Country Report

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Highlights

Editor: **Toby Iles**

Forecast Closing Date: **July 28, 2014**

Outlook for 2014-18

- The political outlook will remain challenging, given the fractious nature of Israeli coalition politics. The government is unlikely to complete its full term.
- Regional threats, including the conflict with Hamas, instability in Syria and Iraq, and tension over Iran's nuclear programme will pose risks to security.
- The chances of a resumption of stalled peace talks with the Palestinians have receded further, given the opposition of many Israeli hardliners to a two-state solution, as well as Israel's refusal to negotiate with Hamas.
- The fiscal balance will improve, moving into surplus by the end of the forecast period, helped by rising revenue from gas. In turn, this will provide the space for a gradual reversal of recent tax rises.
- Monetary policy will remain loose in the near term, as inflation remains subdued and the central bank is concerned about the strength of the currency. Policy will be tightened gradually from 2015 as inflation starts to pick up.
- Real GDP will expand by an average of 4.7% in 2014-18 as Israel's export-dependent economy benefits from a sustained recovery in its main markets, the US and the EU, as well as rising offshore gas production.
- The New Israeli shekel will appreciate against the US dollar in 2014–18, reflecting the start of gas output and a strengthening of the external balance.
- Stronger export growth and rising domestic gas production will underpin significant current-account surpluses in 2014–18.

Review

- Following five weeks of growing violence, a renewed military conflict broke out between Israel and Hamas—which controls Gaza—on July 8th, leading to a decision by Israel to commit ground troops to Gaza on July 17th.
- The Israeli foreign minister, Avigdor Lieberman, has announced that he is ending the 20 month-long partnership between his Yisrael Beiteinu party and the ruling Likud party.
- Inflation fell to a seven-year low of 0.5% year on year in June, although the magnitude of the decline was accentuated by the high base of comparison in June 2013, when value-added tax was increased from 17% to 18%.
- Export performance in the first six months of 2014 was disappointing, with a lacklustre rise of just 1.7% year on year. At US$1.45bn, the seasonally adjusted merchandise trade deficit in June was also the largest so far this year.
- The partners in Israel's Leviathan gas field announced at the end of June that they had agreed with the UK's BG Group to start discussions about exporting gas to the Idku liquefied natural gas plant in Egypt.

Outlook for 2014-18

Political stability

The political outlook will remain challenging, given the fractious nature of coalition politics in Israel. The government will need to respond to a number of issues, including public discontent over growing income disparities, a shortage of housing and rising healthcare and education costs. Political divisions within the coalition are also at risk of being exacerbated by the latest military conflict with Hamas, the Islamist group which rules the Gaza Strip. The right-of-centre Likud party—led by the prime minister, Binyamin Netanyahu—is the largest grouping in the 120-member Knesset (parliament), with 20 seats. However, the election in January 2013 saw a number of new parties and alliances enter the political arena. In particular, a new centrist and staunchly secular party, Yesh Atid, led by Yair Lapid, is now the second-largest grouping in the Knesset, with 19 seats.

The ultra-Orthodox religious parties have been left out in the cold in terms of the present coalition, which is rare for Israeli governments. At the same time, a right-wing religious party, Habeyit Hayehudi (Jewish Home), which controls 12 Knesset seats, has been included in Mr Netanyahu's coalition. The head of Habeyit Hayehudi, Naftali Bennett, is likely to seize upon the latest conflict with Hamas as an added reason for rejecting any notion of a two-state solution to the Palestinian problem. Instead, Mr Bennett believes that Israel's security would be best served by an annexation of Area C (the 61% of the West Bank that Israel already has under its control). Meanwhile, Avigdor Lieberman— the leader of the right-wing Yisrael Beiteinu—announced in July that he was ending his party's 20-month long formal partnership with Likud. Although Mr Lieberman has indicated that his party will remain within the government he has been arguing for an even stronger stance in combating the threat posed by Hamas—including a renewed military occupation of Gaza by Israel (as was the case between 1967 and 2005). The opinions voiced by Mr Bennett and Mr Lieberman are strongly opposed by more moderate members of the cabinet, in particular, Tzipi Livni (Israel's chief negotiator in the peace talks with the Palestinians) and Mr Lapid. Indeed, Mr Lapid has recently warned that if any attempt is made to annex West Bank settlements his party would leave the coalition —a threat which, were it to be carried out, would overturn Mr Netanyahu's parliamentary majority.

Socioeconomic issues—in particular, the high cost of living—will remain a key focus of political debate. Popular discontent over the government's handling of the economy was one of the main factors behind the increase in support for centre-left parties at the last election. The centre-left parties (Yesh Atid, Labour, Meretz, Hatnua, Kadima and the Arab parties) have 59 seats in the current Knesset, only two fewer than the right-wing parties (Likud-Beiteinu, Habeyit Hayehudi, Shas and United Torah Judaism). Mr Netanyahu's government includes two of the centre-left parties, Yesh Atid and Hatnua, giving him control of 68 parliamentary seats in total. Although this provides a sufficient margin to allow for individual defections, it would not ensure an adequate buffer against wider discontent (such as the departure of Yesh Atid, Habeyit Hayehudi or Yisrael Beiteinu). With significant ideological and personality clashes to be overcome, Mr Netanyahu will therefore face a significant challenge in maintaining the cohesion of the coalition.

Election watch

The Knesset term is four years. Although the next general election is not due until 2017, no Israeli administration has completed a full term since the 1984–88 government of national unity. In general, the country's low-threshold electoral system encourages a multitude of political parties, reinforcing the difficulties of forging stable and long-lasting coalitions. The approval of a new law in March that raised the threshold required for Knesset representation to 3.25% of the national vote, from 2% previously, is likely to have only a modest impact in reducing this problem. The composition of the current parliament—split almost equally between right-wing and centre-left blocs—means that the coalition will be particularly prone to internal divisions, making it even less likely that the present 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, and the Egyptian president elected in 2012, Mohammed Morsi (representing the Muslim Brotherhood), acted pragmatically in relation to Israel. However, the Egyptian military's overthrow of Mr Morsi in July 2013, no doubt welcomed by Israel, has so far failed to resolve the uncertainty over Egypt's future. In the meantime, the security chaos in the Sinai Peninsula, which borders southern Israel, has created a major headache for the defence forces of both countries.

Following the breakdown of the US-brokered peace talks between Israel and the Palestinians at the end of April—which coincided with the signing in April of a reconciliation agreement between the two main Palestinian groupings, Hamas and Fatah—subsequent months witnessed a growing escalation of tit-for-tat violence. A full-blown conflict between Israel and Hamas then erupted on July 8th, culminating in Israel's decision to commit ground troops to Gaza on July 17th. Although an imminent and internationally mediated end to the current hostilities is likely—given the mounting death toll on both sides—a lasting solution which prevents future outbreaks of violence is likely to remain elusive. Meanwhile, hopes of reaching a comprehensive peace settlement which could help meet Palestinian aspirations for statehood remains as distant as ever.

Israel will monitor developments in Syria closely. Although it will seek to avoid being drawn directly into the conflict, it has launched a number of air strikes. The government will respond with further military action if it believes that the Syrian regime or its ally, Hizbullah, a Lebanese Shia group, pose a threat to Israeli security. Israel has also condemned the interim deal struck between Iran and the P5+1 (the permanent members of the UN Security Council and Germany) over the former's nuclear programme, warning that Iran's president, Hassan Rowhani, is attempting to deceive the West with his conciliatory gestures. The possibility of an Israeli military strike on Iran's nuclear facilities, although not The Economist Intelligence Unit's central scenario, cannot be ruled out if talks between the Islamic Republic and world powers break down.

Policy trends

Mr Netanyahu will seek to promote a policy agenda that puts heavy emphasis on economic liberalisation and low taxes. Although the prime minister has been forced to put on hold his long-standing preference for tax cuts (following fiscal slippage in recent years), he will be keen to reinstate his tax-cutting agenda—despite likely opposition from centre-left elements—as soon as the public finances show sustained signs of improvement. The appointment in August 2013 of a new director of the Government Companies Authority, which is responsible for overseeing the country's 98 state-owned companies, also signals the prime minister's desire to inject fresh life into the stalled privatisation programme. However, only modest progress is likely, owing to stiff union resistance. There is likely to be particularly stubborn worker opposition to any privatisation of the Israel Electric Corporation, the public monopoly in charge of electricity generation.

A new taxation structure for the energy sector will boost the government's share of hydrocarbons revenue to 52-62%, from around 33% previously. 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. This process will be underpinned by the decision to establish a sovereign wealth fund. A government announcement in June 2013—ratified by the Supreme Court in October—that 40% of total gas production would be available for export has reduced some of the uncertainty that was impeding further development of the sector.

