CHAPTER I

THE ECONOMY: DEVELOPMENTS AND POLICIES

Two of the most crucial problems facing Israel's economy — inflation and the balance of payments — eased considerably in 1985. After many years of rapidly mounting inflation, the government introduced an overall economic program in mid-1985 which halted the spiraling of prices, and in the first four months of 1986 they went up only 1 percent a month on average. Following a marked improvement in 1984, the civilian import surplus continued to shrink in the year reviewed, but at a more moderate pace, and in the second half it tapered off. Unilateral transfer payments from abroad expanded strongly following the decision of the U.S. government to provide its regular assistance to Israel entirely in the form of grants (instead of loans and grants, as before) and the receipt of emergency aid from the same source. The transfers exceeded the import surplus, and so for the first time in many years Israel had an appreciable surplus on current account ($1.1 billion), which made it possible to reduce the net external debt.

1. DEVELOPMENTS UNDER THE PACKAGE DEALS

The soaring of inflation to an alarming 23 percent monthly rate in September and October 1984 and the fear that the situation would get out of control and degenerate into hyperinflation motivated the newly formed national unity government to immediately tackle this problem through "package deals" — tripartite price-wage agreements between the government, Histadrut (Trade Union Federation), and the employers' organization. The first of these deals (from November 1984 to January 1985) provided for a general price freeze (including subsidized goods and services) accompanied by the imposition of price controls, the freezing of taxes, and sterilization of a third of the cost-of-living adjustment. These measures slowed the price advance to 4–5 percent a month in December and January and damped down inflationary expectations. A major factor in the temporary success of the first deal was the consensus of the public and all other parties concerned that urgent action was required to combat inflation. The restraining of inflation, however, was accompanied by the buildup of suppressed upward pressure on prices from the costs side, owing to the continued payment of cost-of-living adjustments (one-third of which was sterilized) and the rise in import prices (due to the depreciation of the sheqel and despite the freezing of import taxes) at a much faster pace than the general price level. The consequent swelling of subsidies and the fiscal deficit necessitated a steep price adjustment at the end of the period concerned.

Table I-1

MAIN ECONOMIC INDICATORS, 1981-85[a]

	1981	1982	1983	1984	1985[b] Jan.-Dec.	1985[b] Jan.-June	1985[b] July-Dec.
Resources and resource use (real percent change over preceding period)							
Public consumption A	1.3	2.1	2.1	0.3	−1.8	−0.2	−5.3
Private consumption	11.5	6.6	7.8	−6.8	−0.4	−0.7	−1.7
Fixed investment	3.7	4.2	13.9	−12.8	−10.1	−6.3	−4.3
Total domestic resource use	6.7	3.5	4.7	−3.8	−1.9	−1.7	−6.2
Gross domestic product	3.8	0.5	2.5	1.7	2.8	2.6	−4.2
Business sector GDP	4.7	−0.7	2.7	1.7	3.8		
Total productivity (business sector)	2.1	−1.7	−0.5	−1.4	2.9		
National saving rate	−3.2	−5.4	−4.0	−3.9	1.8		
Balance of payments ($ billion)							
Imports AB	10.5	10.8	11.6	11.1	10.4	5.1	5.3
Exports B	9.3	8.8	8.9	9.6	10.1	5.0	5.2
Import surplus AB	1.2	2.0	2.7	1.5	0.3[c]	0.1[c]	0.1[c]
Import surplus A	2.1	3.1	3.9	3.3	2.1	1.1	1.0
Basic deficit (+) or surplus (−)	0.1	0.8	−0.2	0.3	−1.0	0.7	−1.7
Unilateral transfers	2.9	2.6	2.9	3.3	5.1	1.5	3.6
Deficit on current account	1.3	2.0	2.1	1.4	−1.1	0.7	−1.8
Wages and employment							
Percent change over preceding period							
Real wages	10.7	3.2	0.9	−4.1	−3.7	−0.1	−10.6
Real labor cost	1.4	4.9	1.6	−7.2	10.5	8.2	1.3
Rate (percent)							
Employment	48.5	48.0	48.2	47.6	46.6	47.0	46.1
Unemployment	5.1	5.0	4.5	5.9	6.7	6.2	7.2
Public sector[d] (percent of GNP)							
Domestic demand	29.4	30.6	29.7	29.7	27.1	28.2	26.5
Total absorption	16.3	20.0	22.8	13.3	19.2	17.8	20.2
Budget deficit (incl. interest) A	13.1	10.6	6.9	16.4	7.9	10.4	6.3
Budget deficit (incl. interest)	16.8	12.3	6.6	16.7	1.3	..	..
Monetary data							
Percent of GNP							
Bank credit	29.0	25.8	22.8	21.5	24.1	23.0	25.2
Financial assets	153.1	183.2	180.9	165.7	193.2	178.2	202.3
Liquid assets	37.2	39.2	38.0	38.9	43.1	40.7	44.5
Money supply	4.1	3.7	3.2	2.2	2.5	2.2	2.7
Percent per month							
Interest on overdraft accounts	8.7	7.6	9.0	19.8	15.3	17.6	13.1
Interest on bank credit[e]	..	..	9.9	17.0	10.4	12.9	8.0

[a] Aggregates labelled A exclude direct defense imports; aggregates labelled B exclude imports or exports of capital services.

