6,115	6,566	6,263	6,430	5,680	6,340	6,253	4,752	6,987	4,578	5,868
2013	5,751	5,887	5,489	6,383	5,784	5,579	6,668	n/a	n/a	n/a	n/a	n/a
Trade balance fob-cif (US$ m)												
2011	-1,130	-866	-904	-1,540	-1,255	-840	-1,639	-1,604	-681	-1,852	-1,341	-989
2012	-2,085	-1,806	-1,338	-1,941	-1,078	-1,635	-1,723	-2,055	-474	-2,334	-54	-1,779
2013	-1,137	-1,088	-584	-1,077	-846	-1,248	-2,235	n/a	n/a	n/a	n/a	n/a
Foreign-exchange reserves excl gold (end-period; US$ m)												
2011	73,396	73,793	74,526	77,408	76,802	77,412	77,942	78,077	76,327	76,900	75,153	74,874
2012	77,114	77,099	76,997	76,628	74,792	75,119	75,386	75,617	76,225	75,896	75,672	75,908
2013	78,412	77,275	76,967	77,146	77,650	78,221	n/a	n/a	n/a	n/a	n/a	n/a

Sources: IMF, International Financial Statistics; Haver Analytics.

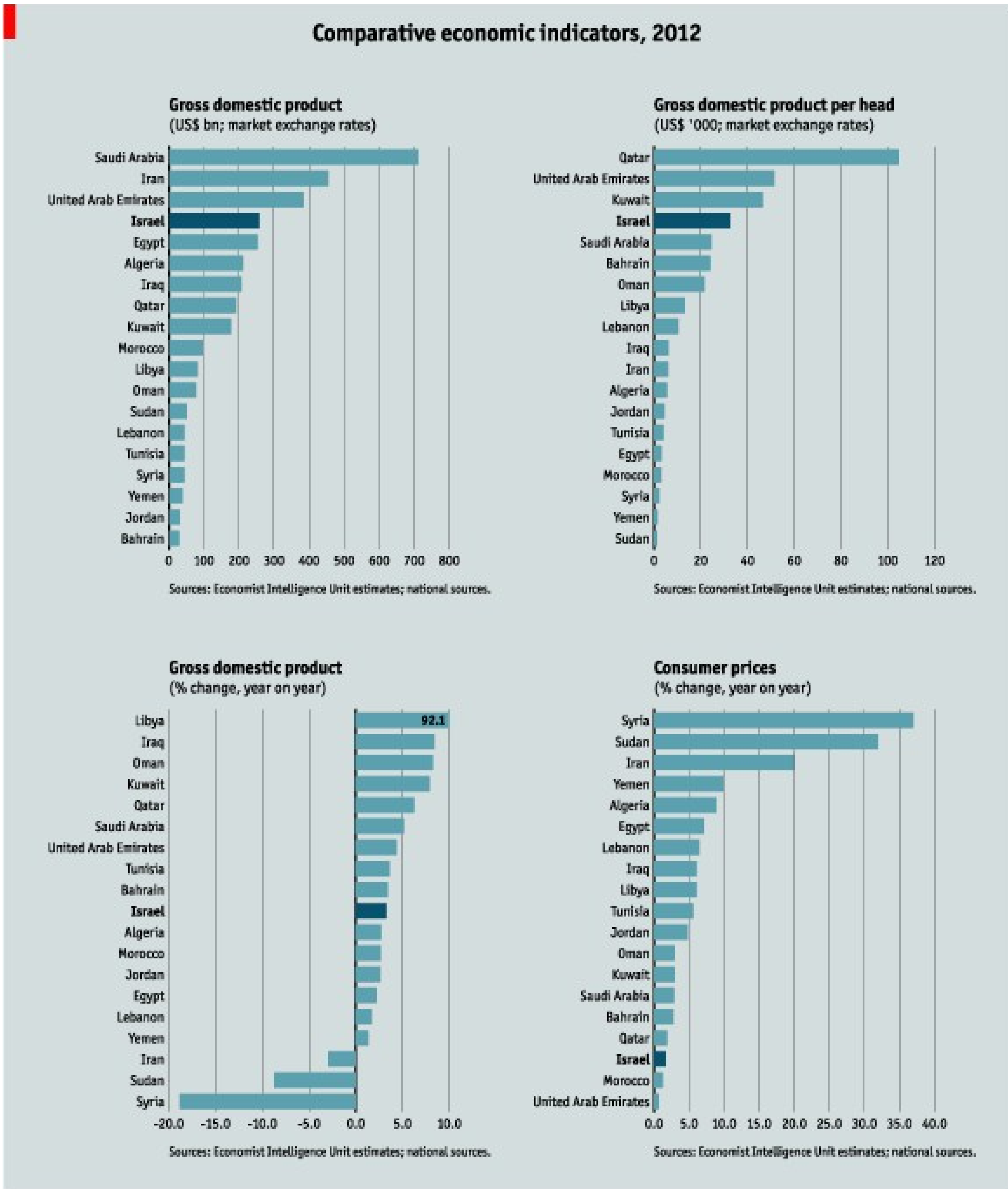
Annual trends charts



Monthly trends charts



Comparative economic indicators



Basic data

Land area

20,325 sq km. This does not include the Gaza Strip, the West Bank, East Jerusalem and the Golan Heights, areas occupied by Israel in the 1967 and 1973 Middle East wars

Population

7,905,600 (mid-2012; Central Bureau of Statistics estimate), of whom 5,960,300 are Jewish

Main towns

Population at the end of 2007 (provisional data):

Jerusalem (a): 746,300

Tel Aviv-Yafo (b): 390,400

Haifa: 265,900

Rishon le Zion: 224,500

Ashdod: 207,300

Petah Tiqwa: 188,900

Beersheba: 186,600

Holon: 169,000

(a) Including East Jerusalem. (b) Municipality of the city of Tel Aviv-Yafo only, does not include population of greater Tel Aviv conurbation.

