

CHAPTER I

THE ECONOMY: DEVELOPMENTS AND POLICIES

The year 1987 was marked by a significant rise in the level of economic activity, with strong growth of business sector product and employment, restraint in public sector employment, and a declining unemployment rate. Total productivity in the business sector went up by 3.5 percent, accounting for half the increase in the sector's product. The 7 percent growth of business sector product embraced all principal economic sectors, with an accompanying renewal of investment and improved export performance. The principal achievement of the stabilization program—the deceleration of inflation to 15–20 percent per annum, as measured by various price indexes—was maintained, and the public sector accounts remained balanced.

Nevertheless, problems remain: the domestic rate of inflation remained well above that of the country's trading partners and some real appreciation of the sheqel was also recorded, accompanied by a moderate increase in the civilian import surplus. In current dollar terms the rise in the civilian import surplus was higher, due to a deterioration in the terms of trade. Private consumption rose considerably in 1987, and there was some further decline in the private saving rate, following its steep fall in the preceding year. The ratio of overall savings to GNP remained low also in comparison to earlier years, but this did not burden the balance of payments since the ratio of investment to GNP also remained modest. Continued rapid growth will require a rise in the share of investment in the national product.

The adoption of the emergency stabilization program marks a turning point in the economy. The program, both comprehensive and wide-ranging, was launched after earlier stabilization attempts of a partial character had failed. The immediate background against which the program was introduced was a renewed surge of inflation, a loss of confidence in domestic financial assets, and a drain on the foreign currency reserves. The program included a direct freeze of the exchange rate, prices and wages, combined with very stringent fiscal and monetary policies, and was supported by a special US emergency grant (for a detailed discussion, see Chapter I of the Annual Report for 1985). Real domestic demand and the civilian import surplus had already contracted in 1984 and early 1985, prior to the introduction of the stabilization program, and these earlier developments contributed to its success.

Table I-1
MAIN ECONOMIC INDICATORS, 1982-87

	1982	1983	1984	1985	1986	1987
Demand, economic activity, labor market	<i>Percent real change</i>					
Public consumption, excl. direct defense imports	2.9	2.2	1.5	-1.0	-3.5	1.8
Private consumption	7.7	8.3	-6.8	0.5	14.2	8.1
Fixed investment	5.1	12.6	-11.3	-7.8	-1.6	13.7
Gross domestic product	1.0	2.6	2.4	3.7	3.3	5.2
Business sector GDP	0.0	3.1	2.8	5.0	5.3	6.9
Business sector employment	1.6	4.3	1.5	0.1	2.1	4.5
Total productivity (business sector)	-1.0	-0.1	-0.3	4.1	3.0	3.4
Gross wages, total economy ^a	-0.4	5.9	-0.4	-9.0	7.8	7.8
Labor costs, business sector	6.8	5.4	-5.6	0.7	8.4	3.0
Unemployment rate (% absolute level)	5.0	4.5	5.9	6.7	7.1	6.1
Gross national saving rate (% absolute level)	28.5	26.5	37.0	28.7	20.8	20.3
Balance of payments and external debt	<i>\$ billion, current prices</i>					
Current account deficit ^b	2.0	2.0	1.4	-1.2	-1.5	1.0
Unilateral transfers	2.6	2.9	3.4	5.1	5.4	4.9
Import surplus (excl. defense imports)	3.0	3.8	3.3	2.1	2.7	3.4
Exports of goods and services	10.6	10.5	10.8	11.2	12.1	14.2
Imports of goods and services	15.1	15.3	15.6	15.1	16.0	20.1
Net external debt	15.6	18.3	19.7	19.3	19.2	19.2
	<i>Index: 1980 = 100</i>					
Relative price of exports ^c	93	91	92	92	82	77
Relative price of imports ^c	91	85	87	93	83	80
Price, fiscal, and monetary data	<i>Percent</i>					
Consumer price index ^d	7.2	9.3	15.2	9.1	1.5	1.3
Wholesale price index ^d	7.5	9.7	15.2	8.0	1.2	1.6
Sheqel/currency basket exchange rate ^d	6.2	9.4	15.7	8.4	0.5	1.1
Interest rate on overdraft facilities ^e	7.6	9.0	19.8	15.3	4.0	4.0
Average interest rate on credit ^e		9.8	17.8	10.8	2.3	2.8
	<i>Percent of GNP</i>					
Domestic public sector deficit ^f	10.2	7.3	16.6	7.3	1.4	1.2
Total public sector deficit ^f	12.1	7.8	19.0	2.2	-2.8	0.1
Tax revenue ^g	45.5	46.1	38.2	45.1	48.4	47.6
Unlinked short-term assets ^h	6.3	6.5	5.6	9.8	14.7	119.8
Total short-term assets ^h	37.3	35.6	36.4	39.0	39.1	41.6
Total financial assets ^h	174.1	169.7	155.0	181.3	186.6	191.3
Total bank credit to the public ^h	23.5	21.6	20.8	23.3	25.1	30.8