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The success of the first package deal in quickly retarding the rise in prices persuaded the parties to the agreement to continue fighting inflation in general and suppressed cost pressure in particular through additional deals of this kind. The prices of subsidized goods and services were raised steeply in order to contain the bulging subsidy bill. However, the second and third package deals failed, and inflation again accelerated, reaching 14 percent a month in the second quarter of 1985. The package deals, in particular the first one, demonstrated that inflation can be speedily harnessed by administrative means, but only for a short period. They are not sufficient for sustained long-run stability.

Although the package deals did not curb inflation, they achieved some success, mainly a reduction of the fiscal deficit and real disposable income. This can be credited to the slashing of subsidies under the last two deals.

After a marked widening of the civilian import surplus from 1981 to mid-1983 (about $1.5 billion), there was a big improvement toward the end of 1983 and in 1984, which continued at a more moderate pace in the first half of 1985 (about $2.5 billion between 1983 and the first half of 1985). The growth of the surplus was largely due to the expansion of domestic demand, which was accompanied by a decline in the relative price of commodities traded internationally. Much of the incremental demand was for imported products, while exports were influenced by the drop in their relative price and the slump in world markets. The outcome was a widening of the import surplus without a more rapid growth of GNP. The improvement in the import surplus is explained by the reversal of the previous trends: domestic demand shrank while GNP continued to forge ahead, led by exports. The weakening of domestic demand reflected a further contraction of investment (including housing), and primarily the slackening of private consumption after the stock market collapse in 1983 had squeezed the public's financial wealth.

The balance of payments financing difficulties persisted in the first half of 1985, despite the improvement in the civilian import surplus and the current account. The aggravation of the economy's external liquidity situation was manifested by a further piling up of net current external debt (short-term foreign liabilities falling due within one year, less the Bank of Israel's international reserves and exporters' credit to their customers)—a trend begun in 1982. This deterioration, reflected in the running down of international reserves and a greater resort to short-term liabilities, was caused by speculative foreign currency purchases by the public from the Bank of Israel. The anticipation of a "corrective" economic plan, which would include a large devaluation and perhaps the impairment of financial assets, spurred the public to step up

(continuation of notes to Table I-1)

[b] Rates of change are from July-December 1984 to January-June 1985 and from January-June to July-December 1985. In the top panel, the figures are based on seasonally adjusted data.

[c] The underlying unrounded figures are (left to right): $ billion 0.26, 0.14, and 0.12.

[d] Total absorption = domestic absorption *plus* income from abroad. See also notes to Tables V-1 and V-2.

[e] Average interest rate on bank credit to the public.

its purchases of foreign currency. These expectations were also mirrored in the high premium on the black market dollar in the first half of the year (until the launching of the economic stabilization program).

The economic developments in the first half of 1985 took place against the background of a less expansionary fiscal policy than in the previous year: the government's domestic deficit shrank, owing primarily to a much larger tax revenue. On the other hand, bank credit rose more rapidly than prices, indicating that monetary policy tended to be expansionary. Domestic uses and GNP increased in the first half of the year, mainly because private consumption picked up somewhat after sagging noticeably from the end of 1983.

2. THE ECONOMIC STABILIZATION PROGRAM

The two developments that persuaded the government to adopt a comprehensive economic plan were, as stated, the renewed acceleration of inflation—which signified the failure of the package deal policy—and a further worsening of the economy's external liquidity situation, which found expression in the net current external debt.

The stabilization program was intended to simultaneously achieve two principal objectives—a speedy containment of inflation and an improvement in the balance of payments. Coping with the two most formidable economic problems at the same time was a departure from the strategy followed in recent years: hitherto economic policy had concentrated on only one of the problems, even if this resulted in the exacerbation of the other one. The failure of the disinflationary efforts stemmed from the inability to see the dependence between the solution of the balance of payments problem and the arresting of inflation, or implementation of only part of the whole set of required measures.

Examination of the inflationary process over the past decade underscores the importance of dealing with inflation and the balance of payments concurrently. The steep jumps in the inflation rate in 1979 and 1983 were connected with immediately preceding balance of payments crises. The means adopted to mend the balance of payments (devaluation and fiscal restraint based largely on the reduction of subsidies) led to the aggravation of inflation because of the unique structure of Israel's financial assets market, the indexation of wages, and the attempt to maintain the real exchange rate through devaluations even when domestic demand was growing. A very large proportion of the financial assets are liquid assets (mainly Patam[1] demand deposits), which are linked to the exchange rate or the consumer price index and in effect are linked money. Another source of liquidity is the budget deficit. Thus most of the liquidity required for accommodating price rises due to cost pressure (depreciation of the sheqel and wage increases) is self-generating, and at the end of the process inflation has been pushed up to a higher level.

[1] Sheqel accounts denominated in foreign currency.

An unstable balance of payments also stimulates speculative demand for foreign currency. This results in liquidity crises and the loss of foreign reserves, which in turn prompt the government to devalue the sheqel and take other protective measures that are liable to undermine price stability. Hence a pre-condition for long-run price stability is a healthy balance of payments, i.e. reduction of the import surplus to a level where it can be financed from stable sources (unilateral transfers and long-term loans) even when the economy returns to a full-employment situation. This would check the growth of the external debt and even bring it down. In this connection it should be noted that the stabilization program received important support in the form of a U.S. government commitment to provide a special $1.5 billion grant over a two-year period, in addition to its regular aid. This bolstered public confidence in the plan, especially in the sustainability of the exchange rate freeze.