Climate

Mediterranean

Weather in Jerusalem (altitude 757 metres)

Hottest month, August, 19-29°C (average daily minimum and maximum); coldest month, January, 6-12°C; driest months, May-September, 0 mm average rainfall; wettest month, January, 133 mm average rainfall

Languages

Hebrew and then Arabic are the official languages; however, English and Russian are also widely spoken

Measures

Metric system. The metric dunum (1,000 sq metres) is also in use

Currency

The New Israeli shekel (NIS) became the official currency on January 1st 1986. 1,000 old shekels=NIS 100. There are 100 agorot in NIS 1

Time

2 hours ahead of GMT

Fiscal year

January 1st-December 31st

Public holidays

All religious holidays begin at sunset the day before. Some institutions also close the day before the major religious festivals. February 24th 2013 (Purim; banks only); March 26th-April 1st (Passover; first and last days are usually public holidays); April 16th (Independence Day); May 15th (Shavuot); July 16th (Tisha b'Av; banks only); September 5th (Jewish New Year); September 14th (Yom Kippur); September 19th (Sukkot starts); September 25th (Sukkot ends); September 26th (Simchat Torah); November 28th (Chanukah; school holiday)

Political structure

Official name

State of Israel

National legislature

Unicameral Knesset of 120 members directly elected by proportional representation for a four-year term. Universal direct suffrage over the age of 18

National elections

Parliamentary election: January 22nd 2013; next election scheduled for January 2017

Head of state

President (largely a figurehead), elected by Knesset majority for a seven-year term. Currently Shimon Peres, who was elected in July 2007

National government

Cabinet, responsible to the legislature; the prime minister, Binyamin Netanyahu, leads the new coalition government, comprising Likud-Beiteinu, Yesh Atid, Habeyit Hayehudi and Hatnua, which was sworn in on March 18th 2013

Main political parties

Likud-Beiteinu (right-wing, formed from a merger between Likud and Yisrael Beiteinu); Yesh Atid (centrist); Labour (left-wing); Shas (a right-wing religious party); Habeyit Hayehudi (Jewish Home, right-wing); United Torah Judaism (an ultra-Orthodox right-wing party that includes Agudat Israel and Degal Hatora); Hatnua (centre-left); Meretz (left-wing); Kadima (centrist); United Arab List; Hadash (communist, predominantly Arab); National Democratic Assembly (Arab)

Key ministers

Prime minister (& foreign affairs & public diplomacy & diaspora affairs): Binyamin Netanyahu (Likud-Beiteinu)

Agriculture & rural development: Yair Shamir (Likud-Beiteinu)

Communications (& home front defence): Gilad Erdan (Likud-Beiteinu)

Culture & sport: Limor Livnat (Likud-Beiteinu)

Defence: Moshe Yaalon (Likud-Beiteinu)

Economics & trade (& religious services): Naftali Bennett (Habeyit Hayehudi)

Education: Shai Piron (Yesh Atid)

Energy & water (& regional co-operation & development of the Negev & Galil): Silvan Shalom (Likud Beiteinu)

Environmental protection: Amir Peretz (Hatnua)

Finance: Yair Lapid (Yesh Atid)

Health: Yael German (Yesh Atid)

Housing & construction: Uri Yehuda Ariel (Habeyit Hayehudi)

Immigrant absorption: Sofa Landver (Likud-Beiteinu)

Intelligence (& international relations & strategic affairs): Yuval Steinetz (Likud-Beiteinu)

Interior: Gideon Saar (Likud-Beiteinu)

Internal security: Yitzhak Aharonovitch (Likud Beiteinu)

Justice: Tzipi Livni (Hatnua)

Science & technology: Yaakov Perry (Yesh Atid)

Tourism: Uzi Landau (Likud-Beiteinu)

Transportation, road safety & national infrastructure: Yisrael Katz (Likud-Beiteinu))

Welfare & social services: Meir Cohen (Yesh Atid)

Speaker of the Knesset

Yuli Edelstein (Likud-Beiteinu)

Central bank governor

Karnit Flug (acting)

Recent analysis

Generated on October 8th 2013

The following articles were published on our website in the period between our previous forecast and this one, and serve here as a review of the developments that shaped our outlook.

Politics

Forecast updates

August 8, 2013: International relations

Israeli soldiers injured after venturing into Lebanon

Event

Four Israeli soldiers have been injured after venturing into southern Lebanese territory and setting off a land mine.

Analysis

Government agencies from both Lebanon and Israel confirmed the crossborder incursion on August 7th and UNIFIL (the UN Interim Force in Lebanon) is now investigating where and how the explosion of a land mine took place. Lebanon's caretaker foreign minister, Adnan Mansour, denounced the incursion as a violation of Lebanese sovereignty and said that the country would be issuing a complaint to the UN Security Council.

The Lebanese-Israeli border has been relatively quiet in the past few years, although the Arab country is still subject to routine flyovers by the Israeli air force. In August 2010 a brief border clash left several military figures dead on both sides but did not escalate further. Since the 2006 war between Israel and Hizbullah, a Lebanese Shia armed political group, both sides appear to be biding their time, with Hizbullah rearming, in anticipation of a future conflict.

The civil war in Syria has escalated tension, with the Israeli air force attacking military targets that were believed to be destined for the Shia group. At present, we do not expect a renewed conflict between Israel and Hizbullah, as the Lebanese group will be focused on preserving its dominant position in domestic politics rather than on antagonising Israel and risking another war. However, the Israeli government and military will be unwilling to accept a dramatic upgrading of Hizbullah's offensive capabilities if it were to receive additional missiles or even chemical weapons from the Syrian government (which could send the weapons to Lebanon as a way of keeping them out of the hands of rebels fighting against the regime of Bashar al-Assad).

Impact on the forecast

We continue to expect a tense atmosphere between Israel and Lebanon, but do not expect a return to conflict in 2013-14.

August 15, 2013: International relations

Militants killed in Sinai

Event

Four militants affiliated with al-Qaida were killed on August 9th in Egypt's Sinai Peninsula in what is widely believed to have been an Israeli drone strike.

Analysis

Details of the raid remain opaque, but it appears that the militants were preparing a rocket attack on an Israeli target from a site some 3 km inside the Egyptian border. The northern Sinai region has become a security problem since the ousting of Hosni Mubarak as Egyptian president in February 2011. The Egyptian army is preoccupied with domestic issues, notably its increasingly tense stand-off with supporters of the Muslim Brotherhood, and weapons have been smuggled into the area from Libya, drawing militants to the northern Sinai and allowing local Bedouin to express their grievances through kidnappings and attacks.

