

CHAPTER I

THE ECONOMY: DEVELOPMENTS AND POLICIES

The year 1986 saw the consolidation of the principal achievement of the stabilization program introduced the previous July—the speedy containment of inflation: consumer prices went up only 20 percent this year, after they had already decelerated sharply in the final months of 1985. The second major success of the government's new policy—the easing of the balance of payments financing strain—was also sustained in the year reviewed, when the current account remained in surplus despite a marked widening of the import surplus. After many years of swollen fiscal deficits, the public sector's budget outturn showed a surplus in 1986, which first became apparent in late 1985. The domestic budget surplus was the outcome of a tight fiscal policy, while the surplus on external account was achieved thanks partly to a large U.S. government aid grant. The favorable budget performance permitted some relaxing of the severe monetary restraint built into the stabilization plan, and real interest rates receded from the peak levels reached in the second half of 1985. Exchange rate stability, supported by the fiscal and monetary policies, continued to be the principal means of stabilizing prices this year as well.

A striking development in 1986 was the steep rise in real wages, which affected both domestic demand and the supply of product. On the demand side, the additional income sparked a much larger volume of consumer spending, pulling down the national saving rate to an especially low level. On the supply side, the much heftier wage bill squeezed business profits and restricted the expansion of output. A conspicuous shift in the composition of demand also constrained the growth of output. Consequently, only part of the incremental demand augmented GDP; the rest was diverted to imports, greatly increasing the import surplus. Export and import prices declined this year relative to GNP prices; i.e. there was a real appreciation of the currency. Nevertheless the business sector product expanded by 3.7 percent, with productivity rising for the second consecutive year. This was a far from negligible gain considering the special factors at work this year, but it is too early to say whether it signaled the start of a long-run uptrend.

Economic developments exhibited an uneven pattern in 1986, from the aspect of their path over the year and as between the various resource uses and the various sectors of the economy. In the first half most of the incremental demand flowed to

Table I-1
MAIN ECONOMIC INDICATORS, 1981-86

	1981	1982	1983	1984	1985	1986
Demand, economic activity, labor market						
			<i>Percent real change</i>			
Public domestic consumption	1.4	2.5	1.7	1.0	-0.8	-4.8
Private consumption	12.0	7.3	8.0	-7.3	-0.4	14.0
Fixed investment	3.7	4.3	14.0	-11.7	-9.9	-5.5
Gross domestic product	3.8	0.4	2.7	1.8	2.8	2.2
Business sector GDP	4.7	-1.1	3.1	1.8	3.8	3.7
Business sector employment	1.4	1.4	4.0	1.4	0.3	1.6
Total productivity (business sector)	2.1	-2.1	-0.1	-1.3	2.9	1.4
Gross wages, total economy ^a	11.1	-0.9	4.7	-2.5	-6.8	11.7
Labor costs, business sector	-1.6	6.1	3.2	-3.6	2.0	12.6
Unemployment rate (% absolute level)	5.1	5.0	4.5	5.9	6.7	7.1
Gross national saving rate (% absolute level)	12.6	9.2	11.8	14.2	18.1	13.5
Balance of payments and external debt						
			<i>\$ billion, current prices</i>			
Current account deficit ^b	1.3	2.0	2.0	1.5	-1.1	-1.4
Unilateral transfers	2.9	2.6	2.9	3.4	5.0	5.3
Import surplus (excl. defense imports)	2.1	3.1	3.9	3.3	2.1	3.0
Exports of goods and services	10.7	10.5	10.5	10.8	11.0	11.9
Imports of goods and services	15.0	15.1	15.3	15.6	15.0	16.2
Net external debt	13.4	15.6	18.3	19.7	19.3	19.0
			<i>Index: 1980 = 100</i>			
Relative price of exports ^c	98	93	91	90	92	82
Relative price of imports ^c	96	91	85	85	93	83
Price, fiscal, and monetary data						
			<i>Percent</i>			
Consumer price index ^d	6.0	7.2	9.3	15.2	9.1	1.5
Wholesale price index ^d	6.2	7.5	9.7	15.2	8.0	1.2
Sheqel/currency basket exchange rate ^d	5.6	6.2	9.4	15.7	8.4	0.5
Interest rate on overdrafts ^e	8.7	7.6	9.0	19.8	15.4	4.0
Average interest rate on credit ^e			10.2	17.1	10.5	2.2
			<i>Percent of GNP</i>			
Domestic public sector deficit ^f	12.3	9.4	6.1	15.3	5.6	-1.2
Total public sector deficit ^f	13.8	10.5	6.0	16.8	-0.2	-5.8
Tax revenue ^g	44.3	48.0	48.5	40.0	48.5	52.3
Unlinked short-term assets ^h	5.8	6.3	6.5	5.6	10.0	14.7
Total short-term assets ^h	36.1	37.4	35.9	36.6	39.6	40.1
Total financial assets ^h	148.5	174.6	169.6	154.2	182.3	186.4
Total bank credit to the public ^h	22.0	20.0	17.9	16.9	20.4	23.0