Fiscal restraint coupled with monetary restraint are the traditional ingredients of every stabilization plan. These lead to the dampening of domestic demand and the slimming of the import surplus. The reduction of the fiscal deficit would also slow the growth of the government debt—internal and external alike—after it had piled up over the years as a result of the deficit and the arrangement worked out after the bank share crisis in October 1983. The large national debt has negative repercussions on the economy and the conduct of economic policy: the interest payments have swelled, putting an onerous burden on the balance of payments and the budget, while the large stock of financial assets, especially liquid assets, hampers the conduct of monetary policy.

It should be stressed, however, that when inflation is running at a high rate, such as that which Israel has experienced, fiscal and monetary restraint alone cannot quickly stabilize prices without greatly harming economic activity and employment. There are two reasons for this: deep-rooted high inflationary expectations formed during a period of protracted inflation, and in the case of Israel the almost full indexation of wages, which pushes up real wages in the process of reducing inflation.

It was therefore necessary to deal specially with the main factors causing the self-perpetuation of inflation, namely to halt the spiraling of costs and to quickly dampen inflationary expectations. It was particularly important to control the principal nominal aggregates. The aggregate that serves as the monetary policy target is bank credit. The existence of a huge stock of linked liquid financial assets diminishes the effectiveness of a conventional monetary policy in fighting inflation. In Israel, which is wide open to foreign trade, the exchange rate is a major determinant of prices, on both the demand and cost sides. The exchange rate also plays a very important role in the financial sphere, for many financial assets are pegged to it. In addition, the U.S. dollar exchange rate, which is published daily, was widely used as a price index in recent years, and so many prices were stated in dollars. Because of these characteristics, the exchange range is suitable to serve, together with bank credit, as a central nominal anchor in the economic stabilization program. But it can be an effective anchor for only a limited period, and this subject to two conditions. One is a healthy balance of payments, i.e. an import surplus that can be financed in the coming years from stable sources. Secondly, wages must be kept in line with the exchange rate: a nominal increase in wages when the exchange rate is frozen results in a real appreciation of the currency, unemployment, and speculative purchases of foreign currency. Hence the importance of making the exchange rate freeze conditional on a wage freeze, even if only for a short span. The freezing of the principal nominal variables has been accompanied by a temporary price freeze, which is due to be gradually eliminated.

The success of the new strategy in speedily stabilizing prices with only a small increase in unemployment also hinged on the government's ability to quickly alter the public's expectations regarding inflation and the balance of payments. Only an overall economic plan that was resolutely implemented could win the public's confidence and change its deep-rooted expectations.

Following is a brief description of the principal components of the program initiated at the beginning of July 1985. The central component was a deep budget cut after government spending had been running well above the projections approved for 1985/86. The objective was to reduce the deficit to a level $1.5 billion lower than in 1984/85. The biggest cuts were in the subsidization of basic products and services and in exchange rate insurance, while on the revenue side a number of taxes were stiffened. Only about one-fifth of the cuts represented a decrease in the government's direct real activities. In addition, it was decided to dismiss 10,000 public sector employees.

The measures for trimming the budget deficit were problematic from several aspects. First, the slashing of subsidies entailed a sharp increase in the prices of basic goods and services and a sizable devaluation. Thus the strategy designed to stabilize prices provided at the outset for a steep jump in prices. Given the existing wage indexation system, it was essential to sterilize the effect of this price change on wages in order to stave off a new round of cost increases. Secondly, while subsidy cuts and tax hikes affect the real income of individuals, their contractionary effect on private consumption is greater the more permanent the public believes the decline in their real income will be. The experience of recent years has shown that such changes are not long-lasting, and so the expected effect of a drop in real disposable income is not clear. In contrast to the effect of taxes and subsidies on domestic demand, the impact of a reduction in government activity is clearcut, and makes itself felt comparatively fast.

The monetary policy target was an initial large real contraction of bank credit (a 10 percent real decrease in the first month) in order to dampen domestic demand, and a nominal credit freeze in the following months so as to prevent credit from accommodating the price changes. In addition, complementary measures were adopted with a view to making monetary policy more effective in the longer run. First, new deposits in Patam demand accounts (which, as stated, were actually a kind of linked money) were terminated (apart from exporters' deposits); since Patam can be withdrawn but no new deposits made, this asset will eventually disappear. Secondly, in its domestic borrowing from the public the government has switched the emphasis from nontradable government bonds and direct deposits with the Accountant General (except for pension and insurance schemes) to tradable bonds sold by tender. This will broaden the monetary policy base, thereby making policy more effective.

Under the wage agreements signed shortly after the initiation of the stabilization program the cost-of-living allowance arrangement was temporarily suspended, and a 14 percent wage adjustment was immediately awarded to compensate for the price effect of the devaluation and subsidy cuts. Leaving the c-o-l allowance arrangement intact, i.e. compensating workers for past rises in the consumer price index, would have resulted, once inflation slowed down, in a sharp rise in real wages, thereby thwarting the stabilization plan. The erosion of real wages was intended to be temporary, and it was agreed to award a 12 percent increase, to be paid in three monthly instalments beginning in December 1985.

3. MAIN DEVELOPMENTS UNDER THE STABILIZATION PROGRAM

The most notable success of the economic stabilization program is the containment of inflation. On the other hand, it has not yet achieved a further narrowing of the import surplus nor a restructuring of the economy, although it probably consolidated the 1984 improvement in the import surplus. The balance of payments financing problem eased appreciably following the receipt of U.S. emergency aid and the halting of speculative foreign currency purchases.