Fiscal policy

Policy over the medium term will be focused on attempts to maintain the improvement in the public finances witnessed in 2013, which has continued so far this year. The main driver of this improved performance has been strong revenue growth, helped partly by an increase in tax rates. This has more than compensated for a continued overshoot on military spending—which is likely to be exacerbated by the war in Gaza. Despite the need for increased military outlays, we expect the budget deficit for 2014 to amount to 2.6% of GDP, down from 3.2% of GDP last year. The fiscal situation will continue to improve in 2015–18, reflecting a further strengthening in tax revenue on the back of a steady recovery in the global economy, as well as mounting income from hydrocarbons royalties. However, the pace of fiscal consolidation could be slower than envisaged if there is a need for a prolonged military operation in Gaza, or if a repeat of the "summer of protests" of 2011 leads to mounting pressure for a further rise in social spending.

Monetary policy

Since the Bank of Israel (BOI, the central bank) started its easing cycle in September 2011, rates have been reduced by a cumulative 275 basis points, taking the policy rate to 0.50% (the latest 25-basis-point cut came on July 28th). Monetary policy is likely to remain loose in the near term, given the subdued outlook for inflation, lacklustre economic growth and the central bank's concern over the strength of the New Israeli shekel. The appreciation of the shekel prompted the BOI to announce a programme of foreign-currency purchases to neutralise the impact of gas revenue on the external accounts, with purchases starting at US$2.1bn in 2013, increasing to US$3.5bn in 2014. However, with upward pressure on the shekel, the BOI has recently resorted to increased ad hoc intervention (on top of its pre-announced purchases); in first-half 2014 the central bank bought a total of US$5.2bn in foreign currency, of which US$3.2bn represented ad hoc purchases. The BOI has also introduced a series of regulatory curbs on mortgage lending in response to rapidly rising house prices. The BOI will begin to tighten policy in 2015, in response to accelerating economic growth and a pick-up in inflation. The base rate will be raised gradually, reaching 4% in 2018.

International assumptions

	2013	2014	2015	2016	2017	2018
Economic growth (%)						
US GDP	1.9	2.2	3.2	2.4	2.4	2.6
OECD GDP	1.3	2.1	2.6	2.3	2.3	2.5
World GDP	2.1	2.6	3.0	2.8	2.8	2.9
World trade	2.7	4.4	5.0	5.3	5.4	5.5
Inflation indicators (% unless otherwise indicated)						
US CPI	1.5	1.8	2.1	2.3	2.3	2.5
OECD CPI	1.6	2.1	2.2	2.3	2.2	2.1
Manufactures (measured in US$)	-3.1	0.0	0.9	1.8	1.9	1.6
Oil (Brent; US$/b)	108.9	107.5	105.1	103.8	97.5	93.0
Non-oil commodities (measured in US$)	-6.8	-3.0	0.1	0.6	3.3	2.9
Financial variables						
US$ 3-month commercial paper rate (av; %)	0.1	0.1	0.4	1.4	2.4	2.9
Exchange rate NIS:US$ (av)	3.6	3.5	3.4	3.3	3.3	3.2
Exchange rate US$:€ (av)	1.33	1.34	1.27	1.26	1.27	1.26

Economic growth

Economic growth will remain relatively lacklustre in the near term, before accelerating sharply in the second half of the forecast period. The initial estimate for annualised real GDP growth in the first quarter of 2014 was disappointing, at just 2.1%, but was subsequently revised up, to 2.7%. Nevertheless, this still represents a slowdown compared with the final quarter of 2013, when the economy expanded at an annualised pace of 3.2%. With both private consumption and investment registering contractions in the first quarter, we believe that the government will be under pressure to offer some extra stimulus to the economy, via a partial reversal of recent tax rises. Coupled with a pick-up in both US and euro zone growth—which will benefit Israel's export-oriented economy—the attempts to reinvigorate domestic demand will lead to an acceleration in overall growth from 3.1% in 2014 to 4.1% in 2015. Rising gas output—and a consequent reduction in energy import needs—will also provide an increasing impetus to growth over the forecast period.

The level of investment will remain sensitive to international developments. However, the exploitation of large gas deposits in the Mediterranean (the Tamar field came on stream in April 2013) will require significant investment in pipelines, terminals and associated infrastructure, and will provide a fillip over the medium term, although it will also draw in imports. Israel's dynamic high-technology sector will also be a key investment driver. In addition, residential construction will grow, helped by government initiatives to expand the housing stock and curb the upward pressure on property prices.

With exports accounting for around 40% of GDP, foreign demand will remain a critical determinant of overall growth. Export performance in the near term will be held back by the continuation of weak (albeit steadily recovering) European demand; countries in the EU absorbed nearly one-third of Israel's merchandise exports in 2013. Although Israel has been gradually diversifying its export trade towards emerging economies, many of the latter are also now experiencing headwinds. 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 natural gas also begin; non-binding deals allowing the future export of gas have been negotiated with companies in both Egypt and Jordan. Overall, we expect real GDP to expand by an average of 4.7% a year in 2014–18, with particularly strong growth in 2017–18.

Economic growth

%	2013[a]	2014[b]	2015[b]	2016[b]	2017[b]	2018[b]
GDP	3.3	3.1	4.1	4.9	5.5	6.0
Private consumption	3.7	3.4	4.3	4.6	4.8	5.3
Government consumption	3.1	2.2	2.1	2.1	1.9	2.0
Gross fixed investment	1.3	2.7	5.4	6.6	7.6	7.7
Exports of goods & services	1.0	2.6	5.6	7.9	9.3	10.3
Imports of goods & services	-0.3	3.2	5.3	6.8	7.6	8.1
Domestic demand	2.9	3.3	4.0	4.5	4.8	5.2
Agriculture	2.0[c]	2.1	2.1	2.0	1.9	1.9
Industry	-1.1[c]	2.2	4.4	5.1	5.8	6.3
Services	4.4[c]	3.3	4.1	5.0	5.4	6.0

[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 early part of the forecast period. Subdued global commodity prices and an appreciating currency will also help to keep inflation low. Reflecting the strength of the shekel—which, despite the conflict in Gaza, has appreciated further in recent weeks—we have reduced our forecast for average inflation in 2014 to 0.9%, below the central bank's 1–3% target range. Inflationary pressures will pick up from 2015 as domestic demand starts to grow more strongly. Nonetheless, a progressive tightening of monetary policy, together with a further rise in the shekel, will help to keep inflation within the target range. We expect inflation to average 2.3% in 2015–18. Overheating in the housing market remains a risk. However, we expect the BOI to unveil further macroprudential measures if this threat persists.

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 prospect of rapidly rising natural gas output have prompted a significant strengthening of the currency. This led the central bank to intervene directly in April 2013 with US dollar purchases (for the first time since mid-2011), followed by the announcement of 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 2014 and beyond as increased domestic gas production benefits the external position, although the authorities will almost certainly respond with further dollar purchases and other measures in a bid to curb upward pressure on the currency.

External sector

Expenditure on imports in 2014 will be constrained by lower commodity prices and a further rise in domestic gas supplies. However, merchandise export growth also remained relatively sluggish in the first half of 2014 (at 1.7% year on year), reflecting an uneven recovery in Israel's main export markets—particularly Europe. As a result, we now expect the trade deficit to widen slightly this year, compared with our previous forecast of a modest narrowing. Tourist receipts will also be hit in the short term by the war in Gaza, particularly given a temporary ban on some flights. Nonetheless, the Open Skies agreement with the EU will provide a boost to the tourism sector over the medium term, by providing improved flight connectivity and leading to lower fares; full liberalisation is targeted for 2018. We expect the current account to record growing surpluses from 2015 onwards as the recovery in export growth accelerates and import costs are held down by a steady increase in domestic gas supplies. Exports of gas will also make an increasing contribution in 2017–18. Reflecting rising dividend payments to international energy firms with stakes in the gas sector, the primary income deficit will increase slightly, despite a rise in income from a growing pool of official foreign assets. Against this backdrop, we expect the current-account surplus to widen from 2.5% of GDP in 2014 to 4.7% of GDP in 2018.

