DIVISION OF ECONOMIC RESEARCH

Macro Economic Forecast for 2014

October 27, 2013

Basic Assumptions and Background Conditions

- ✓ **The global growth pace is expected to accelerate** – according to the IMF[1] the global economy is expected to grow at a rate of 3.6% in 2014, after 2.9% growth in 2013.

- ✓ **The Eurozone is expected to recover** – the Eurozone, to which some 30% of Israeli export is directed, is expected to post a moderate 1% growth in product in 2014 following a 0.4% regression in 2013[1].

- ✓ **Acceleration is expected in the growth pace of the US economy** – close to 25% of Israeli export is directed to the US, which is expected to grow by 2.6% after 1.6% growth in 2013[1].

- ✓ **Rapid growth is expected in developing countries** – China, to which some 5% of Israeli export is directed, is expected to grow by 7.3% next year further to 7.6% growth in 2013. In the same period India, the destination of 3% of Israeli export, is expected to grow by 5.1% in 2014 after 3.8% growth in 2013[1].

- ✓ **World trade is also expected to expand at a more rapid pace** – according to forecasts by the Economist[2], world trade in goods is expected to grow by 5.2% in 2014 after 3.3% growth in 2013.

- ✓ **A slowdown in public sector demand is expected** – after accelerated growth in public consumption in 2013[3] a slowdown in public consumption is expected in 2014 as a result of the approved budget cuts.

- ✓ **A slowdown in private demand is expected** – the combination of tax increases[4], the cut in child allowances[5] and expectations for a rise in unemployment is expected to have an adverse effect on consumer willingness to increase purchases in the coming year. **These moderating factors will be counterbalanced by a number of factors that will continue to support increased private consumption**, including the continuing rise in the value of financial assets and real estate held by the public, which will enhance the "feeling of affluence" along with expectations for a further real increase in the average wage and a comfortable real interest rate environment.

- ✓ **Expansion factors coupled with investments** – construction of the IDF "Training Bases City" in southern Israel, which is currently in progress, is expected to lead to increased investments in infrastructure in the entire region next year, and to a growth in demand for the produce of the domestic industry in relevant spheres.

---

[1] IMF forecast of October 2013.

[2] Economist forecast of October 2013.

[3] Including a one-time increase of approximately NIS 6.5 billion in excess of the permitted expenditure as a result of surplus liabilities.

[4] A further increase in VAT in June 2013, coupled with increased taxes on luxury goods and alcohol and the income tax hike planned for the beginning of 2014.

[5] In the framework of the Economic Arrangements Law 2013-2014, and which began in August 2013.

- **Expectations for a drop in energy prices to domestic industry** – the increasing supply of natural gas to industrial plants is expected to lead to a drop in the energy spend of more production facilities as they connect to the natural gas distribution system, in addition to the large facilities which were connected to the system in 2013. This reduction in expenses is likely to lead to improved competitiveness.

- **Additionally, a reduction in input prices is expected** – in 2014 a drop in the dollar cost of basic commodities is expected worldwide[1].

- **Conversely, input prices subject to sovereign control are expected to rise** – including municipal taxes and water, which will lead to further erosion of the profit margins of Israeli companies.

- **Increase in wage costs –** the additional increase expected in provisions by employers to National Insurance on the portion of the salary which is higher than 60% of the average wage (from 6.5% to 7% at the beginning of 2014) will lead to a further increase in wage costs to companies. Moreover, if the agreement governing contract workers in the cleaning industry is closed, this too is expected to contribute to a rise in wage costs in the business sector.

- **A further revaluation of the Shekel versus the Dollar, albeit relatively moderate, is expected in 2014**[6] - the exchange rate of the Shekel versus the Dollar, in which over 75% of export transactions are denominated, is expected to be around NIS 3.5 to the Dollar at the end of 2014, i.e. approximately one-half percent revaluation. This low level is expected to exacerbate the erosion of margins and the competitiveness of Israeli exporters.

- **A sharp revaluation of the Shekel versus the Euro is expected in 2014**[6] – the exchange rate of the Shekel versus the Euro is expected to be around NIS 4.5 to the Euro in late 2014, i.e. a 5% revaluation during the year, signifying a considerable erosion of the profit margins of exporters to the Eurozone.

- **Increased tax burden for the business sector** – in 2014 the business sector is expected to absorb a further increase in corporate tax (from 25% today to 26.5% in 2014), along with an increase in tax rates applying to exporting industries and in dividend tax under the Encouragement of Capital Investments Law[7].

- **Relocation of production lines and development abroad –** the percentage of industrial plants with manufacturing operations abroad has increased gradually over the past decade, from 16% in 2004 to around 28% in the first half of 2013[8]. This trend of relocating production lines and development to other countries poses a threat to the future of Israel's domestic industry.

This forecast assumes that the security situation will remain stable and that the geopolitical situation will remain similar to the current situation.