After accelerating steadily for many years until it reached an average of 14 percent a month in the year and a half preceding the stabilization program, the inflation rate fell dramatically — to 2.7 percent a month in August–December 1985 and a mere 1.3 percent a month in January–April 1986. This can be attributed to the whole range of policy measures adopted, and especially those that have acted directly on prices through three nominal variables: the exchange rate in relation to the dollar, wages, and bank credit (see Table I–2). These variables were not completely frozen: the sheqel/dollar exchange rate, which was the principal anchor for prices, stabilized at around NIS1.5, but because of changes in the exchange rates of European currencies against the dollar, the sheqel actually depreciated by 1.4 percent a month in relation to the foreign currency basket between August 1985 and March 1986. Credit supply was curtailed mainly by altering the marginal interest rate, lowering foreign currency credit ceilings, and reducing directed credit. As a result, credit grew by only 3 percent a month between August and the end of 1985, and by 2 percent a month in the first quarter of 1986.

Under the stabilization program the path of nominal wages was set only until October, and it was agreed to subsequently reinstitute the cost-of-living allowance arrangement. Real wages fell steeply in the first few months of the plan, after which they moved up gradually; in the second half of 1985 they eroded 11 percent in purchasing power terms, while from the employers' perspective (i.e. labor cost) they remained stable. Wage policy has played a dual

Table I-2

MAIN ECONOMIC INDICATORS BEFORE AND AFTER INTRODUCTION OF THE ECONOMIC STABILIZATION PLAN

(average monthly nominal rate of change, percent)

			1985				1986
	1980–1983	1984	Jan.–June	July	Aug.–Sept.	Oct.–Dec.	Jan.–April
Consumer Price Index	7.5	15.2	11.9	27.5	3.5	2.1	1.3
Exchange rate, IS/$	7.3	16.1	12.0	16.9	0.3	0.3	−0.4
Exchange rate, 5-currency basket	6.6	15.3	12.6	23.4	1.2	1.5	1.2
Bank credit to the public	6.8	16.2	12.3	17.4	4.8	2.1	1.0[a]
Wages per employee post	7.7	16.5	11.5	8.2	0.2	4.6	2.6[b]
Budget deficit as percent of GNP[c]							
Excl. interest on public debt	6.5	9.1	5.2	−5.7	1.7	−2.3	−2.7
Incl. interest on public debt	10.8	13.5	11.5	0.6	8.0	4.0	3.6[a]

[a] Provisional.

[b] January–February.

[c] Domestic deficit (see notes to Table V–1). The figures here are on a cash basis (see Table VIII-6), and differ from those in Table I–1, which are based on the national accounts.

role in the overall plan. First of all, it was one of the factors that reduced disposable income, thereby helping to consolidate the balance of payments improvement; secondly, the suspension of the cost-of-living allowance arrangement in the first three months severed the wage-price link, which was one of the factors that pushed up costs in the past. In the first quarter of 1986, however, wages went up faster than planned (the increase in labor cost was faster yet); thus the wage effect was relatively short-lived, but of considerable importance in steadying prices in the early months.

The reduction of domestic demand was another major feature of the plan. It contributed directly to the stabilization of prices, and even more important, it consolidated the balance of payments gains, thereby making the public aware that the necessary conditions for stabilizing the exchange rate had in fact been created. The receipt of special U.S. government aid also enhanced confidence in the new strategy. Public confidence in the success of the plan was reflected in the discontinuation of speculative foreign currency purchases, which had persisted over the past few years. It also found expression in the inflationary expectations index (based on tradable bond prices): this showed a diminishing of such expectations in the initial phase of the stabilization program, which became more pronounced as implementation of the various measures proceeded apace.

The freezing of the sheqel/dollar exchange rate and the restraining of domestic demand were intended to stabilize prices without any balance of payments deterioration. But in view of the high inflation prevailing before the program was launched, there was a danger that the price rise would prove to be selfperpetuating and result in a real appreciation of the currency and the growth of unemployment. Therefore most prices in the economy were frozen. The resort to such administrative means for any length of time is liable to seriously distort relative prices, and thus production too; but since no shortage of goods appeared in the market, the freeze presumably did not generate suppressed cost pressure on prices. In January 1986 the government began to gradually dismantle the price controls, and today only 49 percent of the consumer price index items are still controlled. It should be reemphasized that a prolonged administrative price freeze has a detrimental effect, and so the removal of controls must continue.

Assessing the impact of the economic plan on demand and the balance of payments is a more complicated matter, for some of the measures adopted (mainly with respect to taxation) were of a one-time or temporary nature, and presumably the real variables responded to them more slowly than did prices. To understand developments in these areas it is necessary to survey the implementation of fiscal and monetary policy.

After many years of large public sector domestic deficits (equal to about 12 percent of GNP p.a. in 1980–84), there was a big improvement in 1985. It began in the first half of the year following an upturn in nonwage tax revenue, and became much more pronounced after the introduction of the stabilization program; in the second half of the year the deficit stood at only 6 percent of GNP. This marked contraction was achieved mainly through the cutting of subsidies and stiffening of taxes, and only partly by curtailing the government's direct demand. Disinflation also helped to boost the real value of tax collections by reducing the erosion caused by the time-lag in paying tax liabilities. In addition, the number of public service employees was reduced, but not as much as envisaged. The budget deficit was pruned further in the first quarter of 1986, when both tax revenue and government spending expanded.