Israel and Egypt have co-operated on Sinai security, even when the Muslim Brotherhood was in power, but Israel is loath to exercise its right to pursue suspects owing to political sensitivities, and its troops are only known to have entered Egyptian territory once, in 2011. These sensitivities have grown more pronounced as the Egyptian army engages in a political struggle with the Muslim Brotherhood. As a result, Egyptian officials have changed their account of the raid: after initially saying that Israel was responsible, they subsequently claimed that the attack was carried out by an Egyptian helicopter. Israel's defence minister, Moshe Yaalon, has not addressed the issue directly, but has stressed that Israel "respects the sovereignty of Egypt in its entirety", which has prompted some speculation that the attack was co-ordinated with the Egyptian authorities.

It would appear that Israel is gradually being drawn into the unrest in Egypt and Syria. Thus far, it has been able to deal with the problem by one-off operations, including at least four raids on Syrian territory. However, thousands of Islamist militants are believed to now be operating in the border areas of Syria and Egypt, and there is a risk that this could lead to Israel being dragged into more continuous fighting.

Impact on the forecast

We will maintain our existing forecast that security chaos in the Sinai Peninsula will remain a major headache for the defence forces of both Israel and Egypt, and that some co-operation in this area is likely.

August 16, 2013: International relations

Peace talks start

Event

The first round of Israeli-Palestinian peace talks took place in Jerusalem on August 14th, a day after Israel released an initial batch of Palestinian prisoners as a goodwill gesture.

Analysis

The resumption of negotiations after a three-year hiatus has elicited little political controversy inside Israel. Likud-Beiteinu, the party of the prime minister, Binyamin Netanyahu, is dominated by settlers, as is his second-largest coalition partner, Habeyit Hayehudi (Jewish Home), but the consensus among politicians and the public is that the negotiations will not succeed, so that even those opposed to them have no reason to protest. The release of the Palestinian prisoners received far more coverage and criticism than the talks themselves. A media blackout on the talks aims to keep the discussions out of the public's eye.

The right also has won what it regards as an insurance policy against a peace agreement, with legislation now working its way through the Knesset requiring a referendum on any pact that calls for the surrender of sovereign territory; this does not include the West Bank, but any land swaps and concessions on East Jerusalem would require voter approbation. Moreover, the government announced in early August that it was building 1,200 new homes in East Jerusalem and the West Bank and hundreds of others in more isolated settlements.

The political balance of power has also come into play. If the right-wing Jewish Home were to quit the coalition, it would probably be replaced by the dovish Labour Party or the ultra-Orthodox faction, Shas, which has shifted to the political centre under its new leadership. Inside Likud-Beiteinu, those contemplating quitting to form a new party can only be discouraged by the rapid decline of Kadima, a Likud breakaway that now has shrunk to a mere two seats in parliament.

Impact on the forecast

The stances of the Israelis and Palestinians on virtually every key issue—borders, security arrangements, refugees and Jerusalem—have not changed, and remain as far apart as ever. We therefore maintain our existing forecast that substantive progress in the talks, even if they are sustained for some time, is unlikely.

August 28, 2013: International relations

Israel prepares for possible retaliation from Syria

Event

Israel is preparing for a possible retaliatory attack by Syria if the US decides to take military action in response to the alleged use of chemical weapons by the Syrian regime.

Analysis

The Israeli army has begun moving Iron Dome and Patriot anti-missile batteries to sites in the north and centre of the country. The prime minister, Binyamin Netanyahu, and army leaders warned in late August that Israel would answer any attack by Syria, or militant groups aligned with the regime in that country, with a "forceful response".

So far Israel has remained largely aloof from the fighting in Syria, except to ensure that certain weapons do not fall into the hands of a Lebanese armed Shia group, Hizbullah—which is an ally of the Syrian president, Bashar al-Assad. The Israeli government regards both sides in the conflict in Syria as hostile: Mr Assad because of his ties to Iran and Hizbullah, and the rebels who are fighting Mr Assad's forces because they have become dominated by Islamists.

Speaking anonymously, Israeli officials have discounted the likelihood that Syria would launch a strike against Israel if the US opts for a limited military response that presents no major threat to Mr Assad's regime. Israel itself has attacked targets in Syria at least four times in the past year without suffering retaliation. According to an unnamed Israeli official who was quoted by the local daily newspaper, *Yediot Ahronot*, Mr Assad's supply of surface-to-surface missiles has, in any case, largely been exhausted after two years of civil war.

However, there remains the possibility that the US administration will decide to mount a much larger-scale military operation that provokes Mr Assad into striking back at his enemies wherever he can—with Israel a prime target. Even so, military planners believe that Syrian retaliatory action against Israel would be largely confined to short-range rockets aimed at the Golan Heights.

Impact on the forecast

The threat of instability spilling across Israel's borders—not only from Syria, but also from Egypt's Sinai region (which has become a staging ground for terrorist attacks over the past two years)—will remain a serious concern for Mr Netanyahu's government. Nevertheless, we believe that Israel will seek to avoid being drawn directly into the Syrian conflict. As a result, our forecast remains unchanged.

August 29, 2013: International relations

Hizbullah considers response to an attack on Syria

Event

With a US and allied military strike on targets of the regime of the Syrian president, Bashar al‑Assad, appearing likely by the end of August, a Hizbullah member of parliament has said that the Shia militia would "deal seriously" with an attack on its main ally.

Analysis

Hizbullah forces have actively participated in the Syrian civil war on behalf of the Assad regime, but the group has little ability to deter cruise missile strikes launched from US warships in the Mediterranean Sea.

The clearest form of reprisal Hizbullah could take would be to launch its own missiles against targets in Israel, the US's main regional ally. Israel's armed forces have mobilised reserve forces and moved an anti-missile defence system, Iron Dome, to the northern regions of the country. A Hizbullah attack on Israel could do substantial damage to the country, but would mean that the Shia group was risking serious return damage, as the US and its allies would be unlikely to hold Israel back from retaliating. Hizbullah did manage to resist and fend off an Israeli assault in 2006, but at that time its main ally was not engaged in a life-or-death conflict against rebel groups nor facing the prospect of Western bombardment.