Forecast summary

Forecast summary

(% unless otherwise indicated)

	2013[a]	2014[b]	2015[b]	2016[b]	2017[b]	2018[b]
Real GDP growth	3.3	3.1	4.1	4.9	5.5	6.0
Industrial production growth	-1.1	2.2	4.4	5.1	5.8	6.3
Gross agricultural production growth	2.0[c]	2.1	2.1	2.0	1.9	1.9
Unemployment rate (av)	6.2	5.7	5.3	5.2	5.1	4.9
Consumer price inflation (av)	1.5	0.9	1.6	2.2	2.6	2.7
Consumer price inflation (end-period)	1.8	0.9	1.9	2.5	2.7	2.8
Lending rate (av; %)	4.5	3.8	4.0	5.0	5.8	6.0
Government balance (% of GDP)	-3.2	-2.6	-2.4	-1.5	-0.7	0.4
Exports of goods fob (US$ bn)	61.7	63.0	67.7	74.6	84.3	96.0
Imports of goods fob (US$ bn)	71.1	72.8	75.3	80.2	87.8	97.3
Current-account balance (US$ bn)	7.2	7.8	9.9	14.0	17.5	20.5
Current-account balance (% of GDP)	2.5	2.5	2.9	3.7	4.3	4.7
External debt (end-period; US$ bn)	95.6[c]	95.6	96.2	98.4	101.0	104.3
Exchange rate NIS:US$ (av)	3.61	3.46	3.39	3.31	3.26	3.22
Exchange rate NIS:US$ (end-period)	3.47	3.41	3.35	3.29	3.24	3.19
Exchange rate NIS:€ (av)	4.80	4.65	4.32	4.17	4.14	4.05
Exchange rate NIS:¥100 (av)	3.70	3.39	3.32	3.25	3.23	3.22

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

Data and charts

Annual data and forecast

	2009[a]	2010[a]	2011[a]	2012[a]	2013[a]	2014[b]	2015[b]
GDP							
Nominal GDP (US$ bn)	205.8	232.0	258.2	257.6	291.4	317.4	342.0
Nominal GDP (NIS bn)	809	866	924	993	1,052	1,099	1,161
Real GDP growth (%)	0.9	5.5	4.6	3.4	3.3	3.1	4.1
Expenditure on GDP (% real change)							
Private consumption	2.1	5.1	3.8	3.2	3.7	3.4	4.3
Government consumption	2.5	3.6	2.5	3.0	3.1	2.2	2.1
Gross fixed investment	-5.2	9.6	15.7	3.5	1.3	2.7	5.4
Exports of goods & services	-11.0	14.0	7.3	1.0	1.0	2.6	5.6
Imports of goods & services	-13.7	15.3	10.5	2.3	-0.3	3.2	5.3
Origin of GDP (% real change)							
Agriculture	9.5[c]	0.0[c]	2.0[c]	2.2[c]	2.0[c]	2.1	2.1
Industry	-5.0	7.7	-6.6	3.0	-1.1[c]	2.2	4.4
Services	1.1	4.7	4.7	2.7	4.4[c]	3.3	4.1
Population and income							
Population (m)	7.5	7.6	7.8	7.9	8.0	8.2	8.3
GDP per head (US$ at PPP)	27,228[c]	28,647[c]	30,211[c]	31,195[c]	32,141[c]	33,115	34,625
Recorded unemployment (av; %)	9.4	8.3	7.0	6.9	6.2	5.7	5.3
Fiscal indicators (% of GDP)							
General government revenue[d]	25.0	25.5	25.6	24.7	25.5	25.8	26.0
General government expenditure	30.0	29.0	28.7	28.6	28.6	28.4	28.4
General government balance	-4.9	-3.5	-3.1	-3.9	-3.2	-2.6	-2.4
Public debt	73.8	70.0	68.5	66.9	66.3	66.2	64.6
Prices and financial indicators							
Exchange rate NIS:US$ (end-period)	3.78	3.55	3.82	3.73	3.47	3.41	3.35
Exchange rate NIS:€ (end-period)	5.44	4.74	4.94	4.89	4.74	4.42	4.22
Consumer prices (av; %)	3.3	2.7	3.5	1.7	1.5	0.9	1.6
Stock of money M1 (% change)	50.8	12.1	4.0	5.0	12.8	15.4	11.4
Stock of money M2 (% change)	17.7	3.9	9.6	8.4	6.2	6.5	6.6
Lending interest rate (av; %)	4.2	5.0	6.0	5.6	4.5	3.8	4.0
Current account (US$ m)							
Trade balance	733	-1,954	-8,188	-9,346	-9,427	-9,800	-7,584
Goods: exports fob	46,806	56,414	64,294	62,321	61,719	62,993	67,748
Goods: imports fob	-46,073	-58,368	-72,482	-71,667	-71,146	-72,793	-75,332
Services balance	4,994	5,996	6,872	9,838	12,869	14,848	16,153
Primary income balance	-5,114	-5,152	-4,350	-8,020	-5,496	-6,236	-7,541
Secondary income balance	7,402	8,279	8,923	8,377	9,242	9,002	8,897
Current-account balance	8,015	7,169	3,257	849	7,188	7,814	9,924
External debt (US$ m)							
Debt stock	94,637	107,823[c]	105,314[c]	96,970[c]	95,633[c]	95,645	96,159
Debt service paid	9,951	10,522	16,362[c]	18,025[c]	12,865[c]	12,849	12,092
Principal repayments	4,590	4,857	9,735[c]	11,557[c]	6,905[c]	7,285	6,425
Interest	5,361	5,665	6,626[c]	6,468[c]	5,960[c]	5,564	5,667
International reserves (US$ m)							
Total international reserves	60,611	70,907	74,874	75,908	81,786	90,814	93,519

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

Quarterly data

	2012 2 Qtr	3 Qtr	4 Qtr	2013 1 Qtr	2 Qtr	3 Qtr	4 Qtr	2014 1 Qtr
Output								
GDP at constant 2005 prices (NIS bn)	230.0	238.1	237.8	236.1	241.5	243.0	246.5	243.4
Real GDP (% change, year on year)	2.9	3.2	3.1	2.8	5.0	2.1	3.7	3.1
State of economy index (% change, year on year)[a]	4.7	15.2	3.5	3.3	3.2	-6.9	3.0	2.7
Revenue (2004=100)[a]	100.3	116.0	100.0	102.1	103.6	103.7	104.9	105.4
Index of goods exports (2005=100)[a]	91.2	126.3	92.1	99.1	99.7	92.7	101.1	103.7
Employment and prices								
Industrial employment (2000=100)	103	102	102	102	103	102	103	n/a
Employment ('000)	3,352	3,394	3,383	3,417	3,434	3,471	3,477	3,527
Unemployment rate (% of the labour force)	6.6	7.0	7.1	6.5	6.2	6.3	5.8	5.7
Consumer prices incl VAT (2006=100)	100.0	100.6	100.5	100.4	101.2	102.2	102.4	101.7
Consumer prices incl VAT (% change, year on year)	1.6	1.8	1.6	1.4	1.2	1.6	1.9	1.3
Wholesale prices, manufacturing output (2005=100)	99.6	100.2	101.8	101.6	99.7	100.6	99.9	99.8
Wholesale prices, manufacturing output (% change, year on year)	3.5	4.0	5.0	3.3	0.0	0.4	-1.9	-1.7
Financial indicators								
Exchange rate NIS:US$ (av)	3.824	3.988	3.841	3.708	3.626	3.582	3.526	3.497
Exchange rate NIS:US$ (end-period)	3.923	3.912	3.733	3.648	3.618	3.537	3.471	3.487
Deposit rate (av; %)	2.3	2.2	2.0	1.8	1.6	1.3	1.1	n/a
Lending rate (av; %)	5.7	5.4	5.3	4.9	4.7	4.4	4.2	n/a
Treasury bill rate, 1 year (av; %)	2.4	2.1	2.0	1.7	1.5	1.2	0.9	0.8
M1 (end-period; NIS bn)[b]	120.3	124.9	125.5	128.7	132.8	141.5	143.8	149.4
M1 (% change, year on year)	3.1	8.3	9.2	12.7	10.4	13.3	14.6	16.1
M2 (end-period; NIS bn)[b]	500.1	515.7	522.9	528.9	534.3	542.2	554.5	566.0
M2 (% change, year on year)	8.5	8.2	7.6	6.9	6.8	5.1	6.0	7.0
Tel Aviv 100 stockmarket index (end-period; Jan1st 1992=100)	969.9	1,054.6	1,049.1	1,100.0	1,069.6	1,142.5	1,207.7	1,282.8
Sectoral trends								
Mining production (2004=100)	96.6	104.0	88.3	96.1	131.9	124.1	132.2	128.2
Manufacturing production (2004=100)	105.1	107.2	106.1	102.3	102.3	99.0	110.9	103.5
Tourist arrivals ('000)	807.2	724.5	716.8	602.4	824.8	698.2	836.4	705.2
Construction completed ('000 sq metres)	2,522	2,279	2,343	2,420	2,720	2,493	2,666	2,575
Residential ('000 sq metres)	1,862	1,765	1,946	1,837	2,110	1,940	2,110	1,963
Foreign trade (US$ m)								
Exports fob	13,719	13,094	13,265	14,336	14,659	12,737	15,139	15,818
Diamonds, polished	2,300	1,559	1,922	2,437	2,496	1,945	2,124	2,184
Imports cif	-18,373	-17,345	-17,432	-17,131	-17,857	-17,723	-18,391	-18,203
Trade balance	-4,654	-4,252	-4,168	-2,795	-3,198	-4,986	-3,252	-2,385
Foreign payments (US$ m)								
Merchandise trade balance fob-fob	-1,740	-1,927	-1,955	-1,516	-1,758	-3,770	-2,383	n/a
Services balance	3,025	1,567	3,288	2,861	3,805	2,056	4,147	n/a
Primary income balance	-2,325	-2,024	-2,081	-1,589	-1,976	-789	-1,142	n/a
Net transfer payments	1,982	2,109	1,949	2,199	2,038	2,415	2,593	n/a
Current-account balance	941	-274	1,201	1,954	2,109	-87	3,214	n/a
Reserves excl gold (end-period)	75,119	76,225	75,908	76,967	78,221	79,902	81,786	85,569