The slashing of the government deficit also helped to curb the monetary expansion, after it had long been the principal factor pumping liquidity into the economy. The Bank of Israel contributed to the monetary restraint by implementing a tight credit and high real interest policy. Following the public's massive switch from foreign currency-linked assets, which are not a source of credit, to sheqel assets, which are subject to low liquidity ratios, fears arose that credit would expand by more than projected. The Bank of Israel therefore upped the liquidity ratios and kept the interest on the discount-window loan and the banks' required reserves at the rates in force on the eve of the stabilization plan. Toward the end of July it began to lower interest rates, but by much less than the drop in inflation; as a result, there was a steep rise in real interest on free (nondirected) sheqel credit, which had already been very high since the end of 1983 (about 40 percent a year, or 3 percent a month). After the stabilization program went into effect, bank credit increased roughly in line with prices, but in the first months of 1986 it went up a little faster than the CPI following a sharp drop in the average and marginal real interest rates.

The severe fiscal and monetary restraint built into the stabilization program and the climate of uncertainty which it generated depressed all domestic demand components and imports in the third quarter of the year, but most of the changes were short-lived. The restraint was reflected in the contraction of the government's direct demand: public domestic consumption fell 5 percent in the second half of the year, when defense spending was sharply cut back and investment was also curtailed. Private sector demand likewise weakened — both consumption and investment, especially in inventories. The slack in dwelling and nondwelling investment carried over through the first quarter of 1986, but the downturn in private consumption was confined to the third quarter of 1985; in the last quarter consumer spending again picked up and even exceeded the level in the first half of the year. Large-scale retail trade data show that the trend continued upward through the first quarter of 1986. Part of the incremental consumption reflected speculative purchases of consumer durables, induced by expectations of a price adjustment following the depreciation of the sheqel in relation to European currencies. But even excluding consumer durables, an increase in private consumption has been evident since the fourth quarter of the year.

The transitory impact of the new strategy on consumers is explained by the nature of the policy measures implemented. The announcement of the stabilization program engendered (temporarily) uncertainty about the employment situation, which was heightened by the government's declared intention to dismiss workers. In addition, there was a severe liquidity squeeze in the third quarter owing to the steep temporary drop in real wages and the precipitate rise in real interest rates on credit and short-term assets. These factors contributed to the sagging of private consumption in the third quarter (6 percent), but this, as stated, lasted for only a brief span. The fiscal restraint was based primarily on the hiking of gross tax rates and the slashing of subsidies, which bit deeply into the public's disposable income. The raising of net taxes can dampen private consumption only if the public perceives it as a permanent change in the tax burden. But in recent years tax and subsidy policy frequently changed direction, and this left its impress mainly on the national saving rate, which fluctuated widely. This time too the public evidently does not believe that the growth of the net tax burden signifies a permanent change, especially in view of the high current tax/GNP ratio and the government's repeated declaration of its intention to lower it in the future. If the public changes its assessment about the temporary nature of the net tax burden, private consumption will turn down.

The slacker demand for inventory investment was probably also a temporary phenomenon, an assessment supported by data on imports of production inputs at the beginning of 1986. The running down of inventories in the second half of 1985 was responsible for about half the decline in aggregate domestic demand; the main factor here was the high interest rates during this period.

The weakening of domestic demand in the second half of the year (by about 7 percent of GNP, seasonally adjusted) should have released resources and improved the price of tradables relative to the prices of domestic uses — a development that has a contractionary effect on the import surplus. While the price of imports relative to the prices of domestic uses did rise in the second half of the year (by 2.5 percent), the relative price of exports remained unchanged. So far the drop in domestic demand has been only partly reflected by a narrowing of the import surplus (2.5 percent of GNP, seasonally adjusted); its main effect has been a dent in GNP (4.5 percent, seasonally adjusted) and an accelerated rise in unemployment. This can apparently be attributed to some extent to the comparatively slow adjustment of production to the new prices because of the declining growth of world trade, and especially a smaller demand for some of Israel's export goods. Another reason is the increase in some production costs under the stabilization program, notably wages and interest.

Real wages per worker fell in the second half of 1985, but this did not find expression in labor costs (wages as perceived by employers), and preliminary indicators even show an increase in the latter at the beginning of 1986. Moreover, per unit wages in the business sector were still high, an outcome of the rapid rise in labor costs in the second half of the 1970s, which outpaced the growth of the sector's product. Thus it is not surprising that the falling demand and mounting wages also affected employment, and that the labor force participation rate drifted down because of the dimmer prospects of finding work. The drop in the employment and labor force participation rates was reflected by a comparatively sharp rise in unemployment in the third quarter (to 7.8 percent) and a slight downturn in the fourth quarter. The adjustment of employment to the accelerated decline in GNP apparently continued in early 1986, and unemployment again turned up (7.2 percent), a development that was particularly severe in the development towns and the Northern and Southern Districts.