[6] December 2014 versus December 2013.
[7] The corporate tax rate applying to exporting industries in central Israel will be raised from 12.5% to 16% and in the periphery from 7% to 9%; dividend tax will be raised from 15% to 20%.
[8] As reported by manufacturers in the Survey of Industry Expectations conducted by the Division of Economic Research.

Forecast for 2014 – Base Scenario

- ✓ **In 2014 the GDP is expected to grow by 3.1%, reflecting a slowdown in growth pace after two years of average 3.4% growth[9].**
- ✓ Excluding the impact of natural gas production by the Tamar site on GDP measurement[10], growth is expected to amount to 2.5%, following 2.6% in 2013.
- ✓ **This reflects a moderate increase of 1.2% in GDP per capita,** after two years of 1.5% growth. Excluding the natural gas impact, the per capita growth is even more moderate at 0.6%.
- ✓ **The slowdown will primarily be the result of the slowdown in the growth pace of the business sector product, which is expected to expand by 3.2% in 2014** after 3.6% growth in 2013 and 3.4% in 2012.
- ✓ **This forecast assumes renewed growth in exports of goods and services (excluding diamonds)**, assuming that the global forecasts for acceleration in world trade in goods are indeed realized, with a moderating impact by the revaluation of the Shekel: 2.9% growth in exports is expected in 2014, after a slight regression of 0.4% in 2013 and approximately 5% growth in 2012.
- ✓ **We estimate that the growth in export will be the outcome of 3.4% growth in exports of goods excluding diamonds** (mainly industrial export), **along with 2% growth in exports of services.** The growth in service exports reflects a slowdown compared to the prior year, which is due to a drop in the scope of sales by startups.
- ✓ **Additionally, renewed growth is expected in industry investments** (excluding ships and aircraft), with these investments expected to increase by 4.7% following a decrease of 1.1% in 2013.
- ✓ **By contrast, approximately 4.2% regression is expected in residential construction in 2014**, following a standstill in these investments in 2013.
- ✓ **In 2014 a slowdown in the growth pace of private consumption is expected:** Forecasts predict 3.1% growth after 4% growth in 2013, as a result of a considerable slowdown in the growth pace of durable goods consumption coupled with a slowdown in the consumption of non-durables. **Thus, per capita consumption is expected to increase by 1.2%** after 2.1% growth in 2013.
- ✓ **A slowdown is also expected in the growth pace of local public consumption** (excluding security imports) as a result of the budget cuts approved for 2014. Thus, in 2014 an increase of 1.8% in domestic public spending is expected, after 2.5% growth in 2013 and 2.8% growth in 2012.
- ✓ **Alongside the anticipated growth in usage components, renewed, moderate growth is expected in civilian imports:** 0.5% growth in 2014 after a regression of 1.8% in 2013.
- ✓ **A further slowdown is expected in new employee hiring:** We estimate that the number of Israelis employed in the economy will grow by around 1.4% in 2014 (close to 50,000 new hires), after 2.3% growth in 2013 and 3.3% growth in 2012. The slowdown is expected in the business and public sectors.

[9] According to initial estimates for 2013, published by the Central Bureau of Statistics in October 2013.
[10] This impact is expected to be expressed in the replacement of imported fuels with local natural gas.

- **In parallel, unemployment is expected to rise in 2014 and will encompass 7.4% of the civilian workforce**, signifying another 30,000 lost jobs and an increase to approximately 278,000 unemployed workers.

- **We estimate that this increase in the unemployment rate will be accompanied by a further increase in the labor force participation rate,** due, among other things, to efforts to increase the integration of minority populations in the workforce. The labor force participation rate is expected to rise to 64.1% compared to 63.8% in 2013, meaning that some 78,000 people will join the labor force next year, with about 40% failing to find jobs.

The Manufacturers Association's Base Forecast for 2014

	2012	2013 CBS Estimate	2014 Manufacturers Association Forecast
GDP	**3.4%**	**3.4%**	**3.1%**
GDP per capita	**1.5%**	**1.5%**	**1.2%**
Business GDP	**3.4%**	**3.6%**	**3.2%**
Private consumption	**3.2%**	**4.0%**	**3.1%**
Local public consumption	**2.8%**	**2.5%**	**1.8%**
Gross Domestic investment	**6.3%**	**1.3%**	**1.1%**
Exports of goods and services (excl. diamonds)	**5.1%**	**-0.4%**	**2.9%**
Of which: industrial, mining and quarrying exports	1.8%	-4.2%	3.5%
Civilian imports	**2.1%**	**-1.8%**	**0.5%**
Unemployment rate	**6.9%**	**6.7%**	**7.4%**

This forecast was prepared by the Division of Economic Research

Dafna Aviram-Nitzan, Division of Economic Research Manager

Tel: 03-5198807