^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).

imports, without any appreciable change in business sector activity and with unemployment going up; in the second half the continued brisk demand fueled the recovery of domestic business activity and employment, and the unemployment rate fell to its level on the eve of the emergency stabilization plan. Activity and employment continued to move up even more strongly in the first months of 1987. The dissimilar movement of the various demand components was reflected by a 14 percent expansion of private consumption, the sagging of other domestic uses, and a 5 percent advance in exports, as well as by disparate variations within each of the uses and in the sectoral composition of GDP. Agriculture, construction, and public services suffered product reverses, while above-average gains were recorded in industry, commerce, and private services. There were also dissimilar trends in relative world prices: a drop in raw material prices, especially oil, and the weakening of the dollar against the other major currencies; these changes, of course, affected Israel's foreign trade.

Economic developments in the year reviewed were decisively influenced by the emergency stabilization program launched in July 1985. Its immediate objectives were to quickly curb inflation and significantly improve the balance of payments. The new strategy was adopted after previous attempts to stabilize the economy had failed, inflation again accelerated, mounting speculative demand for foreign currency drained away international reserves, uncertainty spread, and confidence in domestic financial assets waned. The chief ingredients of the overall plan were the slashing of the budget deficit and the freezing of the principal nominal prices in the economy after an initial adjustment. The means adopted included the pruning of government spending, especially the subsidization of basic products; the augmenting of revenue by stiffening taxes; a devaluation of the currency, accompanied initially by an agreed adjustment of prices and wages and subsequently by an exchange rate and price freeze and the temporary suspension of the cost-of-living allowance arrangement; and a monetary policy designed to restrict the growth of credit. The plan received important support in the form of a special U.S. government grant, disbursed in two \$750 million tranches over the last two years; besides contributing to the current account surplus, it enhanced the credibility of the government's new strategy (see Chapter I in the 1985 Annual Report).

The plan won public confidence and succeeded in quickly lowering inflation and halting speculative foreign currency purchases. Additional effects soon appeared: a rapid shrinkage of the fiscal deficit, domestic demand, real wages, and employment; growing unemployment; a steep rise in real interest rates on sheqel assets and liabilities; and a shift in the public's financial asset holdings toward money and other unlinked assets. The abrupt drop in world oil and other raw material prices helped to keep down domestic prices and reduce imports and the trade deficit in 1986.

Some of these effects were obviously of a transitory nature, and a subsequent adjustment by economic units to the new situation was to be expected. At first there was

naturally considerable uncertainty about the stability of the exchange rate regime and the low rate of inflation. Judging from economic developments during 1986, it seems that the process of adjustment had not yet run its course by year's end, despite the slowing of inflation and easing of the balance of payments strain. Inflation apparently fell faster than expected, and so there was an overreaction in a number of areas to the tough measures introduced at the beginning of the plan; especially striking were the increases in real wages and the share of labor in the business sector product and the growth of private consumption, along with the dipping of the private saving rate to an unprecedented low. The real appreciation of the sheqel in the course of the year was only partly associated with the expansion of domestic demand; it also stemmed from factors that influenced the supply of product, including the increased cost of labor.

To counter the growth of wages and labor costs, the sheqel was devalued by 10 percent in January 1987 under an agreement between the government, Histadrut (general federation of labor), and Coordination Bureau of the Economic Organizations (representing employers), which provided for sterilization of the impact of the devaluation on wage expenditure: the Histadrut agreed to defer payment of 2.7 percent of wages from the forthcoming cost-of-living adjustment, employers' national insurance contributions were reduced by another 2.7 percent, and the remaining effect of the devaluation was to be absorbed by producers. This move was intended to redress the jump in real wages, as their level at the end of 1986 was considered to be higher than warranted by market forces, and they could not be adjusted in any other way because of their rigidity to a downward movement. In those sectors where the pay hikes were warranted by market forces, the devaluation was at best likely to depress real wages temporarily. The mild rise of prices in the first quarter of 1987 was partly related to seasonal factors, but it may also have attested to the success of the devaluation. However, only when wage data for 1987 are available can it be determined if it was indeed institutional rigidities that kept wages from adjusting at an earlier stage.

