Chapter 1

The Economy: Developments and Policies

In 1993 the overall positive trends which had characterized the Israeli economy in 1989–92 continued. The real growth rate of GDP fell, following sharp changes in the composition of demand—particularly in the share of government-initiated residential construction. Nonresidential investment expanded more quickly, however, and exports continued to climb, despite the slow development of world trade. Employment of Israelis increased substantially, and unemployment fell from an annual average of 11.2 percent in 1992 to 10 percent in 1993. Inflation in 1993 remained at the 10–11 percent level achieved in 1992, following six years when it averaged 18 percent. Alongside the steep rise in exports, imports continued to increase rapidly, and the share of the import surplus in GDP rose. The current-account balance of payments deficit grew. At the same time, Israel started utilizing the US guarantees, and its international economic standing continued to improve.

Table 1.1
Main Economic Indicators, 1986–93

	1986–89[a]	1990–91[a]	1992	1993
Growth rate (GDP, percent)	3.6	6.1	6.7	3.4
Per capita growth rate (GDP, percent)	1.9	1.4	3.0	0.8
Inflation during year[b]	18.2	17.8	9.4	11.2
Unemployment rate (percent)	7.1	10.1	11.2	10.0
Immigration (percent)[c]	0.3	3.8	1.5	1.4
Balance of payments on current account ($ billion)	0.6	0.1	0.2	–1.4
General government deficit (–) (percent of GDP)	–0.9	–3.9	–2.4	–1.9
Total productivity[d] (percent change)	2.4	4.4	0.7	–0.7

[a] Annual average.
[b] Percent change in CPI.
[c] Relative to population.
[d] In business-sector product.

Budgetary policy in 1993 had a restraining effect on both demand and economic activity. On the expenditure side, there was a massive reduction of government investment in housing and an increase in its investment in the roads infrastructure. Monetary policy aimed at preserving the relatively low level of inflation of 1992 and stimulating economic activity, and in this context interest rates were permitted to fall slightly. The optimism which accompanied the peace process, together with favorable interest rates, led to a rapid rise in the quantity of money, credit, and the prices of shares and real estate in the last few months of the year.

Israel continues to show impressive economic achievements, particularly in the expansion of employment, investment, and exports. Progress has also been made in reducing unemployment, inflation, and the public debt/GDP ratio. Not all the objectives in these fields have been achieved, however, and other serious problems persist, including the under-utilization of human capital, the slowdown in productivity growth, and the sluggish response of supply and prices to demand.

Continued success in solving these problems depends on ensuring conditions which allow rapid and sustainable growth once mass immigration ends. With this in mind, an attempt is made below to ascertain what caused the slowdown in GDP growth in 1993, and whether this should be viewed as a nonrecurring adjustment or as the first sign of a lower rate of growth as the initial effects of the influx of immigrants come to an end.

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In 1990–92 the Israeli economy achieved rapid growth rates unknown since the early 1970s. This was based on the economic reforms introduced in 1985, and fostered by the influx of immigrants which started at the end of 1989. The object of the reforms, which are discussed below, was to reduce public-sector involvement in the economy and improve the functioning of the markets. The view underlying the reforms led to the choice of an immigrant absorption strategy based on relatively limited government involvement, and ascribed prime importance to individual preferences and considerations of efficiency. On the other hand, the economic expansion which accompanied this absorption made it easier to proceed with the reforms, although in certain spheres considerations related to immigration resulted in temporary retreat on the reform front (specifically, through government intervention in the housing sphere).

The effect of immigration on the economy varied with its extent and the length of time the immigrants had been in Israel. Thus, the effects arising from the initial stage of immigrant absorption—such as the grant made to all immigrants and the immediate solution of housing problems—moderated, while those related to the adjustment of the immigrants' behavior patterns to those of the established population—consumption of consumer durables, employment, and housing—increased. At times the adjustment process was expressed as the creation of pressure in a certain segment, such as government-initiated construction. In the earlier stages, the effects of immigration were felt mainly on the demand side, but with time its effects on supply increased, particularly in the labor market.

Four years after the massive influx of immigrants began, their economic absorption may be described as a partial success. Their participation rate is high, and their unemployment rate, which at times was close to 40 percent, has fallen to 20 percent (compared with 10 percent in the general population). However, the fact that many immigrants have not succeeded in finding employment commensurate with their skills arouses concern. Although this phenomenon was to be expected in view of the differences between Israel and the immigrants' countries of origin, the proportion obliged to accept employment which does not match their skills—particularly among those with higher education—is greater than in previous influxes. The scale and composition of this immigration, as well as the widening gap between the needs of the Israeli economy and the skills the immigrants bring with them, may provide a partial explanation for this. Absorption problems appear to have been among the factors which caused the slowdown in immigration and the fall in the proportion of immigrants with higher education.