[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

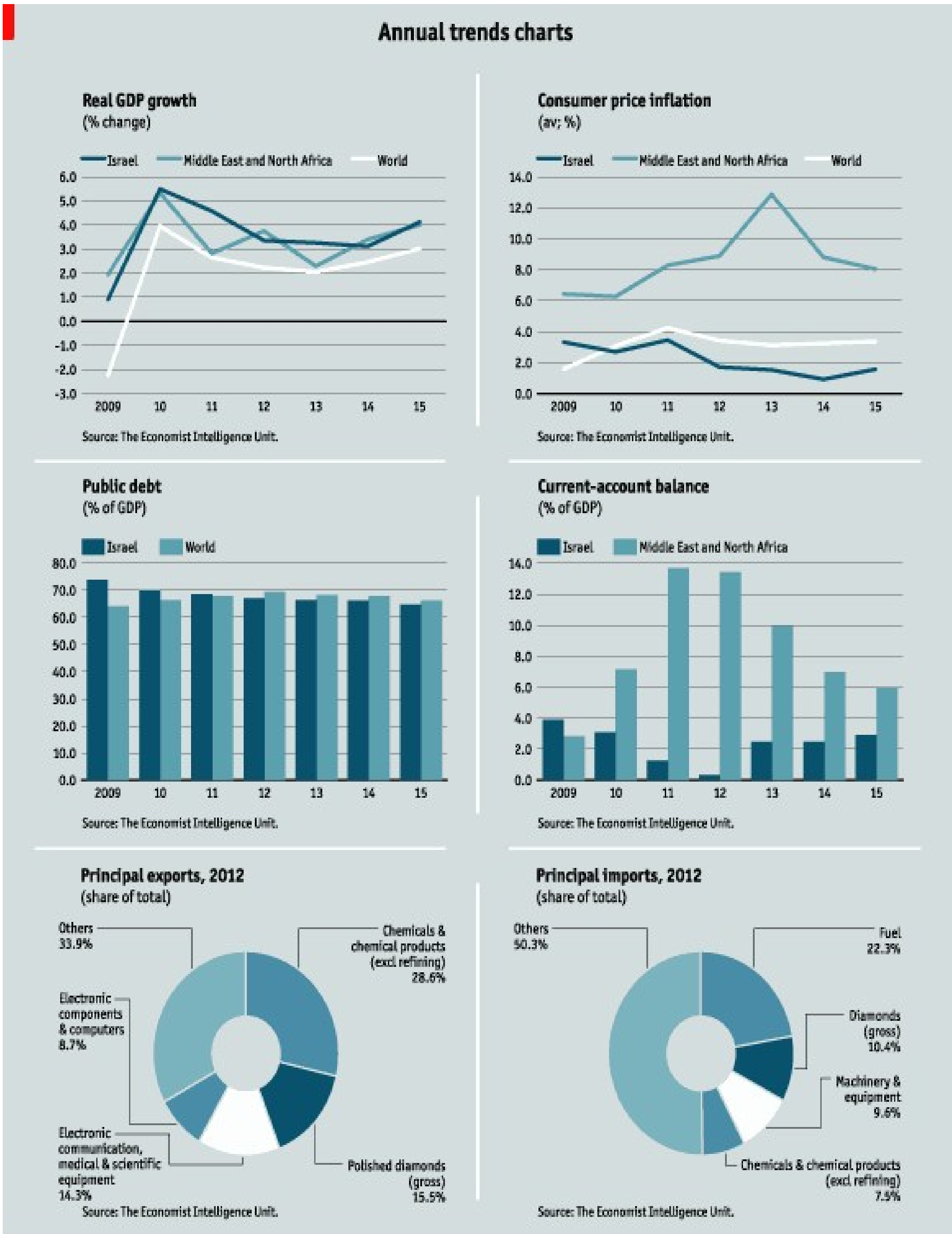
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate NIS:US$ (av)												
2012	3.81	3.74	3.76	3.75	3.83	3.89	3.99	4.02	3.96	3.85	3.89	3.78

2013	3.74	3.69	3.70	3.62	3.63	3.63	3.61	3.58	3.56	3.54	3.54	3.51
2014	3.49	3.52	3.48	3.48	3.47	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Exchange rate NIS:€ (av)												
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	4.76	4.76	4.82	4.77	4.80
2014	4.76	4.80	4.81	4.80	4.76	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Real effective exchange rate (2000=100; CPI-basis)												
2012	85.57	85.79	85.61	86.21	85.37	84.53	82.55	81.97	81.79	83.41	82.93	84.65
2013	85.59	86.76	88.13	89.85	89.59	89.55	90.65	90.74	91.09	90.88	91.35	91.74
2014	92.31	91.36	90.93	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (end-period; NIS bn)												
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	752.9	758.7	758.0	763.8	764.7	768.8
2014	769.1	770.7	768.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Budget revenue (NIS bn)												
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	17.7	24.7	21.6	23.9	21.2	25.5	21.1	26.9	21.3	22.7	24.6
2014	25.8	20.9	27.5	23.8	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Budget expenditure (NIS bn)												
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	27.2	24.0	22.5	24.3	25.6	23.4	27.4	25.6	23.2	37.9
2014	21.0	22.5	29.7	24.5	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Budget balance (NIS bn)												
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	-2.4	1.4	-3.1	-0.1	-2.2	-0.5	-4.3	-0.5	-13.3
2014	4.8	-1.6	-2.2	-0.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
M1 (end-period; % change, year on year)												
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	11.5	13.8	12.7	13.4	13.6	14.9	15.2
2014	15.6	16.6	16.0	20.1	19.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a
M2 (end-period; % change, year on year)												
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	5.6	4.9	5.3	5.2	5.6	5.9	6.6
2014	6.5	7.2	7.3	8.2	7.2	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Manufacturing production index (% change, year on year)												
2012	3.0	0.3	-6.0	14.2	7.4	4.9	10.3	10.3	1.3	7.1	6.1	0.3
2013	2.4	5.1	-1.8	0.6	-6.8	-1.5	-1.5	-12.9	-8.5	9.2	-4.5	9.5
2014	-2.7	2.7	3.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic trade & services index (seasonally adjusted; % change, year on year)												
2012	-0.1	-0.4	-2.1	0.6	1.1	-2.6	0.6	1.7	0.1	3.7	-0.6	0.5
2013	0.2	3.6	2.6	4.3	2.0	3.7	1.4	3.5	4.6	4.3	5.6	4.8
2014	6.0	2.2	1.7	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Average monthly wages (% change, year on year)												
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	1.7	1.6	2.1	2.7	0.3	1.0	0.9	1.6	1.9	0.9	-0.3	-0.7
2014	0.7	0.7	0.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Deposit interest rate (%)												
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	1.7	1.6	1.4	1.3	1.3	1.2	1.1	1.1	1.1
2014	1.1	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Money market rate (end-period; %)												
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	0.1	0.1	0.1	0.1	0.1	0.1
2014	0.1	0.1	0.1	0.1	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)												
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	1,082	1,143	1,162	1,219	1,208
2014	1,200	1,257	1,283	1,251	1,257	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Consumer prices (av; % change, year on year)												
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	1.3	1.3	1.8	1.9	1.8
2014	1.4	1.2	1.3	1.0	1.0	0.5	n/a	n/a	n/a	n/a	n/a	n/a
Core consumer prices (av; % change, year on year; excl housing, fruit & vegetables)												
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	1.0	1.2	1.1	1.1	1.1
2014	0.8	0.5	0.4	0.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Wholesale prices (av; % change, year on year)												
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	0.5	-1.9	-1.9	-2.4	-1.3
2014	-1.0	-2.4	-1.9	-0.2	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Total exports fob (US$ m)												
2012	4,357	4,309	5,228	4,322	5,351	4,045	4,617	4,198	4,278	4,653	4,523	4,088
2013	4,619	4,807	4,910	5,310	4,989	4,360	4,507	4,045	4,185	5,436	5,006	4,697
2014	5,107	5,732	4,979	4,020	5,179	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Total imports cif (US$ m)												
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	5,754	5,887	5,489	6,383	5,846	5,629	6,672	5,639	5,412	6,460	5,727	6,204
2014	6,155	5,801	6,247	5,812	6,022	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Trade balance fob-cif (US$ m)												
2012	-2,082	-1,806	-1,338	-1,941	-1,078	-1,635	-1,723	-2,055	-474	-2,334	-54	-1,779
2013	-1,136	-1,080	-579	-1,073	-857	-1,269	-2,165	-1,594	-1,227	-1,024	-721	-1,507
2014	-1,048	-69	-1,268	-1,792	-843	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Foreign-exchange reserves excl gold (end-period; US$ m)												
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	79,073	78,519	79,902	80,578	80,578	81,786
2014	83,165	83,975	85,569	86,490	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