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In 1986 the government continued the stringent fiscal policy which it had adopted toward the end of 1984 and tightened further in July 1985 as part of the emergency stabilization program. The public sector deficit, a perennial feature of the economy for the past two decades, turned into a surplus in the second half of 1985, and in 1986 the surplus reached 6 percent of GNP. The domestic component was equivalent to 1 percent of GNP, and the external component to 5 percent. Total domestic spending was cut back by 3 percent of GNP, with the defense bill and direct subsidies being most affected; civilian consumption and investment went down fractionally, while transfer payments rose. The payroll item showed a decline in labor input, along with

a rise in wages per employee after they had eroded appreciably in 1985. Domestic revenues were up 3.5 percent of GNP, with the biggest increase recorded in indirect taxes following the expansion of private consumption. The mild gain in direct tax revenue was associated primarily with the slowing of inflation, which increased effective tax rates in the business sector. Direct taxes on wages yielded less income this year despite the sharply higher wage bill. Part of the decline was due to the reduction of national insurance rates, and the rest to a real increase in tax brackets following the slowing of inflation in the second half of 1985. Revenue from taxes reached 52 percent of GNP, a high rate incompatible with the objective of renewing growth in the business sector. To keep the domestic deficit at a low level while easing the tax burden, the government must continue to trim its spending. As in 1985, the public sector had a sizable surplus on external account, owing to the receipt of special American aid and the U.S. government's present practice of extending its regular aid to Israel in the form of grants instead of both loans and grants (the first factor was a temporary one, but the second can be expected in the coming years as well). This assistance contributed greatly to the success of the stabilization program, both directly by helping to finance the budget deficit and to generate a surplus on current account, and indirectly by enhancing public confidence in the government's new strategy and in the sustainability of the foreign exchange regime.

The shrinkage of the public sector domestic deficit since mid-1985 has created more favorable conditions for the operation of monetary policy. (In the past the scope of the Bank of Israel's monetary policy was restricted because of the big fiscal deficits, which had long been the principal source of monetary expansion.) The exchange rate was stabilized in the initial phase of the overall economic plan, and a severe monetary restraint was achieved by implementing a tight credit and high real interest policy. While the high interest rates helped to dampen demand and steady prices, and reinforced exchange rate policy, they harmed output and employment in numerous enterprises. This policy was adopted because of fear of speculative foreign currency purchases, which were liable to cause the whole stabilization plan to break down. The change in relative yields in the economy—a drop in the expected yield on foreign currency and linked assets and the rising yield on unlinked assets, along with the restoration of confidence in domestic financial assets, led to the reshuffling of the public's assets portfolio and a change in the public deficit financing mix: a contraction of foreign currency sales to the public, a much larger income from money creation, and a reduction of the indexed internal debt.

Following the slashing of the government deficit and the speedy checking of inflation in the second half of 1985, the Bank of Israel began to relax the severe monetary restraint, sharply lowering lending and bank deposit interest rates, mainly in the first half of 1986. This was accomplished primarily by reducing the interest on the discount-window facility, as well as the liquidity ratios, which had been raised upon

the initiation of the overall economic plan. The government continued its policy of stabilizing the exchange rate, and devaluation expectations faded in the course of 1986. The downturn in interest rates, inflation, and devaluation expectations further stimulated demand for money, and the adjustment of the public's assets portfolio proceeded apace: the share of unlinked assets continued to expand at the expense of foreign currency-linked assets, and the reduction of interest rates prompted a shift from unlinked interest-bearing assets to money. In the government deficit financing mix there was a piling up of internal debt in the first half of the year, and a similar volume of payments in the second half.

