



Chapter 1

The Economy: Developments and Policies

In 1997 GDP growth decelerated markedly, with a fall in per capita GDP—for the first time since 1989; total factor productivity declined and the unemployment rate rose. There were also several positive economic developments this year, chief among them the contraction of the current-account deficit, along with accelerated export growth, and a significant decline in inflation. These developments reflect primarily the deceleration of domestic demand as the expansionary effects of both the influx of immigrants and the political process waned, and the effect of the tight fiscal and monetary policy implemented this year. External developments facilitated the achievements in the areas of the balance of payments and prices, while moderating the slowdown in economic activity. The economic developments reflect *inter alia* the intensification of the positive process of structural changes in the economy, namely, the expansion of high-tech industries and the contraction of traditional ones.

In 1997 there was a turnaround in the implementation of fiscal policy, and the government met its deficit target. After the relaxation of fiscal discipline in previous years, the public-sector deficit was reduced, so that fiscal policy acted to dampen excess demand. However, the composition of the contraction of the deficit, consisting mainly of a heavier tax burden and reduced public-sector investment, does not support the return of the economy to sustainable growth. Monetary policy focused on attaining the inflation target for the current year and creating the conditions for a declining inflation path, in accordance with the government's decision. The inflation target was attained at the lower limit of the target range set by the government. In order to achieve the target, the average real (expected) interest rate was kept at a level similar to that of the second half of 1996 (about 5 percent). Local currency depreciated moderately against the currency basket this year, remaining near the lower limit of the exchange-rate band for almost the entire year.

In order to be able to achieve sustainable growth in the next few years, making it possible to reduce unemployment without returning to an unstable path, policy measures are required that will support renewed total factor productivity growth, which has declined in the last five years. The main features of this policy are:

meeting the deficit targets while changing the composition of government expenditure to channel more resources to infrastructure investment, reducing the tax burden and reforming taxation, implementing policy designed to achieve in the long term the price stability common in advanced economies, expanding structural reforms in the economy while enhancing competition and intensifying privatization, and reaching wage agreements that will not impede the expansion of business-sector employment.

GDP growth slowed considerably in 1997, total factor productivity declined, unemployment rose, the current-account deficit contracted, and inflation fell to the lower limit of the range set by the government.

GDP growth decelerated markedly in 1997, with a decline in per capita GDP—for the first time since 1989; total factor productivity fell and the unemployment rate rose¹ (Figure 1.1). There were also several positive economic developments this year, the most prominent being the reduction of the current-account deficit, alongside the acceleration of export growth, and the decline of the inflation rate to the lower limit of the target range set by the government. These developments reflected mainly the decelerating growth of domestic demand, due to two factors: first, the decline of the expansionary stage of the business cycle in economic activity, and especially investment demand; this expansion derived from the influx of immigrants, the effect of economic reforms implemented in the past, and business opportunities created as a result of the peace process; second, the effect of the policy of restraint adopted this year in both the fiscal and the monetary spheres. Other factors contributing to the slowdown in economic activity were the security and political uncertainty, the wage path (influenced by the rise in the minimum wage and existing wage-contracts), and the intensification of the process of structural economic changes—the expansion of high-tech industries and the contraction of traditional ones. On the other hand, positive external developments this year—the accelerated expansion of world trade, the improvement in Israel's terms of trade, and the decline in inflation made an important contribution to the country's achievements in the areas of the balance of payments and prices, while moderating the economic slowdown.

Developments in 1997 mainly reflected slower growth of domestic demand due to the fading of the expansion stage of the business cycle and the effect of the restraining policy.

Economic trends in Israel were very different in 1997 from those in the three preceding years, when there was rapid growth and declining unemployment. However, these years were also characterized by a marked expansion of the current-account deficit (to as much as 5.6 percent of GDP in 1996), and two-digit inflation on average, in the context of a rapid rise in the budget deficit and protracted excess demand. Consequently, many of the economic developments of 1997 can be regarded as corrections of the previous trends which, although characterized by high growth rates, embodied a growing risk of a balance-of-payments crisis and the undermining of economic stability against the backdrop of the relaxation of fiscal discipline. The financial crises experienced by several countries in the last few years (including, recently, in Asia) illustrate the urgency of the need to turn policy around, when both the budget and the balance-of-payments deficits reach levels that imperil economic stability.

¹ Basic economic data for Israel are given in Table 1.1.