^a Nominal wages deflated by the consumer price index (adjusted to approximate the price level at the beginning of the month—see Table IV-1).

^b A minus sign denotes a surplus. In analyzing current account trends, advance payments on defense imports should be deducted (see the explanation and table in Chapter VII, section 1).

^c See Table VII-1.

^d Percent annual change at monthly rate.

^e Average annual interest at monthly rate.

^f See Table V-1. A minus sign denotes a surplus.

^g Includes transfer payments from the public (see Table V-2).

^h Average balance relative to GNP (see Table VIII-1).

Following the initial shocks caused by the stabilization program, a process set in of progressive adaptation to the changed economic environment. This process has apparently not yet run its course. So far, three stages are discernible in it: (a) a sharp drop in the inflation rate and a large cut in the budget deficit, with a slowdown of economic activity; (b) the consolidation of stability and a surge in domestic demand; and (c) a rise in business sector activity and employment, associated with changes in the structure of demand and product. There was no distinct break between these stages; it is therefore difficult to pinpoint their timing; broadly speaking, the first stage ended in early 1986, the second continued throughout most of 1986, and the third stage began, according to various indicators, between mid-1986 and the beginning of 1987.

Table I-2
DEVELOPMENTS IN MAIN ECONOMIC INDICATORS, 1977-87

	1977- 1980	1981- 1984	1985- 1987
1. <i>Inflation rate</i> , annual percent change in CPI	80	192	21 ^a
2. <i>Public sector accounts</i> deficit (-) or surplus, percent of GNP	-14.3	-13.3	0.2
3. <i>Current account</i> , net, current \$ million, annual average	-668	-1,663	44 ^b
4. <i>Business sector GDP</i> , annual percent change	3.5	2.8	5.7
5. <i>Total productivity</i> in the business sector, annual percent change	1.1	0.3	3.4
6. <i>Unemployment rate</i> , percent of civilian labor force	3.8	5.1	6.6

^a From August 1985 to the end of the year.
^b Excluding the US emergency grant of \$1.5 billion.

Despite the year-to-year variations, when the period after the stabilization program is compared with earlier periods, a dramatic improvement in the state of the economy stands out: considerable progress has been made in curbing the rapid inflation, the elimination of the public sector deficits, and the halt put to further accumulation of foreign debt. At the same time, the gross domestic product and total productivity in the business sector rose considerably, not only relative to the beginning of the 1980s, but also as compared to earlier periods. The price paid for these improvements was a temporary rise in the unemployment rate (see Table I-2).

The changes observed in the economy since the adoption of the stabilization program

are typical of programs of this kind. Even when a rapid fall in the inflation rate is achieved, skepticism is likely to persist with regard to the ability to maintain the new lower inflation rate—in particular since earlier attempts at stabilization had failed, and at best achieved only temporary slowing of the rate of price rises. In this initial stage there may be a slowdown of output, and even bankruptcies, in enterprises whose calculations of profitability had been confounded by high inflation. With the drastic reduction of inflation, some economic activities are exposed as unprofitable, particularly when real interest rates rise—a phenomenon which often accompanies the initial stages of stabilization programs. Shifts to economically viable activities tends to be delayed until there is greater certainty regarding the stability of the new low inflation rate. In this subsequent phase, additional production factors, previously tied up in the search for protection against inflation, are also released, and a redeployment in the business sector may begin, possibly leading to a renewal of growth under an altered pattern of activities.