Short-term bank credit rose 8 percent in real terms in the first half of the year and 13 percent in the second half, with a big increase in sheqel credit outweighing a decline in that linked to foreign currency. In the first half of the year the main factor in the expanded supply of bank credit was the reduction of liquidity ratios on sheqel assets, while in the second half most of the growth resulted from the public's switching from linked to unlinked assets, which are subject to lower liquidity ratios. Credit demand was influenced by two contrasting trends: the weakening of devaluation expectations, which depressed demand for credit to finance speculative purchases of foreign currency, and the growth of aggregate domestic demand, especially imports, which are largely financed by credit. Judging from the results—the surge in bank credit along with falling interest rates—it seems that the supply factor was the decisive one. After the sharp drop in interest rates in 1986, the average annualized real cost of short-term credit came to 5 percent in the second half of the year. The average cost masks a wide variance between the different types of credit. While the real effective cost of overdraft facilities, which is the marginal cost for a large percentage of consumers, declined in the second half of 1986, the annualized rate still came to 25 percent. The first months of 1987 saw a further rapid expansion of short-term bank credit and unlinked assets, which was generated by a large capital import. Against the background of the general economic stability and fading devaluation expectations, the interest rate differential between sheqel and foreign currency credit resulted in a greater substitutability of these two types of credit. The capital outflow was checked already in the second quarter of 1986, and during the rest of the year there was a slight tendency toward a capital inflow, which intensified after the devaluation in January 1987. In the first months of 1987 the public converted foreign currency on a large scale, and the resulting excess liquidity prompted a further reduction of interest on overdrafts. The magnitude of the capital inflow during this period underscored the problem involved in maintaining a sizable domestic-foreign interest rate differential under conditions of economic calm and exchange rate stability.

The most notable achievement of the stabilization plan was, as stated, the receding of inflation. During 1986 consumer prices moved up at an average monthly rate of 1.5 percent, after slowing appreciably in the final part of the previous year: from a 12

percent average monthly rate in the first half of 1985 to 2.7 percent in the last five months. A stable exchange rate continued to be a principal means of steadying prices in the year reviewed, and it was supported by fiscal and monetary policy. The sheqel remained stable against the dollar until August, and subsequently against a foreign currency basket. Since the dollar fell in relation to European currencies and the yen, especially in the first half of the year, the exchange rate policy resulted in a 17 percent depreciation of the sheqel against these currencies over the year, as contrasted with a 1 percent appreciation in relation to the dollar. The weakening of the latter currency sharply pushed up the dollar prices of imported finished products. On the other hand, the dollar price of oil fell steeply, and those of other raw materials more moderately.

In 1986 the various components of the consumer price index exhibited a widely divergent pattern. There were steep rises in agricultural products (about 60 percent), private services (50 percent), and taxes and public services (40 percent); a mild increase in industrial products (12 percent); a slight one in construction and housing services; and a downturn in water and electricity. Industrial prices went up to about the same extent as in the world market, as could be expected when the exchange rate serves as an anchor for prices. Other consumption items, most of them locally produced goods and services for which there are no imported close substitutes, became much dearer, which implies a real appreciation of the sheqel. We cannot fully explain the degree of the real appreciation, but it was apparently connected with the upturn in unit labor costs, special factors such as rising public service prices and damage from natural causes (which affected farm yields), as well as a more buoyant demand for private services. The higher real cost of labor in 1986 contributed to the rise in the prices of nontradables, while in the case of tradables it mainly diminished their competitiveness, thereby widening the import surplus.

Price controls, which were an integral part of the stabilization program, have been gradually dismantled, and by the end of 1986 only 45 percent of the CPI items were still controlled, compared with 90 percent upon the launching of the program and 25 percent before then. Such controls are now much less important than during the stage of breaking the inflation inertia; their prolongation can have a harmful cumulative effect, and hence they ought to be reduced.

As stated, real wages far outstripped the rise in labor productivity, and so they influenced both aggregate demand and supply. The wage agreement signed shortly after the stabilization program went into force called for a substantial real erosion of wages in purchasing power terms during the first few months, to be followed by a gradual adjustment while keeping labor costs stable.¹ In the second half of 1985

¹ The erosion of the purchasing power of wages in the initial phase of the plan was caused primarily by the lifting of subsidies, which drove up consumer prices but did not affect producer prices. Subsequently real wages went up because of the automatic lagged inflation-adjustment of income tax brackets; the slowing of inflation thus reduced, with some lag, the effective tax rates.