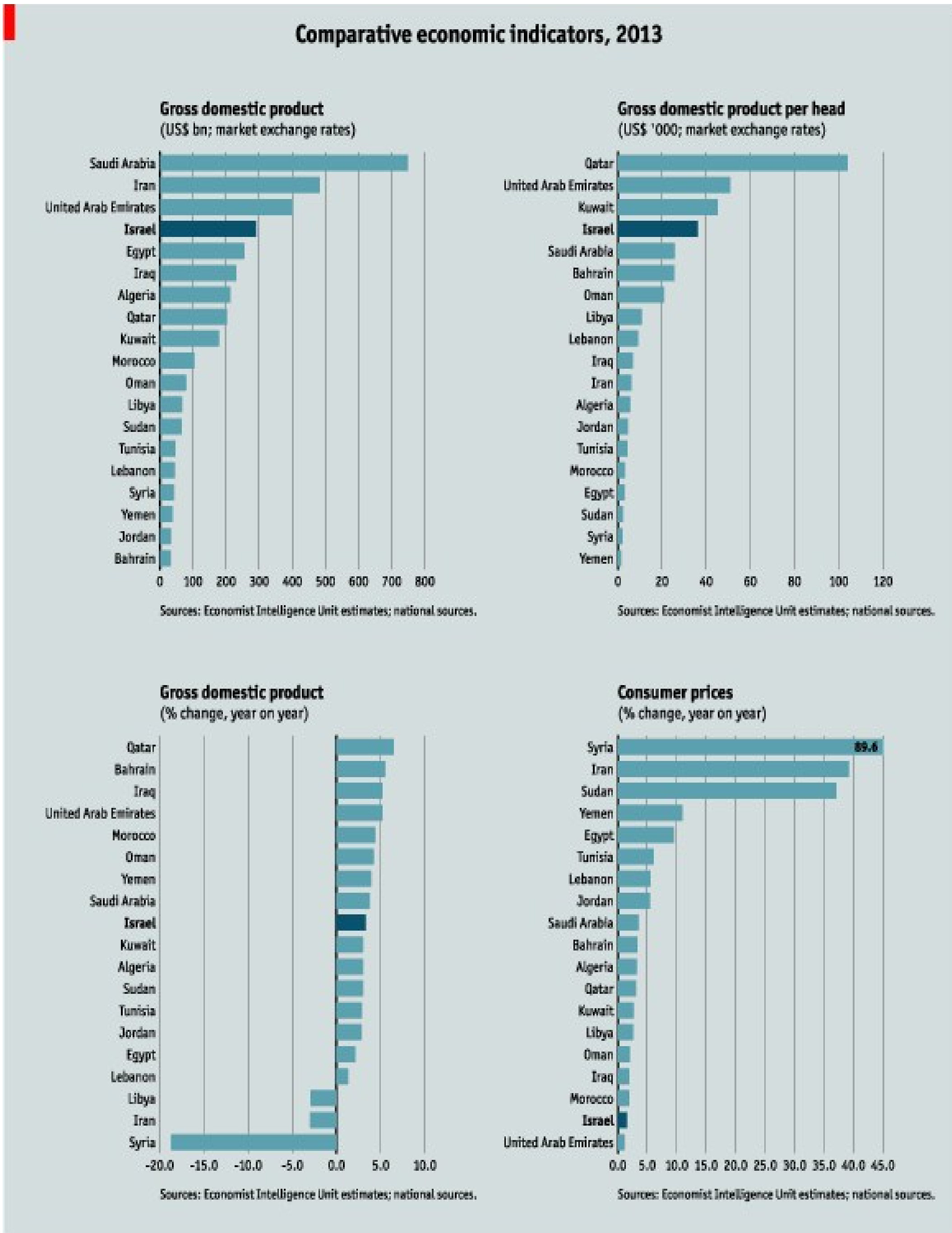
Sources: IMF, International Financial Statistics; Haver Analytics.

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

8.018m (April 2013; Central Bureau of Statistics estimate), of whom 75.3% are Jewish, 20.7% Arabs and 4% "others" (including non-Arab Christians)

Main towns

Population in 2009 (PopulationData.net):

Tel Aviv: 3,340,850

Jerusalem (a): 1,300,968

Haifa: 1,217,737

Ashdod: 228,564

Beersheba: 195,695

Nazareth: 69,078

Eilat: 50,773

(a) Including East Jerusalem.