The steep rise in the real marginal interest rate (the effective rate on overdraft accounts) was, as already mentioned, one of the factors that dampened domestic demand. But short-term credit also serves as an alternative to working capital, and so its sharply higher cost affected the output of many firms, especially those producing mainly for the home market. Moreover, the high interest on sheqel credit during the past two years or so was a far from negligible factor in the growing number of firms that experienced serious difficulties also because of the weakening of domestic demand in the second half of 1985. In the year reviewed the number of firms that went bankrupt rose appreciably. Beginning toward the end of July nominal interest rates were reduced, but more moderately than the drop in inflation. Real interest therefore rose strongly in the initial stage of the stabilization plan. In September it started to move down gradually, but still remained very high until the end of the year; only at the beginning of 1986 did it decline more significantly. The average interest on total bank credit was much smaller than that on sheqel credit, mainly because of the low rates charged on directed export credit; but the average real interest was also much higher than in the past. Some maintain that in view of the waning inflationary and devaluation expectations, interest could have been reduced more rapidly without any expansion of credit. Underlying this argument is the assumption that at such high interest rates demand for credit is inelastic in the short run, an assumption supported by the stability of real bank credit in the second half of 1985 despite the progressive drop in real interest during this period. But it should be emphasized that when the stabilization program was initiated it was not clear how demand for credit would respond in the short run to a drastic change in interest rates. For this reason, and also because of monetary policymakers' fear of speculation, which could cause the program to break down, they preferred to lower interest at a modest pace.

The shrinkage of domestic demand helped, as stated, to narrow the civilian import surplus in the third quarter of the year; but this was short-lived, and in the fourth quarter the surplus again increased. Examination of the trade balance (in dollar terms) shows a further growth of the deficit in the first four months of 1986. This was due partly to the rise in foreign trade prices following the weakening of the dollar against European currencies, and partly to a quantitative increase, which was greater than envisaged in the 1986 National Budget. The deviation from the forecast is explained by the failure of exports to make any headway in real terms compared with the corresponding period the year before, whereas commodity imports (excluding rough diamonds and fuel) expanded, as expected. The fuel import bill decreased, mainly because of the tumbling of oil prices, which has not yet found full expression in the balance of payments. The flattening of exports can be attributed primarily to the poorer performance of civilian electronic products because of the world slump in this industry. However, this industry's sales are quite volatile, and so its performance cannot be regarded as indicative of the overall export trend.

In summary, the fiscal and monetary restraint embodied in the stabilization program has not led so far to a sustained drop in private consumption and the civilian import surplus, and at the beginning of 1986 they were almost back to their level when the program was launched. But it should be noted that before the improvement in the import surplus (which began at the end of 1983) ground to a halt, it had fallen below its level in 1976–81. It is hard to say if the present level, which is still lower than in those years, is sustainable given the present structure of the economy. On the one hand, the improvement in the import surplus was partly of a temporary nature, for one of the contributing factors was the reduced investment in fixed assets and inventories. On the other hand, oil prices fell steeply at the beginning of 1986, and this will have a strong contractionary effect on the import surplus in dollar terms.

A key factor in the success of the overall economic plan until now is the remarkable reduction of the government deficit; this, however, has largely been achieved by increasing the tax burden, which diminishes the prospects of renewing growth in the business sector. A further and sustained narrowing of the import surplus concurrently with the resumption of growth therefore depends on depressing the weight of public consumption in GNP while easing the tax burden. The sharp drop in inflation will probably facilitate this process by gradually releasing resources which in recent years were tied down in financial services because of spiraling prices.

The balance of payments improvement since the introduction of the stabilization program has been most pronounced in the financing of the import surplus. U.S. government transfers were $1.6 billion larger this year. About half the increment derived from the change in the U.S. government's practice of extending its regular aid to Israel in the form of both loans and grants to providing it entirely as grants; the rest of the increment represented special economic assistance, which will be granted next year too. This assistance was made conditional on implementation of a comprehensive economic plan; thus it both stemmed from the stabilization program and contributed to its success by enhancing its credibility and the sustainability of a stable exchange rate. The much larger volume of unilateral transfers and the reduction of the import surplus together produced a $1.1 billion surplus on current account in 1985. But in making a long-term assessment it must be remembered that the special economic aid is temporary, and discounting this item, the current account surplus came to around $350 million.

Another major achievement of the economic plan is the halting of speculative foreign currency purchases, which had been the main cause of the exacerbation of the balance of payments financing problem since the end of 1983. These purchases ceased in the second half of 1985, and during the first few months of the plan the private sector even sold foreign currency to the Bank of Israel. This change is explained by the jump in sheqel asset yields relative to those on foreign currency assets and public confidence in the government's new strategy.

The stabilization program induced another reshuffling of the public's assets portfolio. The steadying of the exchange rate and consequent sharp drop in devaluation expectations, the leashing of inflation, and the rise in interest rates on sheqel assets led to a drastic change in financial asset holdings, notably a shift from Patam to short-term sheqel deposits. In addition, the public's real money balances expanded strongly after shrinking for many years. This, of course, was due to the fall in the rate of inflation, which reflects the price of holding money.