wages developed as planned, but beginning in early 1986 they went up much faster in the business sector than was envisaged. Real labor costs shot up 12 percent in 1986, sharply depressing the return to capital and the profitability of production. It is hard to explain such a steep jump in labor costs, especially as the labor market was comparatively slack. It should be stressed that the big pay hikes in the business sector were for the most part awarded at the plant level, whereas the general collective agreement called for modest increases this year; it is also significant that the increases in the public sector were smaller than in the business sector. The wage hikes at the beginning of the year can apparently be attributed to an erroneous assessment of the expected rate of inflation, while the continued rise in average wages is explained by the rebounding of demand in some sectors, combined with the general downward rigidity of wages. Upon the introduction of the emergency stabilization program all existing wage agreements were temporarily suspended, a number of prestipulated uniform pay adjustments allowed, and implementation of other agreements signed earlier was postponed to the beginning of 1986. These agreements took into account the previous rates of inflation, and their application after the price spiral was checked resulted in hefty real pay increases. Other possible factors were producers' erroneous expectations in early 1986 of a renewed depreciation of the currency and of a higher rate of inflation than actually prevailed, which would have eroded the wage hikes. Such expectations might have been motivated by the announcement, upon the launching of the plan, about the link between exchange rate stability and wage developments.

The sharp real rise in wages and labor costs in the first half of 1986 occurred despite the growth of unemployment. In such conditions wages could have been expected to be subsequently adjusted downward, but this did not happen. This can be partly attributed to the recovery of demand and employment in the second half of the year, and to marked shifts in relative prices, which enabled some firms to pay higher wages. But since demand turned up in only part of the sectors, it is not clear why wages were not adjusted downward in those that ran into difficulties or whose relative output price declined. An analysis of wage, employment, and price trends in the business sector shows that wages went up fastest in services, along with the surge in their relative price and the growth of employment. In industry output prices are intimately connected with those of foreign substitutes, and so they went up at a relatively mild rate. Wages here increased more slowly than the business sector average, along with the growth of output and employment. By contrast, in construction and agriculture, which were hit by crises, wages were not adjusted and employment fell off. It seems that in the short run there is considerable resistance to a downward adjustment of wages.

That part of the wage increases which stemmed from erroneous expectations or institutional rigidity constrained the supply of business sector product. Another supply-

side factor was the deceleration of inflation and the policy measures whereby this was achieved; in particular, the exceptionally high interest rates on short-term credit during the initial phase of the stabilization program had a dampening effect during this period. In the course of 1986 this constraint diminished, as interest rates softened noticeably, although some sectors were still struggling with a heavy burden of past debts. The stiffening of effective rates of business sector taxes also squeezed profits and harmed the competitiveness of tradables in particular.

Two other factors that impeded the growth of business sector product were the shifting composition of demand and the difficulties encountered by firms in adjusting to an economy free of rapid inflation. It should be noted that the deceleration of product, and even its retreat, are typical of the initial stage of disinflation. High inflation distorts the firms' profitability calculations and leads to a greater occupation with financial management, while the curbing of inflation reveals productive activity that is unprofitable. Firms cannot immediately switch to other activities or lines of production, and so it takes some time before the potential growth latent in the newly created stable-price environment comes to fruition. Attempts to prevent the closure of enterprises that have turned out to be unprofitable hamper the effort to restructure the economy and make it more efficient. In addition to the decelerated-inflation effect, the year reviewed saw a marked variation in demand components, in particular a stronger demand for certain products that are not produced in Israel (raw materials and some durables). Other demand changes necessitated an adjustment of production, such as the cutback in domestic purchases by the defense establishment and the shifts in world exchange rates, which entailed a change in the export mix. Adjusting factors of production to a changing demand pattern takes time, even when wages are not pushed up by exogenous influences, and during the transitional stage the less efficient factor utilization is likely to depress output and productivity. Adjusting the export mix to changes in relative world prices also involves a switching of markets; this cannot be done quickly, and in the interim exports and output are liable to slow down. These problems have been exacerbated by the limited mobility of labor in Israel. The drop in oil and other raw material prices has had an opposite effect, increasing supply and the profitability of production.

The supply constraints weakened in the second half of the year reviewed, after the government lowered employers' national insurance contributions, thereby bringing down labor costs, and after a further reduction of real interest rates on credit. In the new economic realities, with inflation greatly toned down, the pattern of wage determination also has to be adjusted, owing to the limited possibility of correcting wage deviations through inflationary erosion.