If a Western assault on Syria was of limited scope and specifically targeted positions or units associated with the suspected use of chemical weapons, Hizbullah may respond only in a limited fashion, perhaps by sending further forces against Syrian rebels. The group's leaders would be well aware that the involvement of the Israeli military against it at a time when being resupplied is a challenge would weaken it sharply. Hizbullah has extended its influence over domestic politics since 2011 (when its cabinet members resigned, prompting the collapse of the Lebanese government and beginning over two years of political uncertainty) and if it were severely weakened militarily in a clash with Israel, its opponents in Lebanon might seek to press their advantage and reduce the group's presence in state institutions (such as internal security services).

There is a risk, however, that Hizbullah's leaders may decide that the destruction of the Assad regime may mean that there is nothing left to lose and retaliate by launching large-scale missile attacks against Israel, although this is not part of our central scenario.

Impact on the forecast

At present we maintain our forecast that Lebanon will experience political violence across the country. Should the US and its allies engage in a sustained campaign against the Assad regime, we would alter our forecast to take into account much greater political disarray in Lebanon, with negative consequences for economic performance as well.

Analysis

August 23, 2013: International relations

Turkey's regional relations have become strained

The removal from office of Egypt's Islamist president, Mohamed Morsi, in a military coup on July 3rd represents a significant blow to the Turkish government. The ruling Justice and Development Party (AKP) led by the prime minister, Recep Tayyip Erdogan, has lost a close ally in the region. Relations have cooled with several other regional governments over their responses to events in Egypt. In addition, coming only weeks after unprecedented anti-government protests in Istanbul, Ankara and other cities, the Egyptian coup has been grist to the mill of Mr Erdogan's increasingly paranoid analysis of domestic and world events ahead of Turkey's local and presidential elections in 2014 and legislative elections in 2015.

Turkey was a vocal supporter of the Egyptian protest movement that led to Hosni Mubarak's removal from office and his eventual replacement by Mr Morsi, a leader of Egypt's Islamist organisation, the Muslim Brotherhood, and the country's first democratically elected president. Having already established himself as a popular figure on the Arab street—notably for his strident position on the Palestinian question, epitomised by his angry exchange with Israel's president, Shimon Peres, at Davos in 2009—Mr Erdogan travelled to Cairo in September 2011, where he praised protests in Tahrir Square as a "light of hope" for the region. After his election Mr Morsi was a guest at the AKP's annual conference in Ankara in September 2012. Turkey provided US$2bn in loans to the new Egyptian regime. This represented a major improvement in the countries' bilateral relations, which had been frosty while Mr Mubarak was in office, in part because of differences over Israel, to which Egypt is bound under the terms of the 1979 Camp David accords.

Turkey's regional position is weakened

Mr Morsi's removal leaves Turkey's regional position weakened. The Arab Spring had already necessitated a significant course correction by the AKP, which had formed successful working relationships with many of the region's autocratic regimes in order to boost Turkey's trade and investment links. This process was not without its hitches. Mr Erdogan moved slowly on Libya, reluctant to jeopardise commercial links with Muammar Qadhafi's regime; this led to anti-Turkish protests in Benghazi. But the AKP accepted the inevitability of regional change and sought to turn it to its strategic advantage. Since 2007 a very narrow understanding of democratisation had underpinned the party's increasing power at home. It now seeks to project this image outwards, presenting Turkey as a natural leader of the Arab Spring. Speaking to parliament in April 2012 the foreign minister, Ahmet Davutoglu, said: "There is a new Middle East and we will be its owner, leader and servant. ... Irrespective what others say, the new order's leader and spokesperson will be Turkey."

That is not how things look now. Not only has the July coup led to a breakdown in relations with Egypt—Turkey's ambassador has been withdrawn and joint military exercises have been cancelled—but relations with other states in the Middle East have suffered too. Saudi Arabia and the UAE have welcomed the removal from power of Mr Morsi and the Muslim Brotherhood, leading Mr Erdogan to dismiss them as "rich Arabs propping up a dictator". Qatar—a close ally of Turkey on Syria and provider of financial assistance of around US$8bn to the Muslim Brotherhood administration before its overthrow—adopted a more cautious stance regarding the coup.

Israel conspiracy claims damage ties with the US

Predictably, the Egyptian coup has also seen Turkey's relations with Israel worsen again. Mr Erdogan has made outspoken support for the Palestinian cause a cornerstone of his foreign policy, particularly since 2010, when nine Turkish citizens were killed when Israeli forces boarded a Turkish ship, the *Mavi Marmara*, which was sailing towards Gaza. A reconciliation, however strained, appeared to have been achieved earlier this year following an intervention by the US president. However, the Turkish government and its many supporters in the media have since stepped up their anti-Israel and anti-Semitic rhetoric. During the recent anti-government protests there were suggestions that the protests were being fuelled by Jewish financing and support. Mr Erdogan was much more blunt in relation to the military coup in Egypt: "Who is behind this? Israel is. We have the evidence in our hands."

The introduction of Israel into Mr Erdogan's account of events in Egypt is worrying for a number of reasons. It shows an unusual level of disregard for potential diplomatic consequences, particularly with respect to the US. It is one thing for Turkey to differ with Israel over the *Mavi Marmara* (ultimately a bilateral matter) or on the Palestinian issue (on which Mr Erdogan's views hardly make him an outlier, particularly in the Middle East). But to accuse Israel bluntly of having orchestrated a coup in another major regional state is a diplomatic intervention of a different order. Relations with the EU—which Mr Erdogan slammed on July 27th for its silence on Egypt—have been worsening for years. But the same has so far not been true in relation to the US. For Mr Erdogan to be condemned by the White House for his offensiveness marks a new development.

Creating siege mentality ahead of elections

A second concern in relation to Mr Erdogan's comments on Israel is that they feed very directly into the conspiracy theories that increasingly shape both the AKP's pitch to the electorate and its worsening clampdown on protest and dissent. Having fingered Israel for triggering an Egyptian coup, the prime minster went on to say that he was speaking out in order to prevent the same thing happening in Turkey. Mr Erdogan seems intent on going into local and presidential elections in 2014 with his supporters feeling besieged by potential threats, particularly of a coup taking place. Increasingly he is playing on the public's fears, rather than its hopes. Previously the government seemed to claim—not without hubris—that it would export Turkish-style democracy across the Middle East. Now it is telling the public that an increasingly authoritarian state under the AKP is needed to protect Turkish democracy from developments in the region.