Economic growth has slowed appreciably since 1973, to the point where GNP per capita came to a standstill in the 1980s. The factor most responsible for this is declining productivity. The sharp drop in inflation and steady improvement in the balance of payments greatly reduced two of the principal impediments to economic growth. The retarding of the price advance was particularly important, as the attempt to hedge against inflationary losses tied down considerable resources in recent years. But some of the basic problems still facing the economy have also contributed to the productivity slowdown. The rate of gross taxation, which is one of the highest in the world, is a disincentive to work and to invest. Moreover, the tax system has many distortions, which work against efficient resource allocation — such as discrimination against labor in favor of capital and the granting of numerous exemptions. There is therefore need for a comprehensive reform of tax rates and the tax base; broadening the base and elimination of some of the exemptions would facilitate the lowering of taxes. The capital market is almost completely dominated by the government, and during the past decade it was mobilized to finance the government deficit. The trimming of the deficit must therefore continue in order to reduce the share of private saving channeled to financing the deficit, as well as government intervention in the allocation of the remaining resources to investment. The past few years have also seen the imposition of a growing number of administrative restrictions which, by encouraging the production of goods in which Israel does not have a comparative advantage, result in an inefficient allocation of productive factors. Infrastructure investment, which was already low, has been cut back in recent years as part of the tight fiscal policy. Its expansion would go a long way to stimulate the renewal of economic growth. It should be stressed, however, that reducing the tax burden and government borrowing from the public and stepping up infrastructure investment all have an expansionary effect on domestic demand; to neutralize it, the weight of public consumption in GNP must be brought down.

Implementation of the recommended measures for renewing growth would bear fruit gradually and in the long run. In the short run it is essential to ensure the consolidation of the stabilization program's achievements. This depends on adherence to the budget framework in the coming fiscal year and on wage agreements that will not disrupt price stability. Real wages must not be allowed to rise, for they are already higher than when the plan was introduced. Cutting the budget deficit is a key factor in the success of the plan, but taxes cannot be kept at their present high level for long without harming the growth of GNP. In the longer run the budget must be restructured so as to depress the weight of public consumption in GNP and permit the lowering of taxes along with the narrowing of the import surplus. It is especially important to reduce the taxes on labor, which are burdening the business sector and hurting the competitiveness of the Israeli economy.

APPENDIX

THE ECONOMIC STABILIZATION PROGRAM (JULY 1985)

Budget

According to a Finance Ministry estimate, at the end of the first quarter of fiscal 1985/86 the budget deficit was running about $400 million higher at an annual rate than was originally projected. This does not take into account the failure to implement earlier decisions on the pruning of subsidies and operation of the amended law for taxation under inflationary conditions. But it should be noted that the original budget for 1985/86 was much lower than in the previous year.

In July 1985 the government decided on a series of wide-ranging fiscal measures, which provided for a $462.1 million smaller disbursement by government ministries[2] and a $75 million decrease in national insurance transfer payments.[3] The government also decided to raise fuel prices and to cut subsidies

[2] All budget cuts cited in the appendix are at annual rates.

[3] Under the economic stabilization program the National Institutions also undertook to cut their budgets by 3 percent.

on basic products and services in order to bring them down to $310 million for the year — the amount originally budgeted. This was $490 million lower than their actual level in the first quarter of 1985/86. With respect to taxation, the government decided on a number of changes designed to boost collections by $202 million a year, and to implement the amended law for taxation under inflationary conditions (according to a Finance Ministry forecast, full implementation of the amended law should add some $150 million to tax revenue).

The cuts decided on by the government totaled $1.25 billion (at an annual rate, compared with the level of activity at the beginning of the fiscal year). These break down roughly as follows (in national accounts terms):[4] 20–25 percent — public consumption and direct public sector investment, 40 percent — domestic production subsidies, 8–10 percent — transfers, 8–10 percent — credit granted, 18–20 percent — increased collection of taxes, dividends from government companies, and various fees.

Some of the planned cuts were of a one-time or transitory nature. About half the reduction in public consumption and investment was to be achieved by temporarily eroding public sector wages and postponing certain expenditures (e.g. the deferment for one year of implementation of the recommendations for improving teachers' pay). In taxation, about half the planned increase was also of a temporary nature.

Some of the government's decisions entailed new legislation, not all of which had yet been completed when this report went to press. These decisions pertained to the taxing of various national insurance benefit payments and allowances and reduction of the seniority allowance to pensioners. The national insurance cuts which the government has succeeded in implementing so far add up to only $25 million. Several other decisions, such as the erosion of real public sector wages, have not yet been carried out, either partially or in full.[5]

Since the introduction of the stabilization plan the government deficit, calculated on a cash basis (according to Bank of Israel accounts), has shrunk dramatically.

Main Budget Cuts

Following are the principal budget cuts decided on: $62.5 million — defense, $91.5 million — education, $62 million — health, $100.5 million — Ministry of Commerce and Trade, $33 million — transfers to local authorities, $14 million — Ministry of Construction and Housing, $37 million — 3 percent reduction in public sector wages, $20 million — revenue from the Airports and Ports Authorities, $7 million — higher education, $5 million — Ministry of Fi-

[4] Excluding the fiscal implications of the changes in exchange rate insurance.

[5] Some of the decisions made in July 1985 were subsequently dropped or modified: (a) the 3 percent real cut in public sector wages was canceled, (b) a committee was formed to issue permits for putting up buildings which had been banned under an earlier decision, (c) in exceptional cases enterprises in Zone A can now obtain development loans (which previously had been prohibited), and (d) the planned cuts in the health sphere were revised. Several other decisions were not carried out because they required further study, such as a levy on large, expensive homes and the reduction of certain transfer payments.

nance, $12 million — 3 percent reduction in public sector employment, excluding defense, police, health, and education.[6]

National Insurance Transfers[7]

A tax was imposed on the child allowance for the second and third child. The allowance for the first child was canceled in the case of families with up to three children, provided that their marginal income tax rate does not fall below 45 percent. In the case of low-income wage-earners, the allowance for the first child will be rebated by the employer, by way of an offset from the at-source income tax deduction. This item is expected to yield $25 million.