Aggregate demand rose 8 percent this year, led by private consumption and inventory investment. Private consumption was up 14 percent in volume despite a mere 2.5 percent growth of disposable income; this implies a substantial drop in the already

low private saving rate. We cannot fully explain the magnitude of the incremental private consumption in 1986, but the main reason was apparently the big increase in disposable income from wages and transfers. In the past too such income was more closely correlated with private consumption than was total disposable income, and it may be a better approximation of household income; this is because total disposable income includes undistributed business profits, which were highly volatile in recent years. While aggregate supply is influenced by real wages in the business sector as perceived by employers (i.e. labor costs), private consumption demand is influenced by net wages in the total economy as perceived by workers. In 1986 net wages rose by 15 percent (4 points more than gross wages), owing to lower effective rates of tax. In retrospect, it seems that advantage could have been taken of this to damp down the increase in labor costs, as was done in the early stage of the emergency program.

Among the private consumption items there was an especially heavy catchup demand for durables, which even exceeded the contraction in the two preceding years. This was one of the changes households made in the composition of their assets portfolio following the shifts in relative yields and the availability of more credit. The trend in inventory investment resembled that of consumer durables: a running down of stocks of production inputs in the second half of 1985, and a big buildup in 1986. The softening of world raw material prices, combined with the fall in domestic and international interest rates and other asset portfolio considerations, spurred imports of raw materials, part of which went to expand inventories. On the other hand, in continuation of the trend in the two preceding years, fixed investment was cut back by 7 percent in 1986, with both the dwelling and nondwelling components being affected. The slackening of dwelling investment was in line with the long-run trend, a result of the slower growth of population, especially young families and new immigrants, who account for the bulk of housing demand. After the leashing of inflation and the diminishing of entrepreneurs' uncertainty, nondwelling investment could have been expected to pick up, but instead it sagged further. This was probably due to the relatively long time required for planning and implementing new investments, the recession in 1985 and early 1986, and the greatly reduced return to capital. In contrast to the general trend, public infrastructure investment was stepped up in 1986; but after being trimmed for many years, the stock of such capital is still low, and this is liable to impede the growth of output. With the upturn in business activity in the second half of the year, there was a bigger import of capital goods, which expanded further in the first quarter of 1987. The brighter business outlook also prompted a larger number of private share and bond issues.

GDP rose 2 percent in the year reviewed, with the shrinkage of public sector product being more than offset by a 3.7 percent growth in the business sector. This year's more buoyant demand, as already pointed out, was not translated into a bigger gain in business sector product because of supply constraints and adjustment problems. For

the most part these were short-term factors directly or indirectly related to the stabilization program; in the second half of 1986 the supply constraints weakened (the adjustment of production probably also got underway), and the continued mounting of domestic demand during this period was reflected in the growth of domestic activity and product. The labor market also recovered: all indicators point to a heavier demand for workers and a drop in unemployment, a trend that became stronger in the first quarter of 1987.

The formidable growth of domestic uses, as contrasted with the milder growth of GDP, led to a marked widening of the gap between them—i.e. a larger import surplus. The incremental demand that did not augment GDP flowed to imports, boosting the volume of civilian imports, other than capital services, by 14 percent. The biggest increases were in consumer goods (40 percent) and production inputs (20 percent), the latter increase resulting in a sizable buildup of stocks, in excess of their depletion in the second half of 1985. Exports made only relatively sluggish headway this year, with mixed trends in the major components: a 7 percent real rise in nondiamond commodity exports despite internal and external difficulties, a slump in services, and an impressive gain in diamonds. The increase in real labor costs at a rate far exceeding that of productivity hurt exports more than production for the domestic market, mainly because of the continued slide of the dollar; in addition, there were other problems that affected certain export industries. On the other hand, metal, electrical, and electronic products and transport equipment fared better this year; this may have signaled the start of the process of adjusting to the cutbacks in defense establishment procurements. Nondiamond commodity exports (seasonally adjusted) posted real advances in the second and third quarters of the year, turned down in the fourth quarter, and recovered some ground in the first quarter of 1987. The factors moderating the nominal growth of the import surplus this year were the steep drop in defense imports, the improved terms of trade, and a smaller net import of capital services following the fall in world interest rates and the contraction of the country's net external debt.

Despite the widening of the import surplus in 1986, it was still smaller than the inflow of unilateral transfers, and so there was again an appreciable surplus on current account. This was of course also reflected in the capital account, which showed a big improvement in the economy's external liquidity situation: the staunching of the private sector's capital outflow, payment of all of the public sector's short-term debt, and an attendant growth in official reserves. It should be noted, however, that this year's better balance of payments performance was also due to a number of temporary factors, such as the American emergency aid grant, a relatively small noncivilian import, and low oil prices. The expansion of domestic resource use this year can also be partly attributed to temporary factors, such as a cyclical upswing in private consumption after a two-year decline. In view of all these

transitory influences, this year's current account surplus cannot be regarded at this stage as indicative of a sustainable stable trend.