August 27, 2013

Iran faces grim choices if the West intervenes in Syria

Iran's new government will face its first major diplomatic challenge in managing the increasing discussion of a

Western military intervention into its main Arab ally, Syria. Iran has limited options for response should the West attack Syria, and any escalation in the war is likely to foster further Sunni-Shia enmity in the region. Moreover, it would all but scupper any chance that the US and Iran could engage in negotiations over the Islamic Republic's disputed nuclear programme. The new president of Iran, Hassan Rowhani, will be forced to maintain support for the regime of Syria's president, Bashar al-Assad, lest he risk provoking a harsh response from hardline conservatives at home.

The tone from the US administration following a meeting between the president, Barack Obama, and his national security team has increased the expectation that the US and its allies will attack Syria after the alleged use of chemical weapons by Mr Assad's forces. The likely means would be missiles from warships or submarines in the eastern Mediterranean or Persian Gulf, or via combat aircraft. Targets could include Syria's air-defence system, command bunkers, communications hubs, government buildings, missile sites or, perhaps, the units thought responsible for chemical attacks.

Syria's government has warned that any US military action would "create a ball of fire that will inflame the Middle East", and many in the US government may be reluctant to re-engage in a conflict in the region. Any intervention carries substantial risks. Syria has relatively sophisticated Russian air-defence systems, which were close to locking on Israeli jets during the 2007 attack on the alleged nuclear site at Dayr al-Zawr. There are also particular problems with trying to neutralise a chemical weapons target. Although such weapons are generally delivered through conventional systems—aircraft, artillery or missiles—that could be targeted, any attack on chemical plants risks contamination and the chance of unguarded nerve agents and other substances falling into the hands of Sunni militants.

Iranian reaction: violence or diplomacy?

Throughout the two-year conflict in Syria, Iran has given logistical support to the Assad regime, with Syria a long-term ally as far back as the 1980-88 Iran-Iraq war. As part of the fallout from the Arab Spring and war in Syria, the Middle East has been increasingly polarised between Sunnis (especially the Sunni-led Gulf states) and Shia (primarily the Iranians, plus Iraq and Hizbullah in Lebanon). Sustaining an alliance with at least one friendly Arab state has been vital for Iran to exert influence over the region.

Iran is well aware of the reluctance within the US towards intervention, and its response to the prospect has been to talk up the dangers of such an attack. Massoud Jazayeri, deputy chief of staff of the armed forces, warned the US of "severe consequences" if it crossed "the red line of the Syrian front". The director of parliament's international affairs committee, Hossein Sheikholeslam, said that the first victim of any attack would be "the Zionist regime [Israel], because the army in Damascus has the ability to attack with severity the occupied territories"; he added that he did not expect Russia to repeat "the same mistake" it made in Libya by tolerating Western intervention. A more sober assessment in a reforming newspaper, *Shargh*, referred to "a swordplay opportunity for the two superpowers", but warned that despite "the high cost" of previous US interventions, "force" remained an option.

The official Iranian response during Syria's civil war has generally favoured diplomacy. The foreign minister, Mohammed Javad Zarif, has reiterated Iran's long-standing opposition to chemical weapons, which were employed by Iraqi forces during the 1980-88 war. Mr Zarif and Abbas Araghchi, a foreign ministry spokesman, have suggested that it was the rebels and not the Assad regime who used the chemicals.

Mr Araghchi has also stressed Iran's co-operation with Russia and their shared preference for negotiations over Syria. However, the diplomatic process over Syria appears deadlocked, with the regional Sunni powers—led by Saudi Arabia and Turkey—and the US insisting that Mr Assad should leave power as soon as possible, while Russia and Iran argue that this should not be a precondition for talks.

Lakhdar Brahimi, the UN and Arab League envoy for Syria, reiterated earlier this month his belief that Iran should be included in Geneva-2, the international conference on Syria scheduled for July but postponed by the US. No details have emerged from the visit to the Iranian capital, Tehran, on August 26th by Jeffrey Feltman, the UN undersecretary-general and a former senior US diplomat with experience of the Middle East: while Mr Feltman's agenda was the UN's interest in Syria, Egypt and Lebanon, he may also represent a back-channel to the US (this was his second visit in a year: in September 2012 he accompanied the UN secretary-general, Ban Ki-moon, to a summit of the Non-Aligned Movement in Tehran).

Possible Iranian retaliatory options

Iran's options for retaliation against US attacks on Syria are limited. Western defence analysts have flagged up the possibility that it might encourage Palestinian or Sunni Islamist attacks on Israel, or attempts to foment a "third intifada" in the Israeli-occupied Palestinian Territories; however, these are groups with whom Iranian influence is diminishing, given the Sunni-Shia polarisation that the Syrian war is encouraging. Among vulnerable Western targets could be the NATO base at Incirlik in south-east Turkey, or even the British bases in Cyprus (where a member of Hizbullah was jailed in May for surveying Israeli tourists).

However, an overt attack on a NATO or allied facility would invite reprisal from the US and its allies—a dynamic that the Iranian leadership will seek to avoid at all costs. Whatever response Iran makes, the Israeli leadership seems fixed on its enmity with the country. After evidence of chemical attacks emerged, Israel's prime minister, Binyamin Netanyahu, described Syria as "the test field of Iran."

Rowhani in a corner

While the effect of US strikes on Syria is uncertain, they would be likely, in the short term at least, to undermine prospects for negotiations between the US and Iran over the latter's disputed nuclear programme. It seems likely that any inflammation of the war in Syria would domestically weaken Mr Rowhani, who stressed the need for dialogue both during his election campaign and following his inauguration at the start of August. in the aftermath of the chemical weapons attack, Mr Rowhani called for the international community to prevent the use of such materials in Syria, but he stopped short of saying who he thought had used the arms.