Taxation

A one-time surtax was imposed on income other than from work (this is expected to yield $100 million). The exemption was abolished for subsidized meals (in enterprises exempted from the payroll tax), as was the tax credit to employees for their contributions to advanced study funds (expected revenue — $32 million). It was decided to increase the dividends from government companies ($25 million), implement the interim recommendations of the committee that amended the law for taxation under inflationary conditions ($40 million), and look into the possibility of imposing a property tax on large, expensive homes and second homes ($5 million).

On the other hand, the import deposit requirement was reduced by 15 percent.[8] As part of the effort to unify exchange rates the June 1 increase in the fuel tax from 22 to 30 percent was rescinded, and the value added tax was lowered from 17 to 15 percent.[9]

On July 1 collection began of the property tax on motor vehicles, equipment, inventories, and buildings, which had been decided on before the introduction of the stabilization plan. These one-time levies, which are not an organic part of the stabilization plan, are expected to yield some $200 million.

Exchange Rate

On July 1, 1985 the exchange rate of the sheqel in relation to the U.S. dollar was reduced by 18.8 percent. It was also decided to stabilize it at around NIS1.5 per dollar, and to allow it to fluctuate within a 2 percent band. The exchange rate freeze was made conditional on economic developments: it was stipulated that if wages should rise by more than desired, the exchange rate would be adjusted upward. Along with the devaluation of the sheqel, the fuel

[6] The fiscal implications of this decision are not clear at this stage.

[7] By the time the Annual Report went to press the Knesset Finance Committee had not yet approved a proposal to impose a one-time levy on pensioners' income (above a certain threshold). For this reason no figures are given here on forecast receipts from this source.

[8] This involves a $30 million loss of income, which the Finance Ministry did not take into account.

[9] The 17 percent rate was in force for only one month (June 1985). Retention of this rate would have yielded more than $250 million on an annual basis. The income forgone because of this change was not included in the tax revenue estimate cited above.

tax and VAT were reduced (as described above). Another measure bearing on the exchange rate was the termination of directed export credit in Israeli currency (see the discussion of monetary developments below).

Wages

The cost-of-living allowance arrangement (COLA) and other wage agreements were suspended, and a new COLA arrangement went into force in October. It provided for a wage adjustment at the rate of 80 percent of the rise in the consumer price index, to be paid when prices go up by 4 percent or more, or after a three-month period, whichever period is shorter. Under the old agreement an adjustment at the rate of 80 percent of the rise in the CPI was paid when the cumulative change in prices ranged between 12 and 25 percent, and a 90 percent adjustment was paid when the CPI went up by more than 25 percent. The erosion of real wages was moderated by the agreed payment on August 1 of a 14 percent adjustment of July wages, a one-time lump-sum payment in early September equivalent to 12 percent of the July wage, and a cumulative 12 percent supplement payable in three instalments: 4 percent on December 1, 4 percent on January 1, and 3.5 percent on February 1. The adjustment of income tax brackets also moderated the drop in gross wages (with the reduction of inflation, this adjustment increased net wages).

Prices

Under the decision to bring subsidies down to the level originally budgeted for 1985/86, the prices of basic goods and services were raised at the beginning of July by 30–100 percent and fuel prices by 27 percent. Following these initial changes, an average 17 percent increase was allowed for other product and service prices, after which an absolute freeze was imposed on most domestic product prices, to be enforced through administrative controls.[10]

Monetary Policy

The role of monetary policy under the stabilization plan was to curb the nominal growth of bank credit via the domestic interest rates. The initial objective was to keep the nominal growth of credit 10 percent below the July rise in prices, to be followed by an absolute nominal freeze over the next three months. Toward the end of July it was decided to abandon the targeted 10 percent real cut because of the difficulties encountered in sticking to it, mainly pressure to lower domestic interest rates.

The reserve requirements on the public's deposits were scaled up several times in July, the banks' recognized liquidity deficiencies were canceled, and the ceiling on nondirected (free) credit in foreign currency was lowered. In addition, the financing arrangements in the export funds were altered: the rate of financing in the Export Shipments Fund was reduced from 90 to 70 percent, but subsequently the cut was gradually restored and by January 1986 the rate

[10] Initially prices were frozen for three months, but the Knesset subsequently enacted a law permitting the extension of the freeze until June 30, 1986.

stood at 85 percent. The interest rates in the Export Production Fund and the Imports-for-Export Fund were increased to 2 percentage points over Libor (the London interbank offered rate).

The export production funds in Israeli and foreign currency were merged into a single foreign currency fund. Those who formerly were entitled to obtain Israeli currency credit will henceforth receive loans in foreign currency (see the section on the exchange rate).

Capital Market

The acquisition of foreign currency in exchange for sheqalim for deposit in residents' Patam demand accounts was prohibited. Those who owned such accounts on the eve of the change may continue to hold them until their conversion into sheqalim. A special resident deposit account, withdrawable either on demand or after one year, was introduced for the deposit of foreign currency obtained from export transactions, the sale of services in Israel to foreign residents, and transfers from foreign residents.

Another decision was to make nonnegotiable government bonds tradable in the future, starting with those that serve as cover for advanced study funds and savings schemes. Linked bonds will henceforth be issued only for periods of two years or more.