As already stated, the stabilization program included tight fiscal and monetary restraint and caused demand to shrink sharply. This contraction helped to slow inflation and further reduce the import surplus which had already begun to decline in the previous year. However, the cutback of demand hurt many business enterprises and raised unemployment in the initial stage of the program.

Although a stable exchange rate remained a principal instrument of price stabilization in 1986, it seems that in the first half of that year there was still considerable uncertainty among the public as regards the ability to continue with this exchange rate regime and maintain the new moderate rate of price increases. Only gradually, in the course of 1986, did expectations of devaluation fade and the public became convinced that the reduction of inflation was not temporary. During the year price controls were gradually lifted and interest rates fell, without speeding up the rate of price rises.

Beginning in early 1986, domestic demand expanded again, fuelled by a particularly steep rise in private consumption. The adjustment of the supply of product to the change in economic conditions necessarily requires more time than the expansion of demand; in 1986 it encountered additional difficulties which cut into the profitability of the business sector and slowed down GDP growth. Difficulties in rapidly adapting wages and employment to the new structure of demand and the changed relative prices took the form of an excessive increase of average wages in 1986; in addition, the effective rate of taxation of the business sector rose, and the construction and farm sectors ran into financing difficulties due to their heavy dependence on credit and the burden of past debts. The overall increase of the business sector product was some 5 percent, and total GDP growth was 3 percent. Domestic demand expanded much more, so that the civilian import surplus swelled greatly, and a real appreciation was generated.

The assessment that average real wages in 1986 had risen to a level incompatible with

the basic economic forces of the post-stabilization period, led to an attempt, in January 1987, to improve the economy's competitive position by a devaluation. . This was done under an agreement between the government, the Histadrut (General Federation of Labor) and the employers organizations, which combined the devaluation of the currency with the sterilization of its impact on wage costs. As it turned out, these steps did not prevent a further rise of real wages in 1987, nor did they hold back a further real appreciation, albeit at a modest rate.

In 1987 GDP growth speeded up to 5 percent, along with a change in structure: the product of the public sector rose only slightly, while the business sector product increased by 7 percent, having already grown by 5 percent in the preceding year. This expansion was not uniform, as between final uses and economic sub-sectors. Prominent on the resource use side were the 11 percent increase of exports and the 14 percent rise in fixed investment, while inventory investment diminished sharply, domestic public consumption went up by only 2 percent, and private consumption rose by 8 percent. This contrasted with 1986, when the expansion of demand was led by a 14 percent surge in private consumption and a rapid increase in stocks, while domestic public consumption and fixed investment decreased, and exports grew by 5.5 percent. The growth of domestic demand, particularly that channeled to the business sector, thus continued in 1987, albeit at a slower pace than the year before, while the growth of total and business sector GDP gathered momentum. This was reflected in a relatively moderate rise in the volume of the civilian import surplus in 1987, after its steep rise in 1986. At the same time, there was a narrowing of the gap between the rate of price rises of imports and exports and that of domestic uses, so that the real appreciation, which in 1986 had been considerable, was much milder in 1987. These developments seem to reflect an expansion of both demand for and supply of business sector product—in contrast to 1986, when the increase in domestic demand far outstripped GDP growth, due to supply constraints.

The most important factor behind the improved GDP growth in 1987 was the general rise in certainty; this includes the stability of the new inflation rate, the fiscal balance, and the improved balance of payments position—the principal manifestations of the stabilization program's success. Enhanced certainty apparently already began to take effect in the previous year, but as stability continued for a second year, expectations of continued growth gathered strength, and contributed to a notable improvement in productivity. The cumulative 10 percent rise of total productivity over the last three years accounts for more than half of the rise in business sector product during that period. The cuts in direct tax rates in 1987 also began to take effect: the reduction of personal taxes had a favorable influence on the supply of labor, and the cuts in corporate taxes, employers' tax, and employers' national insurance contributions raised net profitability and stimulated investment and capacity utilization. An addi-

tional factor nourishing GDP growth was the fall, for the second year running, in relative prices of imported intermediate goods. The freezing of public sector employment increased the supply of labor to the business sector, and the lessening of government involvement in the capital market assisted the private sector in raising capital, with an accompanying fall in long-term interest rates. The expansion of supply derived from these various factors was partially counteracted by the considerable rise in real short-term interest rates and some increase in real unit labor cost.