Figure 1.1: Key Economic Indicators

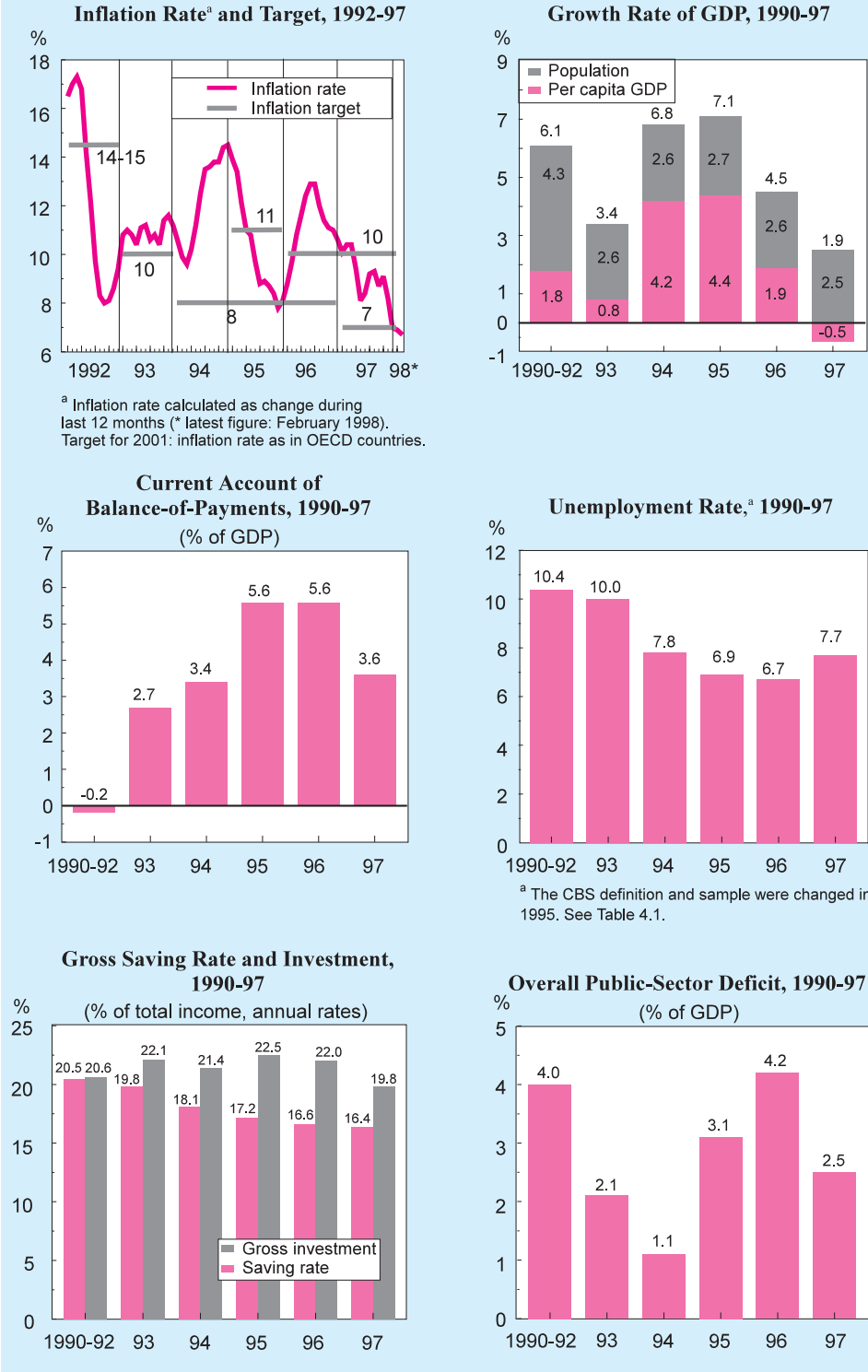


Table 1.1
Israel: Basic Economic Data,^a 1986–97

| | 1986–89 | 1990–91 | 1992–95 | 1996 | 1997 |
|--|---------|---------|---------|-------|-------|
| Mean population ('000s) | 4,405 | 4,803 | 5,330 | 5,686 | 5,827 |
| Population growth rate (percent) | 1.6 | 4.7 | 2.8 | 2.6 | 2.5 |
| Israeli persons employed ('000s) | 1,422 | 1,535 | 1,809 | 2,013 | 2,040 |
| GDP (NIS billion, 1997 prices) | 216.0 | 245.1 | 289.7 | 331.1 | 337.8 |
| GDP (\$ billion, 1997 prices) | 63.0 | 71.5 | 84.4 | 96.5 | 98.5 |
| Per capita GDP (\$'000s, 1997 prices) | 14.3 | 14.9 | 15.8 | 17.0 | 16.9 |
| Growth rate of GDP (percent) | 3.7 | 6.2 | 6.0 | 4.5 | 1.9 |
| Unemployment rate (percent) | 7.1 | 10.1 | 9.0 | 6.7 | 7.7 |
| Inflation rate (percent) | 18.2 | 17.8 | 10.8 | 10.6 | 7.0 |
| Current-account deficit (percent of GDP) | –1.5 | –0.4 | 3.0 | 5.6 | 3.6 |
| Foreign-exchange reserves (\$ billion) | 5.5 | 6.9 | 7.2 | 11.8 | 20.6 |
| Net foreign debt (percent of GDP) | 43.9 | 28.1 | 25.6 | 20.8 | 19.1 |

^a Annual averages.

SOURCE: Based on CBS data.

Positive developments in the external environment in 1997 made a valuable contribution to the economy's achievements in the areas of the balance of payments and inflation, and moderated the deceleration of activity.

The last three years were marked by rapid growth and the decline in unemployment, but this was alongside a marked rise in the balance-of-payments current-account deficit, and two-digit average inflation.

A significant share of the economic developments of 1997 represent corrections of earlier trends which bore an inherent risk of undermining economic stability.

The need to adjust Israel's economic course was reflected in the design of economic policy for 1997, principally by establishing the reduction of the current-account deficit as a central plank of this year's budget. Additional objectives set for 1997 were creating the conditions for continued sustainable economic growth, delineating a downward sloping path for inflation, and proceeding with the absorption of immigrants. Consistent with its long-term perspective, the government set quantitative objectives for the gradual reduction of the ratio of its total deficit (excluding credit) to GDP, in accordance with the Deficit Reduction Law, and for the reduction of inflation by the year 2001 to a rate in line with that prevailing in the OECD countries. In view of the government's failure to meet the deficit target in 1995 and 1996, it was also essential to rehabilitate the credibility of fiscal policy, which is a vital instrument for attaining the government's long-term aims.

THE BACKGROUND AND CAUSES OF DEVELOPMENTS IN 1997

Against the backdrop of the economic developments of the previous years and the economic policy objectives set for 1997, the economic trends of 1997 can be explained by means of several basic factors, and the interactions between them:

- *The ebbing of the expansionary stage of the business cycle* associated with the absorption of immigrants, and the conclusion of the process of the temporary adjustment of capital stock to the desired level, explain a large part of the fall in investment this year (and to a lesser extent in private consumption, too), which was a central element in the deceleration of domestic demand. After extensive investment in residential construction in 1995–96, and a marked rise in investment in machinery and equipment in recent years, the ratio of capital stock to GDP in these spheres returned to the level



CHAPTER 1: THE ECONOMY: DEVELOPMENTS AND POLICIES

that had prevailed before the influx of immigrants, and even exceeded it, after declining at the start of the mass immigration. The restoration of the capital/GDP ratio was accompanied by a decline in the return on capital to a rate similar to that prevailing prior to the influx of immigrants. Consequently, and in the context of expected stability in the stream of immigrants, investment declined. Nonetheless, the investment level remained high, and gross capital stock at the beginning of 1998 indicates a creditable increase of 6.3 percent.

- The contractionary *fiscal policy* implemented in 1997 was intended primarily to reduce the current-account deficit mentioned previously, and it did in fact reduce both the public-sector and the budget deficit. The policy's restraining effect on demand in 1997 was reflected principally by the slowing of the rate of increase of public domestic consumption, the steep drop in public-sector investment, and the rise in the tax rate, which in the short run served to reduce disposable income and dampen the increase in private consumption.

- The continued *monetary restraint*, intended to create the conditions for attaining the inflation target set by the government while generating a downward path for inflation, was reflected by the level of real interest on the Bank of Israel's sources,² which varied around 5 percent, an interest environment that has prevailed since the second half of 1996. This policy has a moderating effect in the short run on both aggregate demand and the supply side. The moderate nominal depreciation path delineated during the year was one of the transmission channels of the policy.

The *structural change in the economy*, arising from the long-term trends of globalization and exposure to competing imports, deepened and intensified in 1997 due to the marked increase in unit labor costs and the minimum wage, continued real appreciation, and the strengthening of the dollar against the European currencies. These processes, which have led to the contraction of the traditional tradable industries (textiles and clothing) in the last few years, also contributed in the short run to the deceleration of economic activity, because the process of absorbing the factors of production ejected from contracting industries in expanding ones (mainly high-tech and service industries) is slow and gradual, and the transition does not allow their full utilization. The wider the gap between the skills required of employees in contracting and expanding industries, and the longer the retraining process, the more acutely will the process of structural adjustment be reflected by unemployment and the deceleration of growth.

- *Security incidents* adversely affected tourism exports and trade with Judea, Samaria and Gaza, while the political uncertainty caused some investment plans to be postponed.

- *Factors* associated with the world economy contributed to the expansion of exports and reduction of the current-account deficit. World trade grew by 8.4 percent (after 6.2 percent in 1996), and Israel's terms of trade improved by 3.9 percent in 1997, after 2.2 percent in 1996. Moreover, the flow of investment by nonresidents reached

The economic policy of 1997 reflected the need to alter trends.

Despite its decline, investment remained high, and gross capital stock to the beginning of 1998 reflected a creditable 6.3 percent increase.

The continued monetary restraint was reflected by the real interest rate on the Bank of Israel's sources of around 5 percent.

The structural change of the economy deepened and accelerated in 1997 due to the increase in the minimum wage, continued real appreciation, and the sharp rise in the exchange rate of the dollar against the European currencies.

The more rapid structural change in the economy in 1997, expressed by the contraction of the traditional tradables industries, contributed to the slowdown in economic activity.

² The term 'real interest' refers to the effective expected real interest rate, in accordance with inflation expectations as derived from the capital market.



The external factors related to the world economy contributed to the expansion of exports and to the reduction of the current-account deficit.

an unprecedented \$ 3.7 billion this year, some 3.8 percent of GDP. The financial turmoil in Asia in the second half of the year had only a slight effect on Israel's flows of trade and capital in 1997, but accentuated the need for great caution in conducting fiscal and monetary policy.

Past experience in Israel and abroad has shown that generating a significant positive turnaround in the balance of payments and a declining trend in inflation, alongside the damping of the business cycle—in this case, the surge in demand (primarily investment) that began with the influx of immigrants—is generally accompanied by a decline in the growth rate to below its potential, and possibly by a rise in unemployment. However, the intensity of Israel's economic slowdown in 1997 indicates that most of the factors mentioned above operated with an intensity that was greater than expected.

