



FEDERATION OF ISRAELI CHAMBERS OF COMMERCE
ISRAEL'S BUSINESS ORGANIZATION

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Macro-Economic Forecast for 2004

1. General

The economic parameters for 2003 point to the difficulties in stabilizing the Israeli economy that has been in a deep recession for the past three years. The difficult economic situation is attributed to both external factors, such as the security situation, world recession and the high-tech market crash in 2000, as well as to internal factors having to do with the historical management of the Israeli economy in general and the state budget in particular.

Mismanagement of the state budget for many years can be blamed for the government's current predicament, faced with a budget deficit on the one hand and a non-productive budget structure on the other.

This complex situation has created a sense of uncertainty among investors and businessmen as well as among private consumers, which threw the economy into an even deeper slump in 2002.

As 2003 is winding to a close, we are witnessing the recovery of western economies, which has a significant and positive impact on Israel's foreign trade. Moreover, the government is trying to bring about a structural change in the public sector while internalizing an efficiency-improvement process and speeding up privatization processes in the aim of making the Israeli economy more open and competitive.

2004 is expected to be a turning point for the Israeli economy. According to projections, the first half of 2004 will be marked by a stabilization of most of the key economic indicators, whereas increase and growth is only expected towards the second half of the year.

Economic stabilization and growth in the second half of 2004 is first and foremost dependent on the continued implementation of short and long-term economic processes

for increasing the efficiency of the various systems in the marketplace, the pace of recovery of the U.S. economy and other western markets as well as the developments in the geopolitical arena.

The first half of 2004 will be marked by stability in most of the main economic indexes. We anticipate that the market will start to show signs of growth in the second half of 2004. Total growth for 2004 is expected to reach about 1.8 percent.

1.1 Gross Domestic Product (GDP)

In 2004 the Israeli economy is expected to grow by 1.8 percent, whereas the business GDP is expected to rise by 2.0 percent. GDP per capita will stand at \$15,800 in 2004, following a slight 0.8 percent rise in the GDP in 2003.

Against the background of the acceleration in world trade and global economic recovery, private consumption and foreign trade will fuel the demand for economic output in 2004. Since exports make up approximately 37 percent of Israel's GDP, any improvement in world economies favorably impacts Israel's foreign trade figures and contributes to growth.

1.1.1 Direct Impact on GDP Growth in 2003-2004:

Domestic investment declined by approximately 11 percent in 2003. In 2004 we anticipate a more moderate decline of about 6 percent in gross investment, primarily in real estate, machinery, equipment and transportation vehicles. Owners of business establishments will still be wary to invest in fixed assets as long as the economic horizon is cloudy.

Exports of goods and services rose by about 2.5 percent. Export figures reflect an increase in diamond exports, which is set off by a further decline in exports of tourist services. Exports are expected to rise in 2004 by approximately 7 percent. This rise is impacted by the recovery of international markets and an increase in the Euro exchange rates (40% of the export is to the European community).

Imports of goods and services fell by 3 percent in 2003, reflecting the drop in private consumption due to the uncertainty prevailing in the Israeli marketplace and the increase in the Euro exchange rate (50% of the import is from the European community). Imports are expected to rise by approximately 4 percent in 2004 given the rise in current consumption and the recovery of international markets and the stabilization in the US Dollar exchange rate.

Private Consumption - 2003 was a very difficult year in terms of private consumption, which fell by 0.8 percent following the decline recorded in

2002. The slump is largely attributed to decreased salaries coupled by rising unemployment, and reflects a sharp 5 percent drop in the consumption of durable and a slight increase of about 1 percent in current consumption (food, footwear and personal effects etc.). The more uncertain the economic situation is, the more focused purchasing becomes. In 2004, as part of the general improvement anticipated for this year, we expect private consumption to rise by a moderate 1.1 percent.