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

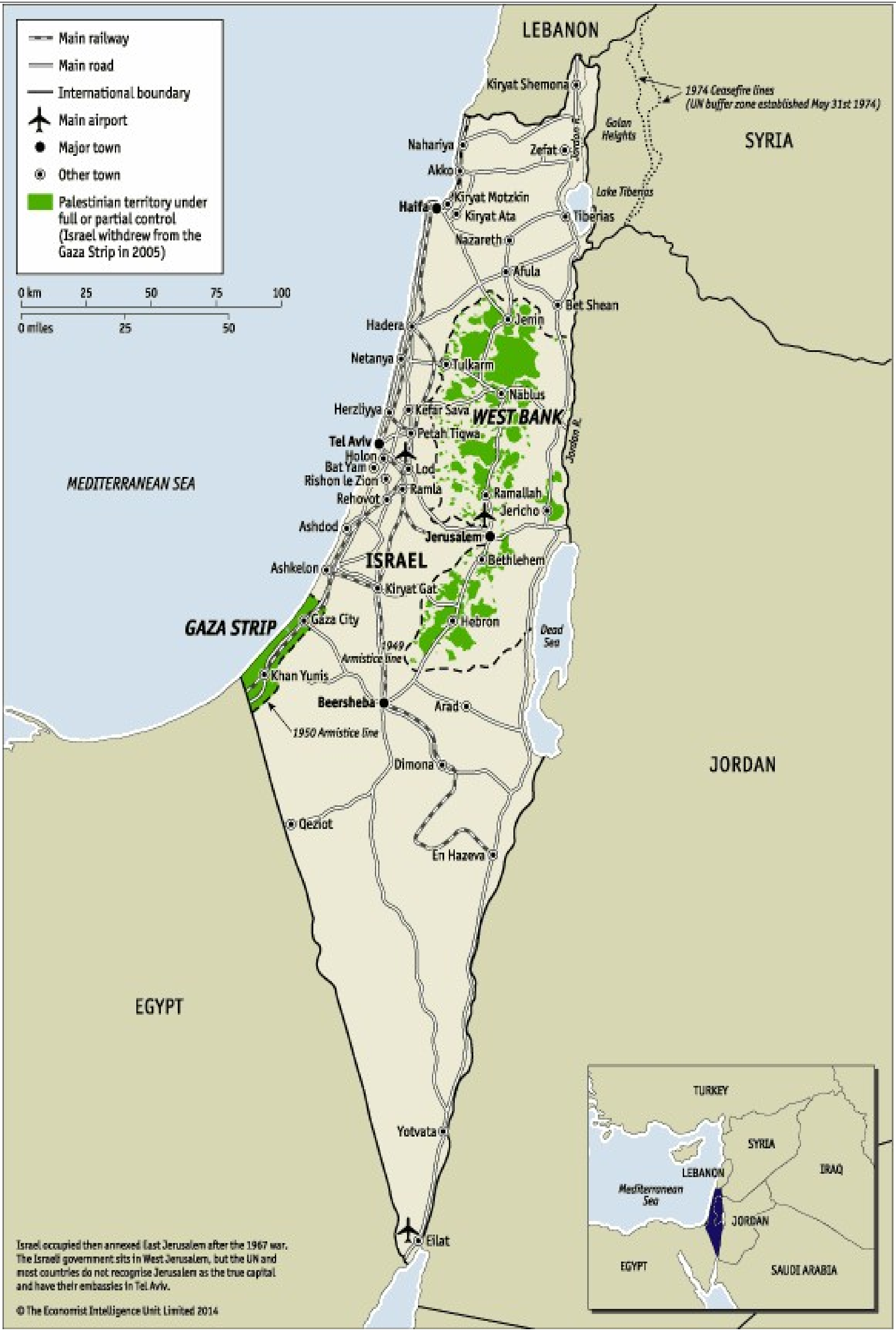
2 hours ahead of GMT

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. March 6th 2014 (Purim; banks only); April 16th-21st (Passover; first and last days are usually public holidays); May 6th (Independence Day); June 4th (Shavuot); August 5th (Tisha b'Av; banks only); September 25-26th (Jewish New Year); October 4th (Yom Kippur); October 9th (Sukkot starts); October 15th (Sukkot ends); October 17th (Simchat Torah); December 17th (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.

Reuven Rivlin replaced the outgoing Shimon Peres on July 24th

National government

Cabinet, responsible to the legislature; the prime minister, Binyamin Netanyahu, leads a coalition government, comprising Likud, Yisrael Beiteinu (which ended its electoral pact with Likud in July 2014), Yesh Atid, Habeyit Hayehudi and Hatnua, which was sworn in on March 18th 2013

Main political parties

Likud (right-wing); Yisrael Beiteinu (right-wing); 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 (& public diplomacy & diaspora affairs): Binyamin Netanyahu (Likud)

Agriculture & rural development: Yair Shamir (Yisrael Beiteinu)

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

Culture & sport: Limor Livnat (Likud)

Defence: Moshe Yaalon (Likud)

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)

Environmental protection: Amir Peretz (Hatnua)

Finance: Yair Lapid (Yesh Atid)

Foreign affairs: Avigdor Lieberman (Yisrael Beiteinu)

Health: Yael German (Yesh Atid)

Housing & construction: Uri Yehuda Ariel (Habeyit Hayehudi)

Immigrant absorption: Sofa Landver (Yisrael Beiteinu)

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

Interior: Gideon Saar (Likud)

Internal security: Yitzhak Aharonovitch (Yisrael Beiteinu)

Justice: Tzipi Livni (Hatnua)

Science & technology: Yaakov Perry (Yesh Atid)

Tourism: Uzi Landau (Likud)

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

Welfare & social services: Meir Cohen (Yesh Atid)

Speaker of the Knesset

Yuli Edelstein (Likud)

Central bank governor

Karnit Flug

Recent analysis

Generated on August 20th 2014

The following articles have been written in response to events occurring since our most recent forecast was released, a
indicate how we expect these events to affect our next forecast.

Politics

Forecast updates

August 4, 2014: Political stability

Israel may be aiming to wind down Gaza conflict

Event

Israel has withdrawn most of its troops from the Gaza Strip and on Monday morning unilaterally declared a seven-hour ceasefire, signalling its intention to wind down Operation Protective Edge after nearly a month. An Israeli Air Force attack that killed ten Palestinians at a UN school drew unusually strong criticism internationally.

Analysis

Israel's prime minister, Binyamin Netanyahu, backed by the defence establishment, is eager to end the fighting. Israel claims to have destroyed the 31 tunnels that Hamas had built to stage raids into Israel, and the Islamist organisation's fighting capabilities have been severely weakened. Military intelligence estimates that Hamas has used or lost two-thirds of its rocket arsenal in the fighting and will not be able to replenish it anytime soon. In addition, Mr Netanyahu does not want to risk becoming embroiled in drawn-out fighting in densely packed urban areas.

Nevertheless, the situation is by no means under Israel's control. Hamas seems determined to continue its rocket attacks until it can achieve at least some kind of symbolic military victory, such as a kidnapping, or win concessions through ceasefire talks. A Hamas delegation arrived in Cairo for talks on Sunday, even though Israel is not planning to send negotiators. The Israeli decision to stay away from the talks may reflect a view that negotiations can only lead to Israeli concessions, whereas Israel's bringing an end to the war unilaterally will leave Hamas with nothing to show for the weeks of death and destruction in Gaza.

However, continued rocket attacks, growing international intolerance of civilian deaths and a desire by Israel to please Egypt and the US, which favour a negotiated truce, may yet bring it to the negotiating table.

Impact on the forecast

Whatever the outcome of the present bout of fighting, the Israeli strategy of containing Hamas by blockading Gaza and fighting periodic wars looks unsustainable. That may give fresh impetus to the peace process as Mr Netanyahu tries to strengthen the position of Mahmoud Abbas, the Palestinian president, and perhaps help to restore Mr Abbas's authority in Gaza. However, events remain fluid and at this stage we are likely to retain our forecast that a meaningful revival of the peace process remains improbable.

August 11, 2014: International relations

Another attempt at a ceasefire is under way

Event

Israel and Hamas agreed to another 72-hour ceasefire late on August 10th and were due to resume negotiations on a more permanent agreement under Egyptian mediation in Cairo. The latest truce followed two days of low-level hostilities after the previous 72-hour ceasefire expired.

Analysis

Although the current truce appeared to be holding and neither side seems anxious to resume fighting on the same scale as before, reaching a sustainable accord to end hostilities in Gaza will not be straightforward. Hamas is holding out for substantial concessions, including an end to Israel's blockade of the Gaza Strip, the reopening of border stations with Egypt and the rebuilding of Gaza's air and sea ports, as well as other, mostly economic demands. Having failed in five weeks of fighting to achieve a military victory, at the cost of some 1,900 Palestinian lives, Hamas is now intent on alleviating Gaza's economic distress while ensuring it has conduits to import arms.

Israel has not publicly spelled out what it will agree to, but *Yedioth Ahronoth*, a daily newspaper, reported that the Israeli government is prepared to countenance opening the border with Egypt, expanding fishing rights and allowing aid to enter Gaza for reconstruction so long as there are controls to ensure that money and material are not used by Hamas for military purposes. Israel opposes rebuilding the air and sea outlets, and has spoken about disarming Hamas.

The negotiations have been complicated by their awkward structure. Israel and Hamas do not talk to each other directly but through Egyptian interlocutors. Although it is serving as an intermediary, Egypt has done little to disguise its hostility to Hamas, which it regards as complicit in the unrest in Egypt's Sinai and an ally of the Muslim Brotherhood (whose political arm was formally banned in Egypt on August 9th). The Palestinian delegation has a blurry chain of command, with negotiators reporting to Hamas's leader, Khaled Meshaal, and the president of the Palestinian Authority, Mahmoud Abbas.

Impact on the forecast

It seems unlikely that full-scale fighting will resume, even if the current round of talks fail. Israel has achieved its military goals and does not want to risk the casualties of a second ground incursion. Hamas's fighting ability has been severely diminished, according to Israeli estimates, with two-thirds of its rockets used or destroyed in the past five weeks. For now, our forecast will remain cautious about the prospects of a more long-lasting peace process.

August 19, 2014: International relations

Palestinians consider joining International Criminal Court

Event

In the context of the recent devastating bombardment of Gaza, there has been growing momentum within Palestinian circles for the Palestinian Territories to join the International Criminal Court (ICC).

Analysis

The ICC is a court of last resort for war crimes. Many Palestinian officials believe that membership of the court could enable cases to be brought against members of the Israeli military and government in relation to incidents that occurred during the recent assault on Gaza—such as the shelling of UN schools—as well as other alleged abuses since 2002 (when the ICC was founded). In April 2012 the ICC declined to investigate charges relating to the 2008-09 Gaza war because the Palestinian Territories was not viewed as a state. However, since it was recognised as a non-member state by the UN General Assembly in November 2012, it has had the option of joining the ICC by signing the Rome Statute. If it were to join the ICC it would be the 123rd country to do so, but only the second Arab state, after Jordan.

Although the Palestinian Territories has since joined a variety of UN agencies, it has not yet moved ahead with the ICC because of pressure from Israel and Western donors, and concerns that Palestinian militant groups could face prosecution. However, recent reports suggest that Hamas—together with Fatah, the moderate Palestinian faction that governs the West Bank—now supports the notion of ICC membership. There is also external backing for such a move from Avaaz, a global campaigning group, as well as Amnesty International. The latter has called on both Palestine and Israel to join the ICC and for the court to investigate alleged war crimes committed by both sides in the Gaza conflict.