Likewise, military strikes on Syria would be likely to strengthen those in Iran who are most sceptical over—or even opposed to—talks with the US. During the two years of the Syrian conflict, Iran has given no indication that it would abandon its Syrian ally. Mr Rowhani will be pressed into a corner by hardline conservatives in Iran to maintain support for Mr Assad.

Economy

Forecast updates

August 13, 2013: External sector

Trade deficit soars in July

Event

Israel's trade deficit in July soared to over US$2.2bn on an unadjusted basis, compared with US$1.25bn in June. On both an unadjusted and adjusted basis, and excluding ships, aircraft and diamonds, July saw the largest monthly deficit since early 2012.

Analysis

The deterioration recorded in the trade in goods in July stemmed from two main factors. On the import side, fuel imports jumped by over US$400m to US$1.42bn, despite the underlying downward trend in energy imports since the Tamar offshore natural gas field began production in late March. Other categories of imports were largely stable, at least on a seasonally adjusted basis, although a large increase in investment goods stood out as they reached their highest level since last October. This rise will be welcomed as a positive sign for future economic activity, especially as it was led by an increase in imports of capital goods and equipment, while imports of business and commercial vehicles declined.

On the export side, the weakness in July reflected a 9% month-on-month fall in manufacturing exports, which comprise some 81% of the total. The weakness was concentrated in the chemicals sector as well as in technology, while pharmaceuticals exports remained at an exceptionally low level for the third successive month.

The Central Bureau of Statistics, in reviewing the July data, noted that exports from high-tech industries, which include pharmaceuticals, declined at an annualised pace of 22.6% in the May-July period, a similar rate of decline to that seen in the previous three months.

Although the trade deficit for the first seven months of 2013 was about one-third lower than in the same period of 2012, the weakness in exports—especially the high-tech sectors that are the key drivers of Israeli growth—is becoming protracted enough to cause concern among policymakers. However, it is as yet unclear whether its cause lies in global developments or stems from domestic factors.

Impact on the forecast

We at present are expecting the trade deficit in 2013 to narrow by around one-third, so the seven-month trade outturn reinforces our forecast. However, if the jump in the deficit in July is repeated in subsequent months, we may be required to revise higher our projection for the full-year trade deficit.

August 19, 2013: Inflation

Inflation edges up

Event

The consumer price index (CPI) for July was up by 0.3% on the previous month, bringing the rate of inflation for the year ending July 2013 to 2.2%, near the centre of the 1–3% target range of the Bank of Israel (the central bank).

Analysis

The details of the July CPI, published by the Central Bureau of Statistics (CBS) on August 15th, showed food and house prices as the key factors responsible for the rise. Prices of fresh fruit and vegetables rose, largely because of seasonal factors, while the cost of alcoholic drinks increased by 10%, although such increases were partly offset by a seasonal drop in clothing and footwear prices (due to summer sales). Economists and policymakers remain concerned by developments in the housing sector, however.

Within the CPI, housing prices are imputed using recently signed rental contracts. These posted a 1.3% jump in July, but were only 3% higher over the past 12 months. However, the CBS house price index, which is not part of the CPI, rose by 0.5% in July and stood 9.3% higher than a year previously. This suggests that upward pressure on housing prices is continuing, although the report by the Tax Authority in early August of a sharp fall in the number of homes bought and sold in July had raised hopes that the residential property market was cooling off.

Although the general economy shows no signs of a general state of excess demand, the ongoing rise in house prices indicates that this sector is in disequilibrium. The seemingly unstoppable rise in house prices is creating social tensions that carry potentially severe political consequences.

Impact on the forecast

We will maintain our existing forecast that inflation will remain around the midpoint of the 1–3% target range in 2013. It remains clear, however, that persistent overheating of the housing market is a risk and may require further macroprudential measures in order to avoid a housing bubble.

August 29, 2013: Policy trends

Government signals renewed privatisation drive

Event

On August 25th the government approved the appointment of Ori Yogev as director of the Government Companies Authority (GCA), which is responsible for overseeing the operations of the country's 98 state-owned companies.

Analysis

The GCA is a powerful entity within the Ministry of Finance, but has functioned since June 2012 under an acting director. It is responsible for some of the country's largest companies, including Israel Electric Corporation (IEC), Israel Aerospace Industries and Rafael Advanced Defence Systems. However, one of the smaller companies, Israel Railways, is most prominent in the public consciousness, thanks to frequent disruptions to services stemming from the ongoing struggle between its union and its government-appointed management over plans to restructure the company and outsource some functions to private contractors.

Mr Yogev's previous connection with Israel Railways (where he had served as an acting part-time chairman) almost scuppered his appointment as GCA head—following accusations that he had failed to disclose potential conflicts of interest. However, this particular hurdle was overcome when the attorney-general ruled that the alleged conflicts were insubstantial.

Although he will report to the finance minister, Yair Lapid, Mr Yogev's real boss will be the prime minister, Binyamin Netanyahu, for whom he has acted as an unpaid economic adviser since leaving the finance ministry for the private sector. He was recently appointed to chair a steering committee charged with reaching an agreement, by the end of 2013, with the Histadrut, Israel's largest trade union organisation, and the IEC's powerful union on a restructuring of the electricity industry.

The electricity reform, like the government's overall privatisation programme, has been blocked for many years by union opposition. As a result, during the period of almost four years that Mr Netanyahu's previous government was in power, virtually no public companies were floated on the Tel Aviv Stock Exchange or sold off to private investors.

Mr Netanyahu clearly intends Mr Yogev to spearhead a renewed privatisation drive. With Mr Lapid and the economy minister, Naftali Bennett, both sharing Mr Netanyahu's ideological commitment to privatisation, Mr Yogev will enjoy strong political support. Nevertheless, union resistance will remain a significant barrier. The first key battleground is likely to be the ports, where a highly-paid workforce has a stranglehold on the country's trade in goods.

Impact on the forecast

Despite the renewed political commitment to privatisation, we expect only modest progress, as public-sector unions maintain their stiff resistance to the sale of state-owned companies.

Analysis

August 1, 2013

Knesset passes the 2013-14 budget

In the early hours of July 30th the Knesset (parliament) comfortably approved—by 58 votes to 43—the proposed biannual budget for 2013-14, having the previous day approved the accompanying Arrangements Law. The latter is an annual piece of legislation into which the Ministry of Finance crams numerous proposals for structural reform straddling many sectors of the economy, in an attempt to avoid a prolonged battle over each item with the vested interests that feel threatened by it.