Public Spending - a moderate 1.0 percent decrease is expected in 2004, mainly reflecting efficiency improvement that the public sector has undergone last year.

1.1.2 Indirect Impact on GDP Growth:

Effect of the security situation on the local market - The conflict between Israel and the Palestinian Authority creates high geopolitical uncertainty.

Implications of the conflict with the Palestinian Authority:

- Reduces the supply of manpower working in construction and agriculture.
- Temporary halt in the trade relations with the Palestinian Authority has resulted in:
 1. Overproduction capacity in some of the trade and services sectors due to lower demands.
 2. Israelis were left with outstanding debts of their PA business associates.
- Sharp drop in incoming tourism – Israel is classified as a dangerous country.

Technology Market Crisis - The high-tech companies' activity is still being influence by the effects of global technology crisis, while the brunt of the blow projects from the strong companies to the smaller-sized companies and startups. In our estimation, the high tech sector is undergoing a reorganization process which on the one hand will reduce activity in the short term, while on the other hand will result in more selectivity in choosing investments by local and foreign venture capital funds.

Global Slump – Changes are now taking place in the U.S. market, and the first signs that the economy is emerging from its recession can be seen. Economists throughout the world predict that in 2004 the U.S. economy will demonstrate 4.2 percent growth. Undoubtedly this process will favorably impact the Israeli economy, although it takes time for the market to catch up.

2. Private Consumption

Private consumption, which is the best indicator to identify if the economy is emerging from its recession, is expected to go up in 2004 by only 1.1 percent. Private consumption accounts for close to 66 percent of total final consumption.

According to forecasts, private consumption in 2003 will decline moderately by approximately 0.8 percent. This decline expresses a slight 1 percent increase in current private consumption against a 5 percent drop in the consumption of durables. The decline in private consumption reflects erosion in wages coupled by rising unemployment, erosion in transfer payments and reduced government's support of the weaker segments of society in the past year.

There were signs of a considerable improvement in private consumption in the second half of 2003 compared to the same period last year. This improvement is primarily attributed to a greater sense of internal and economic security and due to the stabilization in the foreign currency exchange rates.

Private consumption spending per capita, indicates the development of ones economy in compare with international economies, will stand on 15,300 \$ by the end of 2003 and on 15,800 \$ by the end of 2004.

3. Investment

The investment item usually points to the economy's future growth capacity.

Gross domestic investment in the economy is expected to fall by approximately 6 percent in 2004. This decline weights a 10 percent reduction in investments in transportation vehicles and a 3 percent decline in investments in the volume of fixed assets.

A sharp drop of up to 30 percent was recorded in prices of non-residential construction due to a supply surplus in the market. Since this field is business-oriented, we expect a continued 4 percent reduction in the volume of activity in 2004 (following a 6 percent decline in 2003).

In addition, in 2004 the sharp declines in investments in construction are expected to become more moderate, and will stand at 1.5 percent in investments in residential construction and 2.0 percent in investments in non-residential construction. All in all, we expect a 2.0 decline in investments in residential construction and a 4.0 percent decline in investments in non-residential construction.

In 2003 a moderate rise of about 2.0 percent was recorded in investments in machinery and equipment (not including transportation vehicles) mainly imported investments, whereas investments in overland transportation vehicles fell back considerable by approximately 10 percent.

In 2003 the volume of investments in inventories continued to fall due to overproduction capacities. High uncertainty in the marketplace on the one hand

coupled by a decline in the level of activity (which led to an increase in inventories) are expected to **result in a 2.5 percent decline in investments in machinery and equipment in 2004.**

Foreign investments in Israel plummeted in 2002 by 50 percent and totaled \$1.6 billion. This drastic decline occurred as a result of the high-tech crisis and uncertainty due to the tense security situation at home and worldwide following the events of September 11th. A slight regain in foreign investments is projected for 2004 as the U.S. economy is on a path of recovery, which will impact the activity of venture capital funds in locating investments in Israeli companies.