It therefore seems that in 1987 the supply of business sector product increased in line with the expansion of domestic demand, thus closing most of the gap between their respective growth rates that had widened in the previous year. The real appreciation of the sheqel was apparently influenced by additional factors, such as changes in production patterns and in the composition of demand; production capacity in the sectors producing internationally tradeable goods has in recent years expanded slightly faster than in non-tradeable industries, as implied by the composition of investment and the changes in the capital stock. On the demand side, the year 1987 saw a brisker domestic demand for non-tradeables, particularly construction, and their relative prices rose.

Developments during the year were marked by higher GDP growth in the first half of the year than in the second.

An examination of business sector product in the various economic sectors shows a GDP growth of 6 to 8 percent in all principal economic sectors, with an exceptionally high 11 percent growth of in agriculture, which in the year under review enjoyed favorable natural conditions. Yet, the average growth rates for principal sectors mask the disparities between sub-sectors; comparing the cumulative development of the various sub-sectors in the last two years reveals a non-uniform expansion, which could indicate some change in the composition of output. Thus, the change in the structure of output in industry is made up of expansion in sub-sectors with a high proportion of output destined for export and private consumption, while the sub-sectors producing for domestic defense consumption did not expand. In the commerce and services sector, the change consisted of a substantial upswing in commerce, which accords with the large expansion of private consumption and imports, while financial and legal services and banking showed a slowdown, as expected when inflation falls steeply. The picture in the other sectors shows similar differences among sub-sectors (for a detailed discussion, see the introductory section of Chapter VI, The Principal Economic Sectors). We proceed with a more detailed discussion of fiscal and monetary policy, and external factors that affected the economy's performance.

The trends characterizing the *public sector* since the adoption of the stabilization program continued in 1987, albeit with lesser intensity. The public sector's domestic and external accounts were nearly balanced, after the transition, in the preceding year

and a half, from large deficits to surpluses (see Table I-1). Domestic public consumption rose some 2 percent, following two consecutive years of decline. The 1987 increase consisted of a 4 percent rise in purchases and an unchanged labor input. As against this, public sector nondwelling investment increased rapidly, with a strong rise in infrastructure investment. The overall weight of public sector activities in the economy decreased in the year under review: direct public sector demand took a lesser share of GDP, its share in total employment declined, and so did its role in the capital market, as regards both total borrowing and lending to the public. However, the public sector's share in the economy still remains very high.

In the tax system, the year under review saw the implementation of the first stage of an income tax reform: tax rates on individuals and corporations were reduced, and so were employers' national insurance contributions, and the employer's tax in the commerce and services sector was abolished. Another round of tariff cuts was carried out, and purchase taxes were revised. This reduction of many tax rates, which contains an expansionary element, indeed contributed to the increase of domestic demand and the stepping up of business sector activity. The wage increase and the expansion of business activity caused an exceptional increase of the tax base, so that total tax revenue rose at a rate similar to that of GDP. The proportion of taxes to GDP thus remained at a very high 48 percent, as in the preceding year, and much higher than in earlier years or in other countries. This high tax burden may hamper future growth of the business sector. The implementation of the capital market reform was also continued in 1987, with further steps taken to reduce government involvement and enhance competition, thereby improving the choice of investments (for a detailed discussion, see Chapter VIII, Money and Capital Markets, Section 9). However, the ability to proceed with broadening the base of the capital market reform depends on a renewed rise of the saving rate.