MAIN DEVELOPMENTS

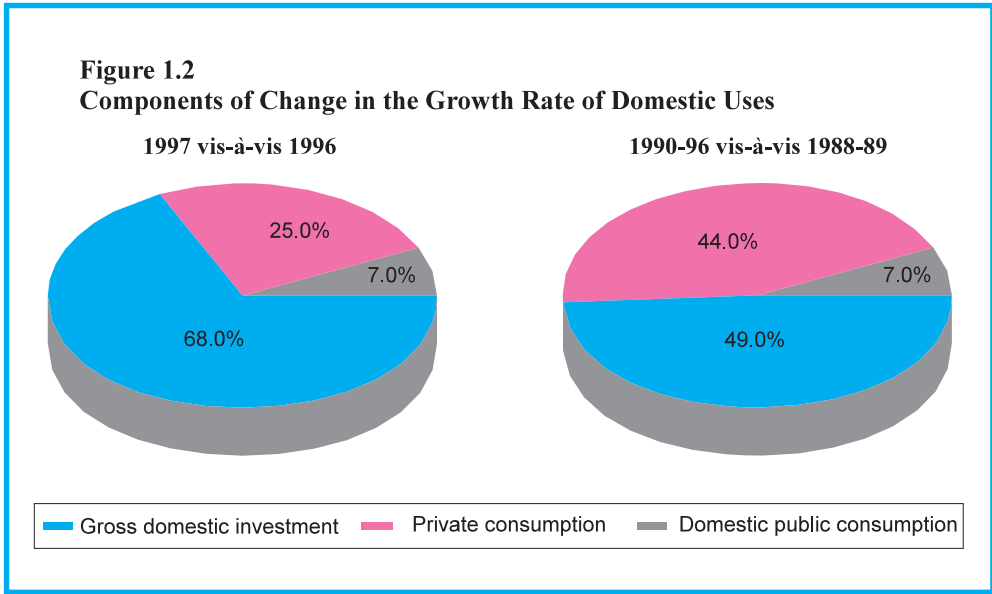
Most of the deceleration of domestic demand derived from the reduction of gross domestic investment.

The effect of the contractionary policy and the waning of the business cycle were reflected by the deceleration of domestic demand growth (measured by the change in domestic uses), from 5.2 percent in 1996 to 1.1 percent in 1997. A quantitative examination of the factors contributing to the deceleration (Figure 1.2) shows that most of it (68 percent) was due to a 5.9 percent fall in gross domestic investment, after this had risen by 6.8 percent in 1996.³ The decline in business-sector investment encompassed all its components—inventory accumulation and residential investment, and investment in machinery, equipment, and vehicles—but the level of investment remained high in 1997 when viewed in a long-term perspective; at the beginning of 1998 gross capital stock in the business sector was up by 7.3 percent. Furthermore, there was a significant decline this year in transport infrastructure investment, despite the cumulative backlog that has accumulated in capital stock in this sphere in the last few decades. The second most prominent factor explaining the slowdown in demand was private consumption, whose rate of expansion fell from 5.2 percent in 1996 to 3.3 percent in 1997—continuing the trend evident since 1995. The moderation of private consumption growth explains some 25 percent of the slowdown in domestic demand growth, and appears to be related to the rise in the tax burden in 1997 and the completion of the process of adjusting the level of consumption to the effect of the influx of immigrants. The rest of the slowdown in the expansion of domestic demand, 7 percent, is attributed to domestic public consumption, which rose by 2.3 percent in 1997, compared with 3.6 percent in 1996.

GDP grew by 1.9 percent in 1997, significantly below its potential, and productivity fell. Per capita GDP declined for the first time in seven years.

The deceleration of domestic demand contributed to the decline in GDP growth, to 1.9 percent, a rate significantly below the potential derived from the increase in the labor force and capital stock, after rising by 4.5 percent in 1996. Furthermore, per capita GDP fell by 0.5 percent in 1997 (for the first time in seven years, Figure 1.1),

³ As Figure 1.2 shows, even in the rising part of the cycle (1990–96) most of the increase in domestic demand was due to the development of investment.



and business-sector product grew by 1.5 percent, compared with 5.2 percent in 1996. Alongside the deceleration of GDP supply, there was a steep 2.4 percent drop in total factor productivity, continuing the decline of the previous four years, and this was influenced by the increase in real labor costs. However, the steeper decline in domestic demand growth than in GDP, alongside positive international developments, and especially the 3.9 percent improvement in Israel's terms of trade, helped to significantly improve the current-account deficit, which contracted from \$ 5.3 billion (5.6 percent of GDP) in 1996 to \$ 3.6 billion (3.6 percent of GDP) in 1997 (Table 1.2), similar to the amount of foreign investment—representing an improvement of 2 percent of GDP (Figure 1.1). A similar reduction (\$ 1.5 billion) was recorded in the civilian import surplus. The significant improvement in the ratio of the current-account deficit to national income derives from a 2.2 percentage point decline in the share of investment in national income, compared with a smaller decline—0.2 percentage points—in that of saving (Table 1.3). The decline in the saving rate, which has persisted for five years, slowed substantially in 1997 as a result of the contraction of negative saving by the public sector.

The composition of the improvement in the current account indicates both a marked slowing in the volume growth of imports, from 8.0 percent (excluding defense imports, diamonds, fuel, and ships and aircraft) in 1996 to 2.5 percent in 1997 (although this rate is still higher than that of GDP growth), and the acceleration of exports, alongside the continued structural change in their composition. The growth rate of goods and services exports (excluding diamonds) rose from 4.9 percent in 1996 to 7.8 percent in 1997; this development was supported by the rapid growth of imports by Israel's trading partners,⁴ which accelerated to 10 percent in 1997, compared with 7.4 percent in 1996.

⁴ Weighted average of Israel's principal trading partners, in accordance with their share of trade.

The slower rise of domestic demand, alongside positive international developments, contributed to the significant improvement in the current account.

The fall in the saving rate, which has continued for five years, moderated considerably in 1997, due to the reduction of negative public-sector saving.

The acceleration of exports was led by manufacturing exports, especially by those of high-tech industries.

Table 1.2
Balance of Payments, 1990-97

| | (\$ billion, annual rates) | | | | | |
|---|----------------------------|------|------|------|------|------|
| | 1990-92 | 1993 | 1994 | 1995 | 1996 | 1997 |
| Import surplus | 6.4 | 8.5 | 9.5 | 12.0 | 13.0 | 11.6 |
| Current-account deficit | 0.0 | 1.8 | 2.5 | 4.8 | 5.3 | 3.6 |
| Implied capital imports ^a | -0.4 | 3.2 | 2.6 | 6.1 | 8.8 | 12.8 |
| Investment in Israel by nonresidents ^b | 0.3 | 0.8 | 0.9 | 2.3 | 2.8 | 3.7 |
| Rise (-) in foreign-exchange reserves | 0.4 | -1.5 | 0.0 | -1.2 | -3.5 | -9.3 |
| Foreign-exchange reserves ^c | 6.5 | 7.1 | 7.3 | 8.7 | 11.8 | 20.6 |
| Net foreign debt | 16.6 | 17.3 | 18.2 | 20.3 | 20.0 | 18.7 |

^a Including errors and omissions.

^b Before 1994, excluding investment in the secondary market abroad.

^c Held by the central monetary institutions at end of period.

Despite the decline in the balance-of-payments deficit, its level (as a percent of GDP) remained high in 1997 compared with its level in the previous decade.

Export growth was led by manufacturing exports, which rose by 13.5 percent in 1997, compared with 7.5 percent in 1996, and by high-tech exports in particular, which increased by 20 percent this year, compared with 11 percent in 1996. Exports of tourism services and exports to Judea, Samaria and Gaza, however, were again adversely affected by security incidents, and exports of the traditional industries fell by some 3 percent. The acceleration and extension of export growth, especially in industries in which Israel has a comparative advantage, will make it possible to establish a process of export-led growth that is appropriate for a small economy such as ours.

Despite the significant reduction of the current-account deficit, it remained high (in GDP terms) in 1997 relative to the previous decade (Table 1.1). The notable impact of the economic slowdown on the reduction of the deficit in 1997 underlines the need to create appropriate conditions for growth based on the expansion of supply in the tradable industries; without conditions of this kind, the deficit might again swell to unsustainable proportions once growth picks up. Although this year foreign investment made it possible to finance the deficit while reducing the external debt, and this investment benefits Israel in many other ways, caution should be adopted in relying on investment flows from abroad as a way of financing a large deficit, as they could come to a stop, or even reverse their trend, quite suddenly. In order to reduce the risk of a development of this kind, it is important that macroeconomic policy be implemented with the necessary care, in order to meet the budget and inflation targets.

Monetary and fiscal restraint, moderate inflation abroad, and the significant easing of demand pressures reduced inflation.

Monetary and fiscal restraint, low inflation abroad,⁵ and the marked easing of internal demand pressures caused the inflation rate to decline; at the end of 1997 this rate was 7 percent, at the lower limit of the inflation target for the year (Table 1.4). This is a significant decline in comparison with the 10.6 percent inflation rate of 1996 (Figure 1.1), and the lowest rate in 28 years.⁶ The rate of price increases slowed

⁵ In 1997 the average inflation rate of Israel's principal trading partners was 1.9 percent, the lowest rate for 25 years; in dollar terms, this represents a 5.8 percent fall in prices.