We project that foreign investments in Israel will rise slightly in 2004 compared to the declines recorded in 2001 and 2002 due to the recovery of the U.S. economy and the search of venture capital funds for attractive investments (assuming geopolitical calm).

4. Foreign Trade

4.1 Exports

A 7 percent increase in the export of goods and services in 2004.

A sharp improvement in export figures was noted in 2003. Exports of goods and services rose by approximately 2.5 percent. This rise reflects an increase in diamond and agricultural exports and is set off by continuing declines in tourist services and startup companies. Exports improved despite the revaluation of the exchange rate since the beginning of the year.

The sectors contributing the most to export growth in 2003 were diamonds (3.3 percent) and agriculture (5.7 percent).

A 7 percent increase in exports is projected in 2004 in view of the economic recovery of international markets and stabilization of foreign currency rates.

Since 2001 exports of tourist services took a very heavy blow due to the tense security situation, losing close to half of its output. In 2003 the tourist industry lost another 9 percent. International terror is expected to further aggravate the situation for the tourist industry, even if its affect will be marginal. It is assumed that tourism will perk up only after a significant improvement in the security situation takes place. Therefore, the tourist industry is expected to shrink back by another 5.0 percent.

4.2 Imports

A 4 percent rise in imports of goods and services in 2004.

Imports of goods and services fell by approximately 3 percent in 2003 largely due to the falling demand for private consumption and less investments in the marketplace.

The economic indicators began to change substantially towards the end of 2003, demonstrating import growth in October and November. This was largely a result of the recovery of international markets and cost-efficiency processes that the Israeli economy is undergoing.

Recovery and growth of international markets on the one hand alongside a process of economic stabilization are expected to trigger a 4 percent rise in 2004, primarily imports of private consumer goods, raw materials and transportation vehicles (assuming custom duties will not be imposed that will impede import growth).

5. Exchange Rate

Based on projections of geopolitical stability and a further decline in interest rates, the exchange rate is expected to stand at NIS 4.5 at the end of 2003. If there will be a resumption in hostilities and security unrest, the dollar exchange rate is expected to go up to NIS 4.8 in relation to the dollar in 2003. **In 2004 the dollar is expected to stand at NIS 4.58 under the condition that interest rates continue to drop and there is relative calm in the region.**

The Euro exchange rate climbed in 2003 by 11.7%, in 2004 the Euro exchange rate is expected to rise by 3.9% and will go up to NIS 5.55.

6. Employment

Unemployment in 2003 reflects the reported decline in the number of jobs in the industrial, services and trade, tourism and high-tech and related sectors.

In our estimation, major cuts in the number of jobs in the business sector are not to be expected, so that the unemployment rate will stand at approximately 10.6 percent. This figure does not include the possible benefits that the government stands to allocate in order to bring down unemployment in the marketplace.

Unemployment in 2003 stands at 10.7 percent, which expresses the depth of the recession with 270,000 unemployed persons in the marketplace. The high unemployment rates reduce private consumption and raise unemployment compensation paid by the government.

7. Prices

The Consumer Price Index decreased in 2003 by about 1.7 percent on average. We anticipate that the CPI will stand in 2004 at about 1.5 – 2.0 percent. This rate weights a further decline in interest rates by 0.5 percent.

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	2002	2003 (est.)	2004 (est.)
Inflation rate	6.5%	-1.7%	1.5%-2.0%
Unemployment rate	10.1%	10.7%	10.5%
GDP Growth	- 1.0%	0.8%	1.8%
Business GDP Growth	- 3.1%	0.6%	1.5%
GDP per capita (\$ 000's)	14.7	15.3	15.8
Private consumption (% change)	- 0.5%	- 0.8%	1.1%
Imports of goods and services (% change)	- 2.5%	3.0%-	4.0%
Exports of goods and services (% change)	- 3.5%	2.5%	7.0%

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