Monetary policy in 1987 remained restrictive, but eased during the year. The public proceeded to adjust its asset portfolio to the lower inflation rate, and the share of unlinked local-currency assets in total financial assets continued to rise. The discussion of the money supply therefore relates to the M3 aggregate, which includes residents' foreign-currency-linked deposits (Patam). As stated earlier, at the beginning of the year the sheqel was devalued by 11 percent, which was expected to cause a temporary rise of the inflation rate. In order to prevent a fall in real interest rates—which might have further boosted domestic demand—the Bank of Israel at the time raised the nominal interest rate for a limited time. However, price increases after the devaluation were less than had been anticipated, so that the real short-term interest rate rose. The public's assessment that no further devaluation was to be expected in the short run, together with the rise in the local interest rate, expressed themselves in a decline of the expected yield on foreign currency assets and a rise in that of local-currency assets. These changes set in motion an inflow of capital, sales of foreign

currency to the Bank of Israel, and an increase in the demand for sheqel assets, which was reflected in rapid growth of the money aggregates. In order to mitigate the downward pressure on the domestic interest rate inherent in these forces, the Bank of Israel absorbed part of the additional money supply by sales of government bonds and Treasury bills. Beginning in May 1987, the Bank acted to gradually reduce the domestic interest rate. As a consequence of this reduction, and the passage of time since the January devaluation, capital inflows gradually ceased, and indeed reversed in the second half of the year to become capital exports. In order to prevent a sharp monetary contraction due to stepped-up purchases of foreign currency, the Bank provided the banking system in the second half of the year with liquidity, lowered interest rates on its discount-window lending, and thereby induced a further decline of interest rates. The downward trend of the short-term interest rate and a slower expansion of financial assets continued in early 1988.

These developments in the money supply are reflected in the composition of the sources of the increase in M3: the capital imports in the first half of the year caused the money aggregates to rise by increasing the foreign currency reserves, whereas the Bank's restrictive monetary policy acted in the opposite direction by contracting the domestic source of monetary expansion (i.e., net domestic credit; see Chapter VIII, Money and Capital Markets). In the second half of the year the decline in the foreign currency reserves had the effect of contracting the money supply, while the Bank of Israel's policy of easing monetary restraint was reflected in an expansion of net domestic credit (see Table VIII-1a).

This year's speculative cycle of capital movements demonstrates the dilemma faced by monetary policy under a stable exchange rate regime, when inflation at home is still higher than abroad, and the exchange rate is adjusted from time to time. In such a situation there are long periods when expectations of devaluation are low, rising with the passage of time since the last devaluation. The response of monetary policy to these expectations, through changes in the domestic interest rate, on the one hand affects the money markets, particularly the foreign reserves, and on the other, affects the real markets, through changes in both domestic demand and supply. A monetary policy which allows the real interest rate to fall in periods of capital inflows and to rise with capital exports tends to dampen changes in the foreign reserves. Contrarily, a monetary policy that prevents changes in the domestic real interest rate restrains the effects on economic activity. After the January 1987 devaluation the concern regarding a re-acceleration of inflation caused priority to be given to the objective of restraining domestic demand, so that nominal short-term interest rates were raised. This move was intended help the devaluation to succeed, and support the maintaining of the stable exchange rate regime—even at the price of increasing capital movements.

Short-term interest rates rose in real terms—to an average annual rate of 20 percent, as against 7 percent in the previous year—and the interest rate on overdraft facilities

came to 39 percent compared to 31 percent in 1986. Long-term real interest rates, on the other hand, on both assets and liabilities moved in the opposite direction, falling by 1 to 1.5 percentage points below the previous year's level, while medium and long-term bank credit expanded. The volume of private capital issues, which had been very small in previous years, increased in 1987 and the cost of raising capital through this channel declined. These developments became possible as the size of the public sector deficit in recent years diminished, and also reflected the first effects of the capital market reform.