In a sign of growing momentum, the Palestinian foreign minister, Riyad al-Maliki, visited the ICC in the Netherlands on August 5th. This visit came a week after a lawyer on behalf of the Palestinian Ministry of Justice submitted a complaint to the ICC prosecutor in regard to the Gaza war.

Impact on the forecast

The ability to bring cases at the ICC would significantly boost Palestinian negotiating power, as it could potential restrict Israeli officials from travelling in ICC member states for fear of arrest. This could support future peace negotiations, which have failed partly because of the power imbalance between the two sides. However, we will await further developments before making any change to our forecast.

Analysis

August 5, 2014

The troubled relationship between Israel and Turkey

Israel's ties with Turkey, in the political, diplomatic, commercial, military and other spheres, would appear to be a primary non-battlefield casualty of the war between Israel and Hamas. Experience suggests that the current negative public rhetoric and opinion in both countries towards the other will not necessarily translate into an equivalent deterioration in economic and business ties. Nevertheless, even if growing bilateral trade persists, other developments such as a Turkish-Israeli energy deal would require improved political relations.

The Israeli-Turkish relationship reached its zenith in the 1990s, when both countries were staunch US allies with common interests in the volatile Middle East, shared by secular governments and sociopolitical elites. The ties between the two countries' military establishments were especially strong in that period, as Turkey used the know-how and capabilities developed by Israeli companies to refit and upgrade its US-made tanks and planes.

Initially, the rise to power of the Islamist Justice and Development Party (AKP) did not affect the relationship, but this gradually changed as the Turkish prime minister, Recep Tayyip Erdogan, strengthened his hold on power and systematically reduced that of the army, judiciary and other secularist bastions. Yet, in sharp contradistinction to the deteriorating political, diplomatic and military relations between Israel and Turkey, trade and commercial relations continued to flourish. Most obviously, Turkey's Mediterranean resort city of Antalya became the preferred location of Israeli tourists seeking cheap and relatively convenient family holidays.

Diplomatic crises

A seemingly decisive change occurred after Israel's "Cast Lead" operation against Gaza in December 2008 and an Israeli commando raid in 2010 on the Mavi Marmara, a ship sent by a Turkish non-governmental organisation to break the Israeli blockade of Gaza, in which nine passengers died. This triggered a major diplomatic crisis and the near breakdown of formal relations between the two countries. Mr Erdogan's rhetorical attacks against Israel became more frequent and far more aggressive, pushing the Israeli media and public to conclude that, above and beyond considerations linked to domestic and regional politics, the Turkish prime minister was himself deeply hostile to Israel. In recent weeks, against the background of the renewed hostilities in Gaza, this rhetoric has become even more extreme.

This led to a grass-roots movement among Israelis to take their vacationing business elsewhere. Yet, at the same time, many Israeli travellers, especially businessmen, used Istanbul and Turkish Airlines as their preferred hub and carrier respectively when travelling to Europe and, especially, the Far East.

Trade links continued to develop

Trade links continued to develop, albeit with ups and downs that had as much to do with domestic and global business cycles as political developments. In 2013 Israeli imports from Turkey rose by some 13%, from US$2.1bn in 2012 to US$2.35bn, according to Israel's Central Bureau of Statistics. Official Turkish data measure Turkish exports to Israel in 2013 at a higher amount. More dramatically, Israeli exports to Turkey soared from US$1.4bn in 2012 to US$2.5bn in 2013—but this gain was concentrated entirely in one sector, namely petrochemicals, and may reflect particular needs and circumstances at an industry- or even company-specific level.

Nevertheless, these trends extended through the first half of 2014, with Israeli data showing that both imports from Turkey—which are much more widely diffused across numerous sectors than exports—and exports to Turkey rose by 10–20% over the equivalent period in 2013.

Conflict again puts economic ties in spotlight

These developments have not gone unnoticed in Turkey and, against the background of the renewed fighting, there have been calls by opposition parties to "revise" trade ties with Israel. Strikingly, the Turkish economy minister, Nihat Zeybekci, spoke as recently as July 22nd in very positive terms about Turkish-Israeli trade, and also reminded his critics that Turkish trade with both the West Bank and the Gaza Strip goes through Israeli ports, airports and customs.

Yet, at the same time, the services sector of trade was taking an intense battering: Turkish airlines joined the general move by US and European airlines to stop flying to Ben Gurion Airport after a rocket landed nearby and was the last to resume flights there. Thousands of Israeli travellers were stranded in Istanbul, forcing the Israeli Ministry of Transport to organise an airlift to extricate them, flying first to Athens and then Israel. Ordinary Israelis, meanwhile, spontaneously demonstrated their displeasure with Turkey by cancelling their holidays booked for the summer, and the unions at many large workplaces announced a *de facto* boycott of Turkey as a vacation destination for their members. Ordinary Turks, for their part, demonstrated in large numbers against Israel's incursion into Gaza.

Israeli gas exports to Turkey?

As if these conflicting currents in trade and political relations were not confusing enough, a new and potentially much bigger economic issue has emerged over the last year. Israel's discovery of large offshore natural gas fields will enable it to become an energy exporter during the second half of this decade. Turkey's rapidly growing economy is also a fast-growing consumer of natural gas, with Russia as its main source of supply. The relative proximity and availability of Israeli gas makes Turkey a logical customer. And many Turkish companies are eager to participate in building the undersea pipelines and onshore distribution network that would accompany a Turkish-Israeli energy deal.

However, even if general trading activity manages to avoid fallout from diplomatic crises, the steady deterioration in political relations between the countries makes a Turkish-Israeli deal look increasingly unlikely. Meanwhile, the Israeli and US companies that own the gas fields are negotiating to sell the gas to European companies that already have underutilised liquefied natural gas facilities in Egypt, where the government of Abdel Fattah el-Sisi is well disposed towards Israel.

There is still room for exports to Turkey and Egypt, especially if the natural gas fields off Cyprus were linked into the same pipeline network—although that would require Turkey and Cyprus to reach a modus vivendi over their deep-seated disputes. But, with respect to the Israeli natural gas sector, it seems that the politicians hold the key to investment and trade between Israel and Turkey, and the business community will have to follow their lead.

August 11, 2014

US-Israel relations get rockier

US-Israel relations, which have been rocky in the five years since Barack Obama and Binyamin Netanyahu were both elected leaders of their respective countries, have taken another turn for the worse amid the fighting in Gaza and US efforts to broker a ceasefire. In addition, although bilateral ties are deep and multifaceted, there are long-term issues that could contribute to more tepid relations.

The US secretary of state, John Kerry, has been the flashpoint of the latest round of tensions as he has sought to bring an end to the fighting. A draft ceasefire proposal he presented to Israel on July 25th was leaked to the press and elicited a barrage of sharp criticism from unnamed Israeli officials, prompting a strong White House reaction. "This is not the way partners and allies treat each other," the State Department spokeswoman, Jen Psaki, said.

Close bonds come under strain

Meanwhile, there have been rumours that Mr Netanyahu hung up on Mr Kerry during a heated phone conversation, a report in a German magazine, *Der Spiegel*, that Israel eavesdropped on Mr Kerry's phone calls and reports that Mr Netanyahu warned the US ambassador not to "second guess" him on issues related to Hamas. Whether or not the stories are wholly or partly true, they certainly reflect the perception that the relations between two countries are unusually strained at present.

US-Israel ties are unusually deep and multifaceted. Unlike most of the US's bilateral relationships, policy is not dictated by the White House or State Department. There is a strong constituency both of US Jews and, in more recent years, fundamentalist Christians, that strongly lobby for Israel, particularly in Congress. The two countries have unusually strong military and intelligence relations, most notably the US$3bn in military aid the US provides Israel every year. The US is Israel's biggest trade partner and arms provider. Even as Obama administration officials were expressing umbrage over Mr Kerry's treatment, Congress voted a US$225m appropriation for Israel's Iron Dome missile-defence system and authorised a shipment of ammunition to restock Israel's army.

US foreign policy unsettles Israel

US-Israel ties have been punctuated by public clashes even during the Israel-friendly administrations of Ronald Reagan and George W Bush. From Israel's point of view, Mr Obama got off to a bad start after taking office in 2009, undertaking a high-profile campaign to mend fences with the Arab world that the Jewish state believed would come at its expense and then aggressively pushing peace talks with the Palestinians. Mr Netanyahu reluctantly agreed to the US's demand to freeze construction of new West Bank settlements at great cost to him politically only to see the talks collapse.