⁶ In 1969 the inflation rate was 3.9 percent; 7 percent is the lowest rate since 1970.

Table 1.3
Saving, Investment, and the Current Account, 1990–97

| | (percent of income, ^a annual rates) | | | | | |
|--|--|------|------|------|------|------|
| | 1990–92 | 1993 | 1994 | 1995 | 1996 | 1997 |
| Gross saving rate | 20.5 | 19.8 | 18.1 | 17.2 | 16.6 | 16.4 |
| Public | –0.7 | 0.8 | 1.0 | –0.7 | –1.7 | –0.5 |
| Private | 20.9 | 19.0 | 17.2 | 17.9 | 18.4 | 16.9 |
| Gross investment | 20.6 | 22.1 | 21.4 | 22.5 | 22.0 | 19.8 |
| of which Business sector | 12.4 | 14.7 | 15.4 | 15.0 | 14.6 | 13.1 |
| Transfers on capital account | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.2 |
| Current account of the balance of payments | 0.0 | –2.0 | –2.9 | –5.1 | –5.1 | –3.2 |

^a Income is defined here as GNP *plus* unilateral transfers.

throughout the year, and plummeted towards the end of the year: in the first quarter the CPI rose at an annual rate of 10.8 percent, falling to 9.6 percent in the second quarter, 5.3 percent in the third quarter, and 2.4 percent in the last. The slowdown encompassed all the CPI components equally, and most of them rose by about 7 percent during the year. Even housing prices, which in recent years have risen more rapidly than the overall CPI, increased by only 7.5 percent, while wholesale prices went up by 5.9 percent. Alongside the deceleration of prices, inflation expectations moderated too, varying throughout the year within the target range set by the government, albeit in its upper half (8.5–10 percent). The considerable impact and the uniformity with which many of the fundamentals affecting inflation operated in 1997, indicates that an opportunity has arisen to reduce inflation considerably from the level of the last few years, provided, of course, that there is no change in the fundamentals.

The slowdown in GDP growth was reflected by the slower expansion of the demand for labor than in previous years—a trend that affected most of the business sector—and the rise in unemployment. Labor inputs in the business sector rose by only 1.9 percent in 1997, compared with 3.3 percent in 1996, and an average of 8.5 percent in 1994 and 1995 (Table 1.5). The slower expansion of employment, alongside the 2.5 percent acceleration in the growth of the civilian labor force, contributed to the rise in unemployment, from an average of 6.7 percent in 1996 to 7.7 percent in 1997 (Figure 1.1). The increase in unemployment was aggravated *inter alia* by the rise in the share of non-Israelis (including Palestinian residents of Judea, Samaria, and Gaza)—the cost of employing whom is relatively low—to a record 10.6 percent of all employed persons in the business sector. The increase in unemployment was accompanied by an acceleration in the rise in real business-sector wages, to 3.4 percent, and this encompassed most industries, while nominal wages rose at a similar rate to that of 1996. The increase in the real wage at a time when unemployment rose, appears to reflect the combination of the sharp 6.1 percent⁷ real rise in the minimum wage (which affected the traditional industries in particular), the decline in inflation, and

⁷ 5.1 percentage points of this increase reflect the rise in the minimum wage from 45 percent of the average wage to 47.5 percent due to a legislative change.

The rate of price increases slowed throughout the year, and fell sharply towards its end.

Slower GDP growth was reflected in a slower increase in labor demand and a rise in unemployment.

The rise in unemployment accelerated, *inter alia*, because of the increase in the share of non-Israeli workers (including Palestinian residents of Judea, Samaria, and Gaza) to a peak of 10.6 percent of all business-sector employees.

Table 1.4
Indicators of Inflation, 1990–97

| | (annual average change, percent) | | | | | | |
|--|----------------------------------|---------|------|------|------|------|------|
| | 1990–91 | 1992–95 | 1993 | 1994 | 1995 | 1996 | 1997 |
| <i>Year-end</i> | | | | | | | |
| CPI | 17.8 | 10.8 | 11.2 | 14.5 | 8.1 | 10.6 | 7.0 |
| CPI excluding housing | 14.5 | 9.2 | 7.6 | 12.2 | 6.4 | 9.8 | 6.8 |
| CPI excluding housing & fruit and vegetables | 15.1 | 9.3 | 8.1 | 9.8 | 8.8 | 10.1 | 6.7 |
| Wholesale price index | 13.6 | 9.0 | 7.2 | 9.7 | 10.0 | 7.0 | 5.9 |
| Exchange rate (against currency basket) | 11.4 | 8.5 | 8.0 | 5.4 | 5.8 | 3.0 | 3.7 |
| <i>Average</i> | | | | | | | |
| CPI | 18.1 | 11.3 | 10.9 | 12.3 | 10.0 | 11.3 | 9.0 |
| CPI excluding housing | 14.5 | 9.7 | 8.5 | 9.4 | 8.8 | 9.9 | 8.4 |
| CPI excluding housing & fruit and vegetables | 15.1 | 9.7 | 9.0 | 8.7 | 9.3 | 10.2 | 8.3 |
| Wholesale price index | 13.8 | 9.2 | 8.2 | 7.9 | 10.7 | 8.6 | 6.3 |
| Exchange rate (against currency basket) | 11.4 | 8.6 | 12.1 | 7.8 | 4.7 | 3.5 | 4.3 |
| Exchange rate against dollar | 9.0 | 7.3 | 15.0 | 6.4 | 0.0 | 5.9 | 8.2 |
| Exchange rate against 4-currency basket ^a | 14.8 | 10.8 | 9.7 | 9.6 | 10.2 | 0.4 | –1.6 |
| Exchange rate in export terms ^b | –4.7 | –3.1 | –1.2 | –4.9 | –2.7 | –3.9 | –3.2 |
| Exchange rate in import terms ^c | –5.7 | –1.7 | –0.9 | –3.5 | –1.7 | –6.7 | –5.5 |

^a See note 3 in Chapter 6.

^b Ratio of export prices excluding diamonds to implicit price index of business-sector product including residential services.

^c Ratio of import prices excluding diamonds to implicit price index of business-sector product including residential services.

The rise in unemployment was accompanied by an accelerated rise of 3.4 percent in the real business-sector wage.

In 1997, private-sector capital inflows increased to \$ 9.1 billion.

the wage increments deriving from agreements signed before unemployment began to rise and demand to decelerate.

Private capital inflows (both financial and nonfinancial) rose by more than 100 percent in 1997, to stand at \$ 9.1 billion; this occurred mainly in the first half of the year when, alongside the increase in foreign investment, credit denominated in and indexed to foreign currency expanded rapidly, *inter alia* because of the yield gap between Israel and abroad. In the second half of the year—after the exchange-rate band was widened, increasing the risk of exchange-rate volatility—short-term capital flows ceased almost entirely, but the rising trend in foreign investment persisted. For the year as a whole, net investment in Israel by nonresidents rose by about 30 percent, to reach \$ 3.7 billion. As a result of these developments and the reduction of the current-account deficit, the Bank of Israel's foreign-exchange reserves stood at a record more than \$ 20 billion at the end of 1997. On the capital market, the real yield to maturity on government bonds declined in 1997, after soaring in the previous two years, and the general share-

Table 1.5
Conditions of Business-Sector Activity, 1990–97

| | (annual change, percent) | | | | | |
|-------------------------------------|--------------------------|------|------|------|------|------|
| | 1990–92 | 1993 | 1994 | 1995 | 1996 | 1997 |
| Business-sector product | 7.4 | 3.4 | 7.9 | 8.8 | 5.2 | 1.5 |
| Domestic labor inputs | 5.5 | 5.5 | 9.5 | 7.5 | 3.3 | 1.9 |
| Civilian labor force | 6.0 | 3.0 | 5.1 | 6.7 | 3.3 | 3.7 |
| Gross physical capital stock | 3.1 | 5.4 | 7.0 | 8.5 | 8.1 | 8.6 |
| Total productivity | 2.6 | –1.9 | –0.8 | 0.9 | 0.4 | –2.4 |
| Yield on gross capital ^a | 13.6 | 13.7 | 12.8 | 12.4 | 11.4 | 9.5 |
| Average business-sector wage | –1.6 | 0.3 | –0.4 | 0.6 | 1.5 | 3.4 |
| Unit labor costs (business sector) | –3.0 | 2.8 | 2.3 | –0.1 | 2.4 | 4.0 |
| Real minimum wage | –1.8 | –1.6 | 1.6 | 2.3 | 2.5 | 6.1 |

^a Yield before tax.

price index rose sharply by a real 26 percent, in contrast with the trend of the previous three years. However, with the eruption of turmoil in the South-East Asian markets (in the second half of the year) the rising trend was checked and volatility increased, alongside a fall in share prices.