It is noteworthy that the wide range of interest rates on different credit categories makes for great differences between the average interest rates paid by the various economic sectors. In 1987 the real cost of an average credit basket, including nondirected and directed credit, suppliers' credit from abroad and deposits earmarked for specific loans is estimated at 10 percent. This average masks a considerable intersectoral variation, ranging from 5 percent in export-intensive industries to 15 percent in the construction industry. For industries primarily producing tradeable goods, interest rates were on average lower than for the non-tradeables sectors (for a detailed discussion, see the introduction to Chapter VI, The Principal Economic Sectors). Furthermore, the level of interest rates on nondirected unindexed short-term credit was higher than that on short-term deposits. These excessive disparities between interest rates, which have prevailed, with fluctuations, since the mid-1970s, are reflected in wide financial margins in this credit category, which is the principal source of the banking system's profits. The explanation for the gap lies, among other things, in institutional restrictions on other fields of banking operations (such as narrow financial margins on directed credit and price controls on commissions), against the background of the high market concentration in the banking sector and the restrictions imposed on short-term capital movements because of monetary policy considerations.

In the course of 1987 the Bank of Israel shifted the emphasis from the direct setting of interest rates to affecting it through the quantity of the money supply—open-market operations, sales of Treasury bills and monetary tenders. Control of the quantity of the money supply will facilitate the application of monetary policy instruments in desired dosages, contrary to the earlier policy which enabled the commercial banks to borrow through the discount-window at predetermined interest rates without any quantitative ceilings (For details, see Section 5 in Chapter VIII, Money and Capital Markets).

Among the *external factors* that affected economic developments in 1987, the most important were the changes in foreign cross rates and the deterioration of the country's terms of trade. The cumulative depreciation of the U.S. dollar against the European currencies during 1986 and 1987 approached 50 percent, and led to changes in international relative prices. Thus, while Israel's competitive position in European markets improved, it weakened vis-à-vis the U.S. This itself should have led to an increase in the proportion of exports to Europe and in the share of imports from the US, but so far

the data do not reveal such trade diversion: side by side with the considerable increase in exports to Europe, those to the US also expanded substantially, supported by the free trade agreement with the U.S. The worsening of the terms of trade is in part related to the changes in foreign exchange rates, and also reflects the new rise in fuel prices after their plunge in the previous year. Prices of other basic commodities rose in 1987 very slightly, after their considerable fall in 1986. The world-wide stock market crash of October 1987, however, had almost no effect on economic developments in Israel.

The various *price indexes* rose in 1987 by 15–20 percent, thus consolidating the principal achievement of the stabilization program. The further decline of the Consumer Price Index, to 16 percent per annum, was due to an exceptional fall in prices of fruit and vegetables in the last two years, whereas the price indexes of GDP and domestic resource uses went up by 19 percent, following their 24 percent rise in the previous year. The exchange rate, as already said, continued to serve as the principal anchor of the price system—a role it has been assigned since July 1985. A comparison of the price changes of internationally tradeable goods with those of non-tradeables shows that the former closely followed those derived from the changes in the exchange rate and price increases abroad. It also shows that prices of non-tradeables rose faster and that, as in the previous year, the highest price increases were recorded in the services; in other words, the real appreciation continued in 1987, albeit at a slower pace than in the previous year. An examination of the factors affecting the cost side in 1987 indicates that over the year as a whole costs rose in line with the overall rate of inflation, but not so within sub-periods. The rise in the principal cost components slowed considerably in the course of 1987 and in early 1988, while the overall inflation rate declined less. We are unable to offer a full explanation for the price movements during the year; it may be that the present patterns of price adjustments are more similar to those prevailing in the early and mid-1970s than to the prompt adjustments of the period of high inflation, so that in the first half of the year price rises lagged behind cost increases and caught up with them only in the second half of 1987.

The labor market in the year under review was characterized by the following developments: business sector employment expanded considerably, unemployment declined, and real wages continued to rise at a rate higher than the increase of output per worker. These developments were affected by the many changes that have occurred in the structure of demand and output since the introduction of the stabilization program. As economic stability increased, some sectors and enterprises benefited from higher demand for their products and relative prices changed in their favor. These sectors and enterprises increased their output and employment, at the same time raising wages, whereas other sectors, for which relative prices had moved adversely or demand had contracted, found it difficult to adapt to these changes, and suffered a squeeze of profitability. For the business sector as a whole the data show that employment rose by 4.5 percent, product per worker by 2.5 percent, and average real