As in previous years, the main parliamentary debate on both the budget and the Arrangements Law had already taken place at the committee stage, when every section and sometimes paragraph are dissected and voted on by the Knesset Finance Committee. Here, ad hoc coalitions between different parties and specific members, often cutting across coalition and opposition lines, had imposed some significant changes in the details of the budget proposals—but not in its overall structure—while removing several important proposals from the Arrangements Law and sending them for more intensive scrutiny to the Knesset committees most relevant to their content.

The second and third readings of the budget bill therefore saw mainly symbolic efforts by the opposition to discomfit the government coalition. However, its threatened use of procedural manoeuvres to delay voting past the revised July 31st deadline for the budget's passage proved hollow. Missing the deadline would have caused the government to fall and created a political, as well as a budgetary, crisis that no-one really wanted. The main thrust of the budget is directed towards reducing the yawning budget deficit that has developed since 2011. This is an objective shared by all of the main parties—although important differences remain over the precise mix of measures to be deployed in achieving this goal.

Budget approval was delayed because of the January 2013 election

The budget is normally approved and in place by the start of the calendar year. However, the previous coalition government, headed by the prime minister, Binyamin Netanyahu, had been unable to reach agreement on a framework for the 2013 budget—leading Mr Netanyahu to call a general election in January. It was not until April that the new government, also led by Mr Netanyahu, took office. In the interim, monthly government outlays have been limited to one-twelfth of the annual amount specified in the 2012 budget. At the same time, tax revenue has fallen sharply, despite the increases in both direct and indirect taxes that were legislated in 2012. Even with these adjustments, and another 1-percentage-point hike in the value-added tax (VAT) rate that took effect in June 2013 (following a similar increase last September), the government is forecasting that the budget deficit in 2013 will rise to 4.7% of GDP, compared with last year's outturn of 4.2% of GDP. The finance ministry then expects the deficit to decline to 3% of GDP in 2014, thanks to the tax rises and spending cuts that will be implemented both this year and next.

The tax changes include a graduated rise in personal income tax rates, from 1 percentage point on the lower tax brackets, a 1.4-percentage-point increase on the middle segments and a 2-percentage-point increase at the highest levels—pushing the top marginal rate to 52% (after including the 2-percentage-point surtax imposed last year). Tax brackets will also not be adjusted for inflation in January 2014, as normally occurs, so that rising nominal incomes will push more people into higher tax brackets. Corporate income tax will rise from 25% this year to 26.5% next year, and the lower rates offered to firms making investments under Israel's incentives programme will also be raised, as part of a general move to ensure that large corporations pay more taxes.

Benefit cuts will squeeze disposable incomes

The disposable income of households will be hurt as much, if not more, by sharp cuts in child allowances, which will take effect almost immediately, as well as by other measures that will result in higher fees and/or reduced service levels from various government ministries and agencies. A key feature of the budget—and the only one bearing the distinctive imprint of the finance minister, Yair Lapid, and his party, Yesh Atid—is the sizable cut in government support for ultra-Orthodox institutions and families. Yesh Atid's electoral success enabled Mr Lapid to persuade Mr Netanyahu to exclude the ultra-Orthodox parties from the current coalition and to reverse their previous success in securing considerable government funding for their constituents.

Structural reforms noticeable by their absence

The aim of these moves, coupled with the changes in the military draft law passed last week, is to speed up and broaden a process that has been under way for the past decade, of increased ultra-Orthodox participation in the labour force. Other than this, the new budget and Arrangements Law are largely devoid of important structural reforms—and this is widely viewed as the main shortcoming. Although the budget should help to bring the deficit down to a more acceptable level by 2014, there are few measures that can be considered as direct growth stimuli; indeed, the research department of the Bank of Israel (the central bank) estimates that the planned fiscal tightening will cut 0.7% from GDP growth next year. Mr Lapid is promising that, by 2015, the economy will be over the hump and experiencing healthy growth rates. However, his optimism is not widely shared among professional economists, in or out of government. The Economist Intelligence Unit currently forecasts that real GDP growth will pick up to just over 4% in 2015; but this will still be well below the 5.2% average rate of expansion recorded in 2004-07, prior to the global financial crisis.

August 20, 2013

First-half growth exceeds expectations

The first estimate of Israeli economic growth in January-June 2013, published by the country's Central Bureau of Statistics (CBS) on August 18th, showed GDP expanding at a surprisingly rapid rate. The annualised rates of growth, of 3.4% for the first half and of 5.1% for the second quarter, were much higher than had been forecast, and reflected a rise in both private and public consumption. This may not be maintained into the second half, but the external sector should help to sustain reasonable momentum.

Although the first-half rate of growth was hardly changed from the 3.5% recorded in July–December 2012, quarterly data had shown a clear declining trend—from 3.9% in July–September 2012 to 3.1% and 2.7% respectively in the final quarter of 2012 and the first quarter of 2013. Other economic data, as well as sentiment indices and anecdotal evidence, all supported the view that the rate of expansion was slowing. The sharp jump in the April–June quarter was therefore unexpected.

Customers stock up prior to tax rises

However, a closer examination of the preliminary data—there will be two updated estimates, in September and October—suggests that the supposed strength they reflect is largely illusory and is unlikely to carry into the second half of the year. In particular, the higher consumption (both private and public) that has driven the sharp jump in second-quarter GDP is likely to have comprised demand brought forward from later in the year.

Private consumption expenditure rose at an annualised rate of 6.7% in April–June, compared with a still healthy 5% in January–March. However, whereas consumption in the first quarter was skewed strongly towards durable goods, which soared by an annualised 18.6%, consumption of non-durables rose faster than that of durables (by an annualised 4.9% and 3.7% respectively) in the second quarter. This suggests that consumers were stocking up on items they purchase regularly, seeking to beat the tax rises implemented in May (on tobacco and alcohol) and June (value-added tax—VAT), as well as the rumours of, and actual budget proposals concerning, other tax increases, not all of which were included in the final version legislated in July.