Real economic developments (especially the deceleration in domestic demand beyond the slowdown in GDP growth), as well as financial and price trends, were also reflected by the development of real long-term interest rates, the ratio between prices of tradable and nontradable goods (the real exchange rate), and real wages. The decline in the real yield to maturity on 10-year bonds, from 4.5 percent in 1996 to 3.9 percent in 1997 (annual average), is consistent with the fall in investment relative to savings and in the rate of return on capital.⁸ With regard to relative prices, experience in Israel and abroad shows that in a small, growing economy the growth path is usually accompanied by real appreciation, as productivity and technological progress in the traded sector outstrip those in the untraded sector, while at the same time the relative demand for nontradable goods rises, pushing their price up. Consequently, the development of the real exchange rate is examined with reference to its trend, too. In 1997 real appreciation slowed to some extent, and it reached 3.2 percent on the basis of the real exchange rate in terms of exports, compared with 3.9 percent in 1996 and even higher average rates in 1985–95. In terms of imports, too, real appreciation was lower than in 1996 (5.5 percent compared with 6.7 percent in 1996), but this rate was still higher than the average in the previous decade. However, the rapid fall in inflation in the second half of 1997 appears to have generated some real depreciation. Despite the moderation of demand and the decline in productivity, real business-sector wages rose rapidly, leading to a 4.0 percent increase in unit labor costs in that sector, continuing the annual average rise of 1.1 percent in the preceding two years. This development, which encompassed most industries, appears to have contributed to the growth of unemployment.

⁸ Nevertheless, at the end of 1997 and the beginning of 1998 the yield to maturity on medium- and long-term bonds rose to a level similar to that of 1996.

In the second half of the year, there was an almost complete halt in short-term capital inflows, but the upward trend of foreign investment continued.

Despite the moderation of demand and the decline in productivity, the real business-sector wage rose rapidly, resulting in a 4 percent increase in unit labor cost.



Thus, the changes in the level and composition of domestic demand do not appear to have fully impacted on all relative prices. This seems to be the result of the combination of the following three factors:

Financial factors in the direction of real short-term appreciation acted in opposition to the forces in the real sphere exerting pressure for depreciation.

First, the change in the nominal exchange rate was modest, and it maintained a path close to the lower limit of the exchange-rate band (Figure 1.3). This path reflects the considerable excess supply of foreign currency in the wake of the rise in the various categories of capital inflow, enabling the financing of the (lower) deficit on the current account, and the significant increase in the foreign-exchange reserves in the Bank of Israel. Hence, financial factors for real short-term appreciation offset the real forces for real depreciation. Second, there was a steep increase in the minimum wage, and the wage path failed to respond to the rise in unemployment and the deceleration of demand. Third, there was incomplete flexibility, especially in the short run, in the response of domestic prices—especially of nontradable goods and services—and of inflation expectations to the reduction of excess demand and the relatively moderate path of foreign prices and the nominal exchange rate. As a result of all these factors, profitability appears to have declined in 1997, too, especially in the traditional tradable industries, which compete mainly, both in Israel and abroad, with European goods.⁹ The steep increase in unit labor costs in 1997 brought their cumulative rise in 1994–97 to 9 percent, alongside the steady decline in total factor productivity. As a result of these factors, the rate of return on capital in 1997 fell to a level similar to that of 1986–89.¹⁰ The cumulative fall in profitability intensified the process of the contraction of some traditional industries this year, which is part of the structural economic change Israel is undergoing, thereby contributing to the general economic slowdown.

FISCAL AND MONETARY POLICY

Fiscal policy in recent years intensified the fluctuations in economic activity across the business cycle.

The marked slowing of economic growth illustrates the cost of the interaction between an unsustainable policy and the business cycle evident in many modern economies. Although part of Israel's business cycle in the current decade derives from positive processes associated with the absorption of immigrants, progress in the political process, and structural economic changes, it can be said that the fiscal policy of the last few years—the significant expansion in 1994–96, when there was excess demand, and the corrective restraint required in 1997—exacerbated the fluctuations in economic activity across this cycle. In previous years, monetary policy was contractionary in order to attain the inflation target, in the context of excess demand and considerable fiscal expansion. The persistence of monetary restraint in 1997 contributed to damping demand pressures and economic activity. It can be surmised that if fiscal policy had acted to prevent deviation from the budget deficit targets in former years, enabling a more

⁹ In 1997 there was significant local-currency appreciation against most of the European currencies.

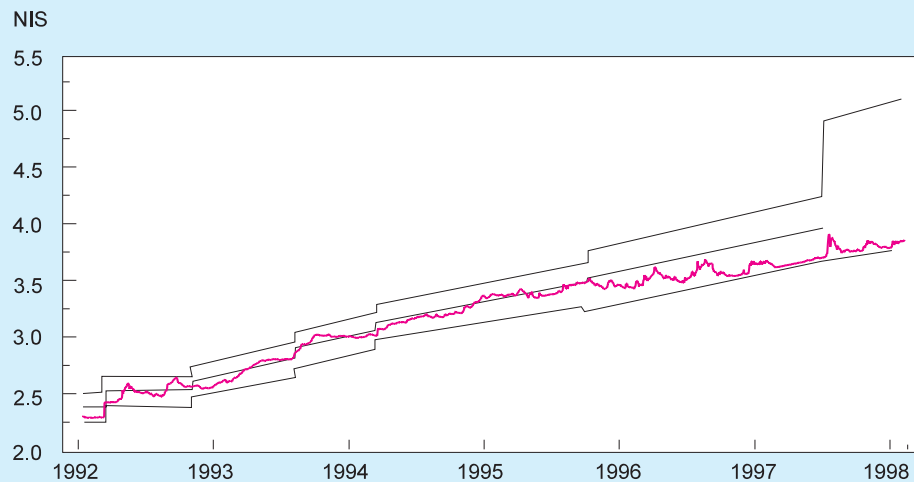
¹⁰ However, the corporate tax rate was reduced substantially between the two periods, from 49 percent in 1986 and 45 percent in 1987–89 to 36 percent as of 1996.

balanced mix of fiscal and monetary policies, and obviating the need to introduce significant corrective measures in 1997, the cost arising from the business cycle would have been reduced.

One of the key questions arising in analyzing policy in 1997 is why was a less contractionary policy not adopted, despite the economic slowdown? In the fiscal sphere, it was necessary to adopt a policy of restraint, in order to reduce the risk of a balance-of-payments crisis and give the government's long-term economic targets greater

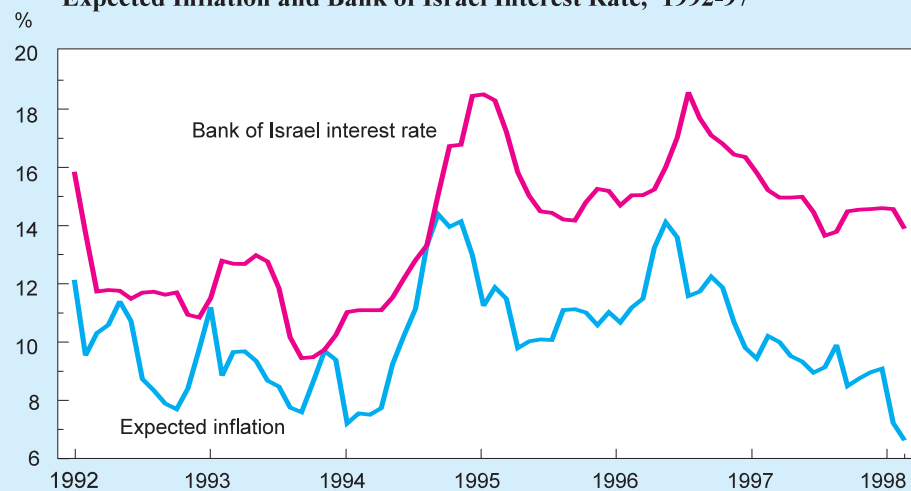
Figure 1.3

NIS/Currency-Basket Exchange Rate,^a 1992-97



^a Latest figure: February 1998.