The current account surplus is equal to the difference between national saving and domestic investment. Viewed from this angle, the following picture emerges: after being very low for several years, the national saving rate turned up in 1985–86 to reach its level in 1976–80. This can be credited to a much better performance by the public sector, which outweighed the setback in the private saving rate. On the other hand, gross domestic investment has been drifting down for quite some time. The improved current account position, in comparison with the average level in 1976–80, thus reflected a much smaller rate of investment. Stepping up economic growth in the future, together with a continued structural change, necessitates the expansion of investment, and only a sustained rise in the national saving rate can prevent a renewed growth of the external debt.

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The speedy curtailment of inflation and the remarkable improvement in the balance of payments since the introduction of the stabilization program highlight the difference between it and previous strategies. Unlike its predecessors, the present overall plan has simultaneously tackled the two foremost problems facing the economy, and has placed the stress on slashing the government deficit. This plan rests on the premise that price and balance of payments stability is a precondition for renewing economic growth, and so it has focused on halting the deterioration in these two areas, leaving the task of coping with the growth and productivity problems to a later stage. The impressive progress made in the last year and a half in balancing the budget, cooling inflation, and strengthening the external liquidity position makes it possible to presently shift the emphasis to restructuring the economy and stepping up growth. But there must be no relaxing of the stabilization effort, for developments in 1986 reveal that along with the notable achievements, problems still remain: a high rate of inflation in comparison with Israel's trading partners, the fact that the present budget surplus is partly a result of transitory factors, and the widening of the import surplus.

It is hard to directly influence the resumption of growth. Sustainable long-term growth must be based on a steady rise in productivity and an expanding domestic investment; the principal contribution of economic policy is to create appropriate conditions for this and, above all, to reduce distortions. Some of the factors that prevented a greater expansion of business sector product in 1986 arose in the course of implementing the stabilization program—the steep rise in real labor costs, the stiffening of taxes, and a highly differential cost of credit. These combined with long-term factors that have been a drag on economic growth for more than a decade, and in which government intervention has played a central role. These include differential

tax and subsidy rates, tax exemptions, investment grants, and other kinds of discriminatory aid, as well as administrative intervention in many areas in the shape of various controls, the direction of credit, and the issuance of various authorizations and permits. All these cause many distortions, impair efficient resource allocation, and hamper the expansion of business sector product. Some of the distortions in recent years can be attributed to the prolonged inflation, which caused a shift in emphasis from productive activity to financial management; the curbing of inflation has exposed production and efficiency problems in many industries.

The sharp pruning of the fiscal deficit has decreased the public sector financing requirement; i.e. a larger share of private saving can now be channeled to private investment. To ensure its efficient allocation, it is important to reduce the government's role in financial intermediation and the direction of credit, as well as the preferential treatment of government securities. In 1986 and early 1987 a start was made in reforming the capital market: the obligation to invest long-term savings in government bonds was reduced, a general permit was given to float private bond issues, and several other changes were introduced to equate the terms of government and private security issues. In addition, some replacement of the quantitative restrictions on capital imports with a levy is planned as a first step in opening the local market to foreign credit; this is expected to contribute to a more efficient allocation of credit. At the same time, taxes should be reduced on labor and profits, as they are presently very high and constitute a disincentive to work and invest. Since net tax rates are much lower than gross taxes, a reform is needed to reduce gross taxes without affecting net taxes (by reducing transfer payments, exemptions, etc.), while eliminating some of the distortions in the tax system. In mid-1986 a start was made in bringing down taxes on labor by decreasing employers' national insurance contributions, and in April 1987 personal and company income tax rates were reduced. A lighter taxation of company profits would directly boost profitability in the business sector, whereas the present easing of personal income tax apparently does not reduce labor costs in the short run.

In the second half of 1986 and the first months of 1987 there were signs of an upturn in business sector activity, product, and investment. It is too early, however, to say if this heralds the start of long-run growth. To consolidate this trend, it is necessary to continue the aforementioned reforms while striving to sustain and reinforce the stability achieved so far. It may well be that the resumption of growth will make it easier to rectify the problems that surfaced in 1986.