The public sector contributed its share too, with general government consumption expenditure posting a sharp 8.2% rise in April–June. This, like the rise in private consumption and in overall GDP, marked the highest quarterly rate of increase since 2011, when the Israeli economy's prolonged period of rapid growth began to fade. The jump in public spending was again unexpected given that the absence of an authorised government budget in the first half of the year led to the imposition of legal constraints on government outlays. Nor did the rise stem from higher defence imports, which sometimes cause short-term blips. However, the second-quarter data may simply have been compensating for the slightly negative change in public consumption recorded in the first three months of the year.

Other components of GDP made little or no contribution in the second quarter. The negative trend in fixed capital formation actually intensified in April–June, compared with January–March, with both main components—investment in plant and equipment, and residential construction—declining more rapidly than in the first three months, thereby continuing the trend that began during 2012.

The external sector was another source of disappointment, despite being a net contributor to growth in the first half of the year. This contribution came in the first quarter, when exports posted a rise of almost 11%, while imports managed a rate of less than 2%. However, in April–June, imports maintained their rate of expansion, while the growth in exports slumped to barely 1%.

Start-ups provide boost

In fact, even the positive data for the first half were flawed, as the CBS was careful to note: exports net of the proceeds of sales of start-up companies, and of diamonds, actually fell by an annualised 2% in January–June. This confirms the picture emerging from the monthly trade data and presages a negative theme in the second-quarter balance-of-payments data due in September. The boost provided to exports from sales of start-up companies—which is likely to intensify in the third quarter, in the light of recent announcements of several large sales—is welcome, but cannot obscure the fact that "regular" exports of both goods and services, including from the technology sectors, have been weak.

Nevertheless, the outlook for real GDP growth in the second half of the year is reasonably positive. This reflects several factors, primarily the impact of the replacement of imported fuels by domestically produced natural gas, which in March began flowing from the Tamar field, the output of which will increase during the year. Imports will be further reduced by the expected slowdown in consumption, so that, although growth will not be driven by either private or public consumption, as it was in the first half, the external sector may become the locomotive, allowing the economy to maintain a growth rate of around, or at least near to, 3% a year.

August 28, 2013

Bank of Israel leaves rates on hold

At its monthly meeting on August 26th, the monetary policy committee (MPC) of the Bank of Israel (BOI, the central bank) decided to maintain its key interest rate at 1.25% during September, marking the fourth successive month of rates remaining unchanged. The committee cited several factors that influenced its thinking, but it seems

that two considerations in particular, one foreign and one domestic, were paramount.

The recent nervousness in global financial markets, driven by continuing uncertainty over the future of the US Federal Reserve's policy of asset purchases—and which has led to sharp falls in some emerging markets—appears to have weighed heavily on the committee's thinking at its latest meeting. In response to the increased external uncertainty, the MPC has rescinded its decision made earlier this year to skip its meetings in April and September, when Jewish holidays affect the flow of timely economic data. The September meeting has instead been reinstated, allowing a rapid response to developments and decisions overseas during the coming month—including that of the US Federal Reserve.

House price trends another key focus

In terms of domestic considerations, a key focus for the MPC was the current state of the domestic housing market. In its accompanying statement, the committee highlighted the fact that housing prices have resumed their upward trend, with the year-on-year increase in apartment prices accelerating to 9.3% in July (from 8.7% in June). The BOI's assessment stands in contrast to the Treasury's efforts to portray conditions in the housing market as comparatively stable. While recognising that low domestic interest rates are currently stoking the demand for housing credit, the central bank has been attempting to ward off the risk of a "bubble" by announcing a series of regulatory measures aimed at the mortgage market.

The latest package was unveiled on August 21st, extending a series of directives stretching back to 2010 (the previous set of restrictions on borrowers was announced in December 2012). With effect from September 1st, the Supervisor of Banks, David Zaken, has ordered banks to refrain from making mortgage advances on which the monthly repayment exceeds 50% of the borrower's monthly income; if the repayment is 40–50% of income, the bank is henceforth required to weight the loan at 100% for capital-adequacy calculations. Furthermore, banks may not extend more than two-thirds of a mortgage loan on variable interest-rate terms, irrespective of the duration of the loan. This is in addition to a previous directive limiting variable interest-rate loans of up to five years' duration to one-third of the total amount of the mortgage loan. Finally, no mortgage loan may exceed 30 years in duration.

As noted by the Supervisor of Banks, the rationale underlying the latest set of restrictions in the housing market is to prevent excessive risk-taking on the part of both borrowers and lenders. Concerns have been expressed that many borrowers have been taking out loans that may seem affordable in the current environment of very low interest rates and low unemployment but which could prove problematic when interest rates eventually start to rise (in turn, leading to mounting losses for banks). At the same time, the Supervisor of Banks is not seeking to affect house prices directly, which are outside his purview. Indeed, the BOI's view continues to be that the housing market's underlying problem is one of insufficient supply and it has continued to urge the government to adopt measures that could encourage more residential construction.

The MPC is currently in a state of flux

Speculation in some quarters that the latest directive on mortgage loans—announced a week before the MPC meeting—may have been designed to pave the way for another cut in interest rates proved incorrect. However, in deciding to leave monetary policy unchanged the committee may have also taken into consideration recent and forthcoming personnel changes.

Half of the committee's six members must be BOI employees, but their numbers shrank when Stanley Fischer stepped down as governor at the end of June. The deputy governor, Karnit Flug, is now acting governor and hence committee chair, but she has announced her intention to leave the BOI once a new governor is appointed. Her colleague, Barry Topf, had notified his intention to retire at the end of 2013, prior to Mr Fischer's departure. Consequently, with a large part of the MPC in the process of being replaced it would be natural for the existing team to opt for continuity in terms of monetary policy for the time being.

Meanwhile, the process of selecting a new governor is moving ahead, with three candidates being vetted by the Tirkel Committee, which is charged with checking the professional and personal credentials of candidates for all senior government posts. Mario Blecher—a former senior official at the IMF and, briefly, governor of the Argentine central bank— and the former BOI deputy governor, Zvi Eckstein, are the main contenders. Victor Medina, whose career encompassed senior posts at the BOI and Ministry of Finance, as well as in industry and commercial banking, is viewed, at the age 74, as a "dark horse".