Expected Inflation and Bank of Israel Interest Rate,^a 1992-97^b



^a Latest figure: February 1998.

^b Expected inflation is calculated from the difference between gross yields on nominal and indexed bonds in the capital market. The Bank of Israel interest rate is the rate set at the monetary auction weighted by the amount of loans. As of August 1996, the interbank interest rate is used as a yardstick, if there is no monetary auction.

The need to return to fiscal discipline in order to accord credibility to the government's long-term economic objectives necessitated a restraining policy.

Monetary restraint continued in order to attain the government's inflation target.

The public-sector deficit rose by 3.1 percent of GDP from 1994 to 1996

credibility; these constraints prevented policy makers from adopting a more expansionary policy, especially in view of the uncertainty as to whether the deficit target would be met by the end of the year. In the monetary sphere, the contractionary policy was maintained, despite the significant adjustment in fiscal policy, in order to ensure the attainment of the annual inflation target set by the government and bring the economy to a declining inflation path, as required by the government's decisions regarding inflation targets for the coming years. In effect, until the last third of the year, the inflation environment did not decline to a rate that would ensure the attainment of the annual target. The importance of policy credibility was accentuated in the second half of the year, in view of the financial crisis in Asia. The implementation of monetary policy reflected these considerations, as well as the view that the comparative advantage of monetary policy, and its seminal contribution to achieving the other objectives of economic policy, lies in guaranteeing the conditions for attaining the inflation target. All these considerations created a mix of fiscal and monetary restraint that contributed, together with other important factors, to damping demand and economic activity in 1997.

Fiscal policy in 1997 reflected the need to reduce excess demand and restore the credibility of the government's long-term objectives, which are expressed in the Budget Deficit Reduction Law and the inflation target, after fiscal discipline had been breached since the submission of the supplementary budget in 1994 (Table 1.6). This was reflected by the acceleration of domestic public consumption, from an annual growth rate of 1.6 percent in 1991–93 to 3.9 percent in 1994–96 (adjusting for the effect of the National Health Insurance Law), the steep rise in real public-sector wages, and the one percentage-point increase in the share of transfer payments in GDP. The expansion of public-sector expenditure persisted in this period, despite the slowing of the rise in tax revenues—part of it as a result of legislation and part of it unexpected—whose share in GDP (adjusting for the effect of the National Health Insurance Law) fell by about 2 percent (Figure 1.4). Because of these developments, the public-sector deficit rose by 3.1 percent of GDP in 1994–96, and the government deviated from the domestic deficit target in 1995 and 1996. In 1996 the declining trend in the public-sector debt/GDP ratio, which has been evident since 1989, slowed markedly.

There was a turnaround in the implementation of fiscal policy in 1997, and the government met its total deficit target of 2.8 percent of GDP despite the economic slowdown, which reduced tax revenues. The commitment to fiscal discipline was expressed in the adjustments made to the budget during the year in order to ensure that the target was met. Nonetheless, the government's domestic deficit was 0.6 percent of GDP above the original estimate—a discrepancy that is similar to the decline in revenues resulting from the overestimation of GDP growth—but the surplus in the government's economic activity abroad, compared with the planned deficit of NIS 1.8 billion, made it possible to meet the overall deficit target, and the total public-sector deficit contracted by 1.7 percent of GDP. As a result of the reduction of the deficit and the fact that it was financed by privatization proceeds, the decline in the public debt/GDP ratio accelerated in 1997 despite the slowdown in growth.

Table 1.6
Main Indicators of Fiscal Policy, 1990–97

| | (percent of GDP, annual rates) | | | | | |
|--|--------------------------------|-------|------|------|------|------|
| | 1990–92 | 1993 | 1994 | 1995 | 1996 | 1997 |
| Central government domestic budget deficit | | | | | | |
| Ceiling ^a | 6.2 * | 3.2 | 3.0 | 2.75 | 2.5 | 2.3 |
| Actual | 4.9 * | 2.4 | 2.0 | 3.2 | 4.7 | 2.9 |
| Ceiling on overall central government deficit ^b | 8.5 * | 4.4 | 3.5 | 3.8 | 3.6 | 2.8 |
| Actual overall central government deficit | 5.3 * | 3.9 | 2.1 | 4.1 | 4.1 | 2.4 |
| Overall public-sector deficit | 4.1 | 2.1 | 1.1 | 3.1 | 4.2 | 2.5 |
| Public-sector domestic deficit | 7.2 | 3.8 | 2.3 | 4.5 | 5.3 | 4.0 |
| Net public sector debt | 112.1 | 101.8 | 94.9 | 92.1 | 91.3 | 90.1 |
| <i>of which</i> Domestic debt | 93.3 | 81.3 | 74.8 | 74.6 | 77.2 | 84.5 |

* For 1992 only.

^a Until 1996 the deficit ceiling as prescribed by law, in 1997 the planned deficit.

^b Until 1996 the planned deficit, in 1997 the deficit ceiling as prescribed by law.

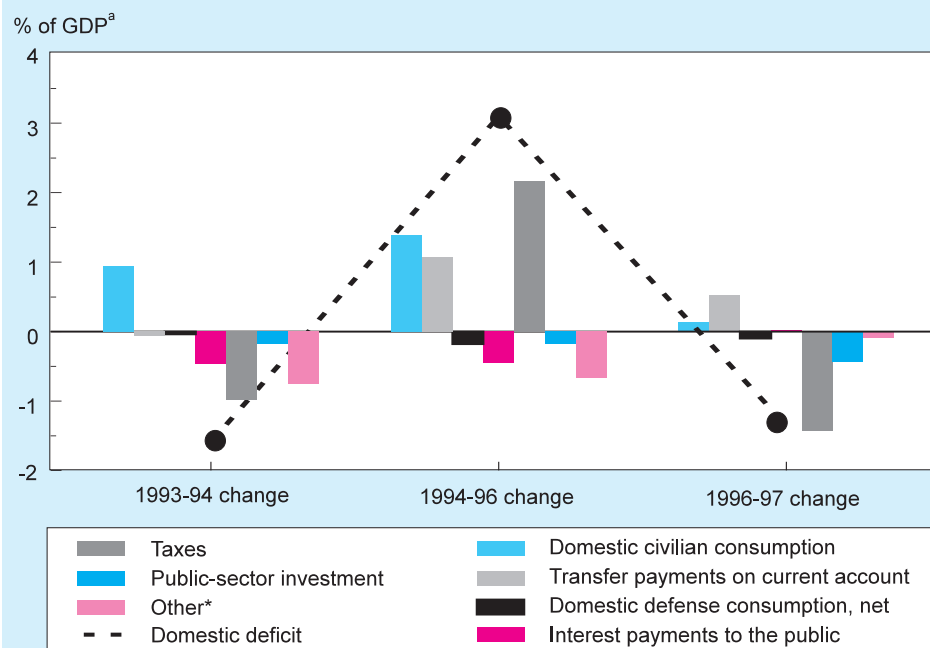
The reduction of the deficit in 1997 was achieved by increasing the tax burden—measured by the tax receipts/GDP ratio—and reducing public-sector investment. On the other hand, public consumption and transfer payments continued to rise more rapidly than GDP. The heavier tax burden, reflecting changes in legislation amounting to NIS 2 billion at the beginning of the year and a steeper rise than expected in corporate tax receipts, contributed 1.4 percentage points to the reduction of the deficit/GDP ratio, while the decline in public-sector investment contributed 0.4 percentage points. By contrast, domestic civilian consumption and transfer payments to individuals contributed 0.2 and 0.5 percentage points respectively to the rise in the deficit. The share of domestic defense expenditure in GDP remained stable in 1997, as it has since 1994, a development that requires particular caution in restraining civilian expenditure, whose rise in the past was possible thanks to the steady reduction of defense expenditure. The increase in public-sector employment accelerated in 1997 to 3.0 percent, beyond the rise in the Israeli labor force. Real public-sector wages fell by 0.2 percent this year, after rising steeply in previous years.