wages per employee post, by 8 percent. The reduction of taxes on wages and the rise in productivity mitigated the impact of the wage increase on unit labor costs, so that they went up by only 3 percent, following an 8 percent rise in the previous year. It seems difficult to reconcile the further reduction in the share of returns to capital in the business sector with the strong recovery in business activity. (It should, however, be noted that the labor market had not been in equilibrium for some time, including 1985.) Part of the explanation may lie in the uneven development of the different sectors and within them. Downward rigidities in the labor market make it difficult to reduce employment or real wages in firms that have run into difficulties; the estimate of average profitability therefore covers expanding and profitable sectors as well as sectors that accumulate losses. Economy-wide arrangements, such as across-the-board wage increases or the minimum wage law, compel ailing firms to raise wages above the level warranted by market forces, thus impairing their profitability. As described earlier, the rise in short-term real interest rates in 1987 was also uneven in the various sectors, and weighed particularly heavily on firms that had run into difficulties and needed more credit after having accumulated losses. In order to consolidate the changes in the productive structure, it is necessary that the scope of economy-wide wage arrangements be reduced, that interest rates become more uniform, thus facilitating a reduction of the marginal short-term real interest rate, and that public assistance to losing sectors be channelled in a manner and direction that will encourage their adaptation to the changed conditions.

The expansion of the private sector's use of domestic resources continued in 1987, with a slower rise in *private consumption* and stocks, and a renewal of growth in fixed investment. Private consumption, which had climbed 14 percent in 1986, rose in 1987 by 8 percent, and the private saving rate remained at the exceptionally low level to which it had sunk in the previous year. The exceptionally steep rise of private consumption in 1986 apparently was an over-reaction to its contraction in the initial stage of the stabilization program, and may be explained mainly by the large increase in disposable wage income and transfer payments in 1986. This income variable has already in the past exhibited a closer correlation with private consumption than total disposable income since it is a better approximation to household income. Nevertheless, we cannot offer a full explanation for the continuing high growth of private consumption in 1987 and for the fact that the private saving rate remained at the previous year's low level. These are apparently related to the success in slowing inflation and the strengthening of economic stability, which generated expectations that more resources will be available to the economy in the future, thus reducing individuals' propensity to save against a rainy day. An examination of the components of private consumption shows that in most items the expansion has tapered off, with acquisitions of durables displaying the highest increase, as in the previous year.

The increase in *fixed investment* in 1987 comprised a rise in residential construction,

which had contracted continuously since 1982, as well as a 15 percent rise in nondwelling investment. The turnabout in residential construction is connected with the increase in the population groups in need of new dwellings, the rise of disposable income in the last two years, and the cumulative fall, for three years running, in the relative price of apartments. Nondwelling investment had decreased continuously for the last three years; its rise in 1987 was apparently a response to the deceleration of inflation, the reduction of uncertainty, the enhancement of economic stability in the wake of the stabilization program, and the accelerated growth of the business sector product, to 5 percent in each of the two preceding years and 7 percent in 1987. These factors reduce the risks faced by entrepreneurs and facilitate the planning of production and the investments consequent upon it. Further supportive factors were the cut in corporate tax rates and the fall in the long-term cost of capital—a first fruit of the capital market reform. As part of the latter, the obligatory investment in government bonds of institutional saving schemes was reduced, the issues of non-negotiable bonds to institutional saving funds were cut sharply, while business firms were given a general permit to issue private bonds. As a result, businesses were able to raise more capital at a falling cost, thus contributing to investment growth. It may be emphasized that at times of considerable change in the sectoral composition of the national product, a rise in investment is to be expected, since expanding sectors need to increase their capital stock while the capital stock set free in contracting industries generally has no alternative use. Despite the increase of nondwelling investment in 1987, the net addition to the capital stock was only slightly greater than in the previous year, and the share of investment in the national product is still low. In order to maintain the momentum of growth, the proportion of investment in GNP will have to increase in the future. Finally, despite the year's substantial increase in infrastructure investment, particularly in road building, the infrastructure of the road network still lags behind the growth of the number of motor vehicles in recent years, and road congestion has increased greatly. Further expansion of these investments is needed to prevent bottlenecks in production and distribution.