Relations grew tense again with the outbreak of the Arab Spring at the start of 2011, as Mr Obama backed the revolution in Egypt against Israeli misgivings. New strains followed as the US warned off Israel from attacking Iran to stop its nuclear programme and later as the US opened talks with Iran in a bid to find a negotiated agreement over programme. Mr Kerry's failed effort starting last year to restart Israeli-Palestinian talks earned him a reputation in Israel as naïve and bumbling.

Unlike past episodes of bilateral tensions, the troubles these days are both recurrent and have in the background a poor personal rapport between Mr Obama and Mr Netanyahu. Mr Netanyahu was widely accused of not so quietly backing the Republican candidate, Mitt Romney, in the 2012 presidential race.

Longer-term issues

Beyond that, there are longer-term issues that may well mean more tepid ties even after Mr Obama leaves office. The US's bitter experience in the war in Iraq and its reduced reliance on imported oil means that it is less inclined to entangle itself in the Middle East, reducing Israel's value as a regional ally. Meanwhile, the Arab Spring has created realignment of interests in the Middle East. Not only is Israel worried that the US is not sufficiently committed to preserving order and stability in the region or facing down the Iranian nuclear threat, so are Saudi Arabia and Egypt. All three countries have been pursuing their interests independently of the US, even if the Arab world's deep antipathy to Israel requires that co-operation remains quiet and covert. Correctly or not, the US is perceived as being weak and disengaged, which only exacerbates this phenomenon.

Inside the US, popular support for Israel may be waning. US Jews are overwhelmingly liberal, which makes Israel's treatment of the Palestinians difficult for many of them to support. Many are indifferent if not alienated by Israel and Zionism. Among the US public in general, support for Israel is weakest among younger people and Democrats, which bodes ill for the future of the broad, bipartisan support the Jewish state has tended to enjoy. A July 23rd poll by Gallup found that just over 50% of 18–29-year-olds thought Israel's current actions in Gaza unjustified, whereas a majority of those over 50 years old thought Israel justified. In the same poll, among Democrats (of any age) surveyed 30% thought Israel justified, whereas just over 45% thought Israel unjustified in the current hostilities.

Many in Israel—particularly on the political right, where US pressure to reach an agreement with the Palestinians is seen as a threat to the future of the settlements—have been casting about for alternative to the US relationship. However, this does not look very promising. China and Russia are two countries most often cited as alternative or at least complementary partners, and Israel has been working hard to cultivate diplomatic and commercial ties with the latter. But neither have the economic or military might to replace the US, nor with either country would Israel enjoy the popular support it does in the US, which has served as a foundation for the deep relationship over decades.

Particularly as its relations with Europe have grown frostier, Israel will be relying on the US as an ally even more for the foreseeable future. However, it may have to adjust itself to a new era where the relative balance of political power between the US and Israel shifts against it.

Economy

Forecast updates

August 13, 2014: Fiscal policy outlook

Budget deficit jumps

Event

The government ran a budget deficit of NIS 2.3bn (US$659m) in July, up from just NIS 0.4bn in the year-earlier period. The January-July deficit, at NIS 6.4bn, remained well below the year-earlier figure of NIS 10.6bn.

Analysis

In reviewing the monthly data, the Treasury cited two main factors for the seemingly large jump (at least on a comparative basis) in the July deficit: the initial compensation payments to businesses and properties damaged by shelling from the Gaza Strip, and the deferral of July tax payments allowed to businesses in the areas affected by the fighting. In absolute terms, however, the July deficit is negligible, and the January-July figure, as well as being much lower than that of 2013, is only 20% of the budgeted total for 2014. Initial survey findings and anecdotal evidence suggest that the fighting had a depressing impact on private expenditure—and hence on indirect tax receipts—throughout the country, not just in the south. This is also likely to be reflected in the August data, and the test of the wider macroeconomic impact of the conflict in Gaza will come in September, when the Jewish holiday season should trigger a sharp rebound.

The July data support the official Treasury line that the direct costs of Operation Protective Edge—variously estimated at NIS4bn–8bn—can and will be absorbed within the 2014 budget, which would otherwise have come in well below its deficit target. The focus is now firmly on the 2015 budget, which is still under preparation and has not yet been presented to the prime minister, let alone debated by the full cabinet. The finance minister, Yair Lapid, has repeatedly ruled out any tax increases next year, but the proposed elimination of value-added tax (VAT) on new home purchases and the hefty extra demands of the Ministry of Defence—totalling perhaps NIS 18bn over several years—will oblige the government to make some harsh choices if Mr Lapid is to keep his promise.

Impact on the forecast

We will update our fiscal data with the latest figures. However, we maintain our forecast that the 2014 budget deficit is likely to be smaller than the 2013 figure of 3.2% of GDP, notwithstanding the need for increased military outlays.

August 15, 2014: External sector

Israel reports weak trade numbers in July

Event

The trade data for July provided further evidence of widespread weakness in goods exports, while imports moved from stagnation to decline. The trade deficit posted another high for the year, whether measured in unadjusted, seasonally adjusted or trend data terms.

Analysis

The deterioration in exports is no longer news. The monthly data for July reconfirmed this trend, but added a new element, namely a perceptible decline in imports on a seasonally adjusted basis, which encompassed all the main import categories—raw materials, consumer goods and investment goods. The decline in imports is further evidence of a general slowdown in economic activity that seems to have been under way before the launching of Operation Protective Edge—but will certainly have been exacerbated in consequence.

Nevertheless, it is the malaise in exports that is now attracting widespread attention. It is now apparent in all the four categories of export industries, as defined by technological intensity. Of these, the high-technology sector is the largest and most important, and has shown a declining trend since December 2013. The medium-high sector, which in terms of gross value is almost as large as the high-tech sector but whose products have lower added value, held up slightly longer but now shows a faster rate of decline.

The hostilities in and around the Gaza Strip, mainly later in July, probably had little direct impact on goods trade in July, although the travel restrictions on foreign visitors reportedly slowed trade in diamonds. The impact on services, notably tourism and travel, will be apparent when data for those sectors is published in September, and will be felt in the current-account data for the third quarter—not due until November.

Meanwhile, the growth and revenue assumptions that will underlie the 2015 state budget will have to take account of the negative trends at work in Israel's primary engine of growth, namely high-tech exports. The budget process may also provide an opportunity for a policy response.

Impact on the forecast

This is in line with our forecast for the trade deficit to widen this year in absolute terms, and we will further analyse the weak export picture. We already plan to reduce our forecast for services credits, because of the expected negative impact of the conflict on tourism and travel. These changes will alter our overall current-account forecast, although we still expect a surplus.

August 19, 2014: Economic growth

Growth slows in the second quarter

Event

Real GDP growth in the second quarter slowed to an annualised rate of 1.7%, from 2.8% in the first quarter and 2.4-2.5% in the latter two quarters of 2013. For the first half of 2014, annualised growth was 2.5%, down from 3.2% in the second half of 2013.

Analysis

The first estimate of the national accounts for the second quarter and first half, published on August 17th, confirmed that overall economic activity was slowing even before the outbreak of hostilities in Gaza—a widely held view based on the evidence contained in a broad spectrum of recent data. The weakness in second-quarter GDP was concentrated in exports and investment, with the former contracting at an annualised rate of almost 18% and the latter by 4.5% (although this was less than half the 9.5% rate posted in the first quarter). In contrast, both private and public consumption rose smartly, the former at a 3.1% rate that was more than double the anaemic 1.5% posted in the first quarter, and the latter at 4.2%, compared with 3.2% in the first quarter.

The slowdown in the second quarter represented an intensification of the trend already under way, with the rate of expansion in the first half falling for almost every component and sub-component of GDP, compared with the second half of 2013. Given the negative impact of Operation Protective Edge on the economy, especially on private consumption, in July-August, growth in the third quarter seems likely to be weaker again. And, although falling imports appear to boost GDP, this reflects relatively weak demand, as well as the working-off of the inventory accumulation that took place in the second quarter.

Furthermore, with respect to the budget, the immediate impact of the growth slowdown, even if it proves short-lived, is to increase the projected revenue shortfall for 2015 and thus to exacerbate the government's difficulties in preparing the 2015 state budget.

Impact on the forecast

On July 25th we indicated that we would cut our GDP growth forecast in our next outlook, when we will lower our figure for 2014 growth from the current 3.1%. The second-quarter GDP numbers support this decision. The Bank of Israel (the central bank) has cut its main policy rate in recent weeks, and other measures may now be needed to stimulate the economy.