Experience in Israel and abroad has shown that budget composition has a considerable effect on the development path of the economy. Reducing the size of the public sector, and diverting the resources thus freed to infrastructure investment and the reduction of the tax burden, encourages a sustainable rise in GDP. Consequently, despite the significance of reducing the fiscal impulse in 1997 in order to reduce the balance-of-payments deficit, the composition of the reduction of the deficit—increasing the tax burden and reducing investment—is not sufficiently supportive in reviving sustainable growth. Freeing existing bottlenecks in the infrastructure—mainly in transport—and easing the tax burden, which will act as an incentive for private-sector activity, make it necessary to address the composition of budget expenditure in order to reduce public

The budget deficit was cut in 1997 by increasing the tax burden and reducing public-sector investment.

It was essential to dampen the fiscal impulse in 1997, but the composition of the reduction—a heavier tax burden and lower investment—does not stimulate the renewal of sustainable economic growth.

Figure 1.4
Components of Change in Public-Sector Domestic Deficit, 1993-97



* Including income from property, transfer payments on capital account, direct subsidies, and credit subsidies.

^a The columns reflect the contribution of each component (as a percent of GDP) to the change in the public-sector domestic deficit during the period. The sum of these changes is the change in the deficit as a percent of GDP, as shown in the curve.

consumption and transfer payments, which have risen in recent years, measures that will free resources for those purposes. If these subjects are not tackled, bringing the economy back to a path of sustainable growth that is consistent with its potential may be deferred beyond what is required by the current adjustment process.

In 1997 monetary policy acted to attain the government's inflation target (7–10 percent) while sustaining the crawling exchange-rate band, and the Bank of Israel continued to focus its policy on bringing the economy to a declining inflation path—in accordance with the government's decisions—realizing that this is monetary policy's principal contribution to creating the conditions for Israel's growth potential to be realized. Since the inflation rate in Israel is significantly higher than that in its main trading partners, and in view of the goal of deepening the country's integration in the global economy, the government demonstrated the importance it attaches to the reduction of inflation by its December 1996 decision to set the target for the year 2001 as the inflation rate common in the OECD countries, and in its decision of August 1997 that monetary policy should continue to aim at the gradual reduction of inflation, with the object of attaining the same price stability in the long term as the advanced economies. As is customary in some of the OECD countries, the purpose of setting a quantitative target for inflation and pursuing a credible policy for attaining it was to affect the



CHAPTER 1: THE ECONOMY: DEVELOPMENTS AND POLICIES

processes of determining wages and prices as well as inflation expectations. The inflation target also designates a framework and operative guidelines for monetary and exchange-rate policy, and for budgetary planning.

Against the backdrop of these goals, the Bank of Israel maintained real interest rates at an average level of 5 percent during 1997, similar to that prevailing in the second half of 1996; nonetheless, the level of real interest on the monetary loan was 0.8 percentage points higher than the 1996 annual average. This level was maintained until the end of the year, despite the economic slowdown, because the inflation environment was not substantially changed until the last quarter of the year, due to the need to establish the downward trend of inflation, in accordance with the government's target for the year 2001, and because caution was required in the last third of the year in order to prevent a crisis from developing along the lines of those in South-East Asia. Furthermore, in light of the experience of 1993 and 1995, when the relatively rapid reduction of the interest rate in the wake of the moderation of the rate of price increases contributed to the resurgence of inflationary pressures and to interest-rate fluctuations (in the context of a rise in excess demand), the Bank of Israel refrained from reducing the interest rate rapidly before it was apparent that the inflation environment had in fact established itself at a lower level. However, the development of the various indicators of the inflation environment during the year, including the effect on prices of the slowdown in growth, enabled the Bank of Israel to reduce average nominal interest rates by almost 2 percentage points compared with 1996 (Figure 1.3) without harming the chances of attaining the inflation target. These reductions were accompanied by the accelerated annual growth rate of the narrow money supply (M1), from 11.9 percent in 1996 to 14.1 percent in 1997 (Table 1.7). Nevertheless, as a result of the significant moderation of price increases and inflation expectations towards the end of the year, the real interest rate rose to 6 percent at the end of the year.

The nominal exchange rate was one of the channels by which monetary policy and other basic factors affected the inflation environment in 1997. The NIS depreciated by a moderate average 4.3 percent against the currency basket—less than the inflation differentials between Israel and the countries whose currencies comprise the basket. Although in both halves of the year the rate of depreciation was similar, there were differences between them as regards developments in the foreign-currency market. In the first half of the year pressure for local-currency appreciation against the currency basket intensified, primarily as a result of the rapid expansion of credit denominated in and indexed to foreign currency, and the Bank of Israel had to intervene in foreign-exchange trading and buy almost \$ 7 billion from the public in order to defend the lower limit of the exchange-rate band. At the same time, the Bank of Israel absorbed local currency from the public to a similar extent, in order to sterilize the effect of the foreign-currency purchases on the monetary base. Since the interest paid by the central bank on the money absorbed from the public was higher than the yield obtained this year from the foreign-exchange reserves purchased, these activities incurred a cost that was reflected by a rise in the surplus of expenditure over income in the Bank of Israel in 1997.

The Bank of Israel refrained from reducing interest rates rapidly before there was a high probability that inflation had in fact established itself at a lower level.

In the first half of 1997 pressures for local-currency appreciation vis-à-vis the currency basket intensified greatly.

Table 1.7
Monetary Indicators, 1990–97

| | (percent, annual rates) | | | | | |
|--|-------------------------|------|-------|-------|------|------|
| | 1990–92 | 1993 | 1994 | 1995 | 1996 | 1997 |
| M1 ^a | 25.6 | 23.7 | 20.6 | 8.4 | 14.9 | 14.3 |
| M1 ^b | 26.9 | 27.8 | 5.0 | 16.5 | 11.9 | 14.1 |
| Credit ^a | 32.8 | 44.9 | 28.1 | 26.2 | 22.0 | 18.0 |
| Nominal interest rate on | | | | | | |
| Bank of Israel resources | 14.2 | 11.3 | 13.4 | 15.5 | 16.1 | 14.3 |
| SROs (CDs) | 12.1 | 9.7 | 11.6 | 13.3 | 13.8 | 12.2 |
| Nondirected credit in NIS ^b | 24.2 | 16.5 | 17.4 | 20.2 | 20.7 | 18.7 |
| Expected inflation | 14.6 | 9.0 | 12.9 | 10.8 | 11.8 | 9.3 |
| Average currency-basket interest | 7.7 | 4.7 | 4.8 | 5.4 | 4.7 | 4.9 |
| Real interest rate on 5-year bonds | 1.9 | 2.8 | 2.9 | 4.1 | 4.4 | 3.9 |
| Nominal average share yield | 52.5 | 49.9 | –10.3 | –13.4 | 1.9 | 39.8 |

^a Rise in annual average. M1 = cash in the hands of the public *plus* demand deposits.

^b Rise during the year.

In light of these pressures, and the acceleration of foreign-exchange liberalization, the government decided in mid-June 1997 to alter the exchange-rate band, further increasing the flexibility of the exchange-rate regime. In the wake of these changes, and the subsequent reduction in the interest rate, expected yield differentials were reduced, and there was greater risk in foreign-exchange transactions, because of both the widening of the band and the greater volatility of world exchange rates due to the crises in Asia and elsewhere. As a result, there was a change in the nature of capital flows to Israel: foreign-currency credit did not increase in the second half of 1997, while investment in Israel by nonresidents expanded. Due to this expansion, alongside the continued improvement in the current account of the balance of payments, the exchange rate began to rise moderately again, remaining near the lower limit of the exchange-rate band. With the exception of a few days, however, the Bank of Israel did not intervene on the foreign-currency market in the second half of 1997.

The developments in the foreign-exchange market in 1997 illustrate once more the problematic nature of the commitment to an inflation target, given the constraint of sustaining the exchange-rate band in the absence of complete consistency between the two commitments. When achieving the inflation target makes it necessary to maintain a specific interest rate, foreign-exchange flows—whether as a result of capital inflows or of the current account on the balance of payments—could push the exchange rate to one of the limits of the band. Intervention by the central bank in this case, in order to defend the band, makes it necessary to sterilize the consequent inflow, which incurs a cost.