The civilian import surplus in 1987 increased moderately in real terms, relative to the preceding year, as the expansion of domestic demand, excluding direct defense imports, was only slightly greater than GDP growth. In the previous year, domestic resource use expanded much more than GDP, with the result that the import surplus widened greatly in real terms. In current dollar terms, however, an increase of about \$650 million was recorded in 1987, due to the rise in the dollar prices of foreign trade as the dollar depreciated, and the deterioration in Israel's terms of trade, partly due to the upturn in fuel prices. This worsening of the terms of trade means an increase in the economy's real expenditure. (In the previous year foreign trade prices rose moderately, and the terms of trade improved.) The slight real-term rise of the civilian import surplus in 1987 reflects volume increases of 11.5 and 10.5 percent in imports and exports,

respectively. The growth in the various export components was uneven, reflecting not only adjustments to developments at home, in response to contraction in specific domestic markets, but also adaptation to changes in external conditions which have a differential impact on the various export sectors. The quantitative increase in imports recorded in 1987 was concentrated in merchandise imports, excluding fuel, and covered all its components—consumer goods, capital goods, and intermediates; a particularly large rise was recorded in imports of tourism services.

Unilateral transfers declined in 1987, with public sector transfers contracting sharply as the US emergency grant came to its end, and private sector transfers increasing considerably. The current account (after deduction of advances for future defense supplies—see Chapter VII, The Balance of Payments), which had been in surplus in the two preceding years, ran a deficit of about \$250 million in 1987. The financing of this deficit was accomplished without difficulty, and came from net investment from abroad and medium- and long-term foreign loans. In addition, the year was marked by large capital imports which increased the foreign currency reserves. The country's net foreign debt remained stable¹ for the third consecutive year, and its ratio to GNP declined.

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The accelerated GDP growth in 1987, accompanied by its structural change, is an encouraging development that may be attributed to the success in reducing inflation and the budget deficit, and to the atmosphere of stability prevailing in the economy. At the same time, sustained long term growth must rest on a continuous rise in productivity and profitability in the business sector, and also requires a further increase in investment. A one-time rise in investment can be financed by temporarily increasing the foreign debt, but a long-run rise in the share of investment in the national product requires a reduction in the share of consumption in GNP—i.e., raising the national saving rate. Together with building up the private saving rate, continued reduction of the share of public consumption in the national product is important as the key to long term growth with balance of payments stability. The objective of lowering inflation further, to a one-digit figure, has also not yet been attained. As long as domestic inflation is higher than that prevailing in Israel's trading partner countries, expectations of devaluation are from time to time generated, impairing stability and increasing uncertainty.

Taking full advantage of the stabilization policy depends greatly on continuing the reforms already initiated, as well as on reforms in additional areas. As regards the tax system, the gross rate of taxation as a proportion of the national product is still very high, and should be reduced, together with a matching cut in public sector spending.

¹ For the explanation of the stable level of the external debt, despite the current account surplus in 1986 and the deficit of 1987, see note 1 to Chapter VII.

There is also a need to lessen the distortions in the tax system, by completing the reform of direct taxes and reducing discriminations between indirect taxes on domestic production and imports. In the labor market, greater flexibility in the economy-wide wage arrangements will make it possible to compensate wage earners in profitable sectors without dragging other sectors into granting wage increases they cannot afford, and into lay-offs. As for credit, greater uniformity of interest rates, together with a lower marginal interest rate, would reduce discrimination between different users of credit. Where the balance of payments is concerned, fewer restrictions on foreign trade will enhance the ability to influence the price level through the exchange rate. Improving the domestic capital market, combined with greater access to the international capital markets, is likely to augment the supply of capital required for investment, and bring its prices closer to those facing the national economy. The full implementation of the capital market reform will further diminish the government's involvement in business activity. In the short run these steps will contribute to a further lowering of inflation, and promote continued growth; they will also bear fruit in the long run, by reducing distortions in the economy and improving its performance.