THE TARGETS FOR THE NEXT FEW YEARS

The achievements of reducing the balance-of-payments deficit and slowing down the rate of inflation, which are important conditions for getting the economy back onto the



CHAPTER 1: THE ECONOMY: DEVELOPMENTS AND POLICIES

path of sustainable growth, were accompanied by the slower expansion of economic activity and a rise in unemployment. The challenge confronting the economy over the next few years is, therefore, to return to growth rates compatible with its potential, enabling unemployment to be reduced, yet avoiding reversion to an unstable development path. Against this background, it is vital to steer clear of policies based on increasing demand in the short term that are not necessarily consistent with the renewal of sustainable growth and the reduction of inflation, and which may harm the relative stability attained in 1997. The considerable progress achieved in the last few years in integrating Israel into the world economy—a process which made a considerable contribution to the country's growth and represents a major component in its continuation—demands discipline from policy makers. This is required particularly as the economy becomes more exposed to trade and capital flows which may respond quickly and strongly if policy is perceived to be following an unstable path. The importance of such discipline is even greater at present as the use of the loans guaranteed by the US government comes to an end, and in light of developments in Asia which made international capital flows more sensitive to economic policy.

The return to sustainable growth is all the more challenging at the beginning of 1998 because of the expected deceleration of Israel's exports in the wake of the predicted slackening of world trade following the Asian crisis. In order to meet the challenge successfully, a number of policy measures are required, including altering the composition of government expenditure so that more resources are directed to infrastructure investment; extension of structural economic reforms, while enhancing competition and accelerating privatization; reducing the tax burden and reforming the tax system; ensuring that wage agreements will not harm higher employment; making professional retraining more efficient and regulating the employment of foreign workers; and deepening the liberalization of the money and capital markets. These steps hold the key for raising total factor productivity—which has declined by 3.8 percent over the last five years—a component without which it will prove very difficult to return to a path of sustainable growth. As the implementation of these measures is a lengthy process, and their contribution is evident only with a lag, they should not be expected to affect growth immediately.

Fiscal policy has a major role to play in attaining these targets. The continued reduction of the public-sector deficit in line with the long-term goals defined in the Budget Deficit Reduction Law is a central component in underpinning the improvement achieved in 1997 in the balance-of-payments current account and in the continued reduction of the current-account deficit. Meeting the deficit targets and returning to a declining public-debt/GDP ratio will also play a central role in the economy's progress towards the target of an inflation rate in the year 2001 similar to that common in the OECD countries, in accordance with the government's decision. Nevertheless, faster progress towards sustainable growth also requires focusing on the composition of the budget. To release resources to the private sector and for infrastructure investment—steps which will support increased productivity—it is vital that the deficit is cut by means of reducing the share of public consumption and transfer payments in GDP, and

The challenge facing Israel in the next few years is to return to growth rates that are consistent with its potential, enabling the reduction of unemployment, but without risking a reversion to an unstable development path.

Opening the economy to international trade and capital flows requires discipline on the part of policy makers.

To accelerate Israel's progress towards sustainable growth, it is important to ensure that the budget deficit is reduced by curtailing the share of public consumption and transfer payments in GDP, rather than by increasing the tax burden and reducing public investment.

In view of the severe backlog in transport infrastructure, special emphasis should be placed on developing this sphere, while adhering to the budget framework.

Public consumption is expected to continue growing in 1998 at the same rate as GDP, while budgetary investment is expected to remain unchanged.

Further progress in the process of structural reform could contribute substantially to enhancing competition, reducing costs, and stimulating economic activity, without generating inflationary pressures.

not by means of increasing the tax burden and cutting public investment. At the same time, despite the need for rapid progress in the infrastructure, care must be taken that projects in this area are chosen after thorough economic cost/benefit analysis. The trend of private-sector participation in the financing and implementation of infrastructure projects should be accelerated. In light of the great cumulative backlog in the development of the transport infrastructure, a lag that is evident by international comparison, progress in this sphere—especially a massive improvement of the public transport system in the Tel-Aviv metropolis by means of a suburban railway, improvement of the roads infrastructure, and the extension of operational capacity of the air and sea ports—warrants special attention, while ensuring that the budget framework is maintained.

The 1998 budget approved by the Knesset represents partial progress in the right direction. While it does conform with the targets of the Budget Deficit Reduction Law, and unlike last year does not raise tax rates, its framework is too taut, and the budget reserve limited. Public consumption is expected to continue growing in 1998 at a similar rate to that of GDP, but investments are expected to remain at a standstill, so that their share in GDP will fall. Certain policy measures essential for the preservation of the deficit framework (for example in the health system) have not been finalized at the time of writing this report, and the income forecast seems optimistic, even if economic growth is in line with the original budget forecast. Over and beyond these structural factors, the growth rate in 1998 is likely to be lower than that used in the budget—*inter alia* because of the Asian crisis—so that income will be reduced. In this context it is essential that public-sector wage agreements are in line with the budgetary assumptions, i.e., that they do not permit a rise in the real wage. In addition, it is vital to establish a system of monitoring the implementation of the budget and drawing policy conclusions as necessary during the year.

Another area in which policy measures have a great effect on the economy's progress towards sustainable growth is that of structural reform and privatization. Reforms in communications in the last few years are a prime illustration of the contribution of greater competition to a significant reduction of prices side by side with a marked rise in the activity level. Further and faster advance in this process, mainly in the infrastructure industries (transport, electricity, fuel, and the domestic telephone system) can make a major contribution to increasing competition, cutting costs, and boosting activity in a noninflationary manner. Combining structural reforms with privatization can also greatly help reduce the public debt, as in 1997. In the labor market, particularly in light of the high unemployment rate, the system of professional retraining of workers must be improved so that their qualifications and skills can adjust more fully and speedily to opportunities arising from economic changes. The increase in the number of institutions for higher education in recent years was an important step in this direction. Against the background of the increased number of foreign workers, despite the rise in unemployment, their employment must be regularized in such a way that will ensure fair competition with domestic labor, on the one hand, and the rights of those foreign workers employed legally in Israel, on the other.



CHAPTER 1: THE ECONOMY: DEVELOPMENTS AND POLICIES

The slowdown in price rises in 1997, especially towards the end of the year, and the effect of the basic factors which influence inflation, including monetary and fiscal policies, provide an opportunity to lower inflation significantly. This opportunity is supported by recent developments in the world economy following the Asian crisis, which are expected to moderate world prices. Experience of disinflation in Israel and abroad has shown, however, that to ensure disinflation and to lower its cost to the economy, it is of prime importance to ensure that the various economic factors act consistently with the inflation target which has been set. The ability to achieve such consistency depends on the credibility of the government's and central bank's commitment to reducing inflation; it is therefore vital that such commitment is soundly based, by means of setting long-term inflation targets which clearly follow a path that converges with the target level. To give a foundation for the reduction of inflation it is essential that the inflation target is reflected in the wage agreements which are currently being negotiated in both the private and public sectors, in the budget prices, in controlled prices, and in the characteristics of the exchange-rate regime. A long-term inflation target will reduce the burden which weighs heavily on monetary policy in its response to deviations from the inflation target. In any event, the path of disinflation requires monetary policy to focus on achieving it, while adjusting the interest-rate level to changes in the inflation environment in light of economic developments. Intensified capital inflow to Israel necessitates the utmost caution in the management of the interest-rate policy.

The availability of long-term capital is an important factor in the healthy development of the business sector. Whereas liberalization of foreign currency and the integration of Israel's economy into the world economy have broadened the opportunities for Israeli companies to borrow on the international market, on the domestic market they must compete for long-term capital against earmarked government bonds bearing high rates of interest and allocated to the pension funds. Arrangements which will cut the share of these bonds in the portfolios of institutional investors and divert these investors into long-term investments in infrastructure and the business sector, as is the norm in the advanced economies, will make a major contribution to the development of the capital market. The capital market is also in need of a reform that will narrow the taxation differential between domestic investment and investment abroad, so as to make the allocation of the public's portfolio more efficient. These reforms are also an important component in the measures needed to complete the liberalization of foreign-exchange control and ensure conditions appropriate to making the NIS a fully convertible currency.

Arrangements that will limit the share of earmarked bonds in the asset portfolio of institutional investors, and direct these investors to long-term investment in the infrastructure and the business sector, will contribute greatly to developing the capital market.