Table 1.2
Business-Sector Growth Rate, 1986–93

	1986–89	1990–91	1992	1993
Business-sector product[a]	4.7	7.5	8.0	3.5
of which Tradables[a,b]	3.0	5.8	10.1	4.1
Nontradables[a,b]	5.9	8.7	6.5	3.1
Domestic labor inputs[a]	1.9	3.5	8.7	3.9
Gross capital stock[a]	2.7	2.1	4.2	4.9
Total productivity[a]	2.4	4.4	0.7	–0.7
Real unit labor costs[a,c]	2.6	–4.2	0.2	2.4
Net domestic product per man-hour[a]	2.8	4.4	–0.8	–0.7
Yield on gross capital[d]	8.8	11.1	12.6	11.8
Gross tax rate on nonwage income	31.8	24.9	24.6	27.5

[a] Annual change, percent.
[b] Business-sector product resulting from production of tradable goods, defined as imports, exports, and their domestic substitutes; nontradables consist of other output.
[c] Based on net product at factor prices.
[d] Before tax.

The rate of immigration in 1993 was similar to that of 1992 (about 80,000 arrivals), less than half the 1990–91 rate. Immigrants contributed proportionally more to the increase of the labor force than to that of the population, due to their higher participation rate and the fall in their unemployment rate.

The immigration cycle had two important effects on the housing market in 1993: one was the sharp contraction of the extensive construction initiated by the government with the start of the immigration, and the other was the increased demand by successful (or wealthy) immigrants for housing.

Developments in 1993 again demonstrated the great potential importance of politicɛ and security-related events for economic activity, employment, and growth. Two effect were prominent:

First, the closure of the administered areas due to the increase in terrorist activities ɛ the beginning of the year resulted in the substitution of Israelis for skilled workers fror these areas, particularly in construction and agriculture. This led to higher employmer among Israelis, on the one hand, and lower productivity and upward pressure on labc costs, on the other.

Second, the optimism arising from the peace process increased demand, economi activity, and investment, making a major contribution to the stock-market boom and t higher real-estate prices. Externally, the peace process continued to improve Israel' geopolitical standing. If it persists, it may ease the continued penetration of new market support Israel's integration into the international economic community, and increase th supply of foreign capital.

In this context, the marked improvement in the international assessment of Israel' economic stability and credibility in recent years, both economically and politicall should be noted. This was expressed in the better country risk rating published b various international organizations.

However, there is still a great deal of uncertainty concerning the fulfillment of th potential of the peace process, and it is difficult at this stage to base forecasts on it.

As mentioned above, the rate of GDP growth slackened in 1993, the sharp fall in th growth rate of business-sector product being particularly marked (Table 1.2). Althoug the overall levels of demand and capacity continued rising at rates similar to those o 1992, there were changes in the composition of demand, and domestic producer encountered difficulties in meeting the increase in demand. The share of construction i total demand fell in 1993, while that of other investment and exports, which have highe direct and indirect import components, rose. Consequently, the growth of demand fo domestic product fell, although the rapid rate of increase of aggregate demand wa maintained.

In addition, some producers in industries in which demand rose were unable to adjus their production fully, because *inter alia* they could not obtain suitably skilled labor. As result, some of the additional demand directed to domestic producers shifted to imports.

These developments went hand in hand with a decline in total productivity an profitability. The former resulted from the change in the composition of demand and th labor force, and from the subsidy on incremental employment. The change in th composition of demand led to difficulties of expansion in certain industries, and to th accumulation of unutilized capacity in others. In the labor force, the problem was partl due to the replacement of skilled workers from the administered areas by less-skille workers, and partly to the higher proportion of immigrants among the employed. Th higher employment rate among immigrants appears to have been associated witl accepting workers whose skills were less suited to the requirements of the domestic mar

Table 1.3
GDP and Aggregate Demand[a], 1986–93

(annual averages)

	Real annual change, percent				Percent of GDP
	1986–89	1990–91	1992	1993	1993
GDP	3.6	6.1	6.7	3.4	100
Per capita private consumption	5.3	1.7	4.5	5.0	
Private consumption	7.0	6.4	8.2	7.7	63
Public consumption	1.4	2.2	4.3	1.3	25
Gross domestic fixed investment					
Nonresidential	1.7	24.2	11.0	16.7	16
Residential	2.9	43.1	-0.6	-27.1	6
Domestic use of resources[b]	4.7	10.3	6.9	5.2	146
Exports	4.7	0.4	14.3	10.6	34
Imports[b]	6.5	11.8	12.4	12.8	46
Business-sector use of resources					
Nontradables[c]	5.3	15.1	5.4	0.1	33
Domestic use of tradables[c]	6.2	11.4	10.1	9.6	55
Total use of tradables[c]	5.5	6.8	11.7	10.0	89

[a] National accounts figures.
[b] Excluding direct defense imports.
[c] See definition in note to Table 1.2.

ket. The employment of workers whose productivity is low was made possible to some extent by the subsidy on incremental employment (see below).

Domestic resource use in 1993 saw a rapid rise in private consumption and accelerated growth of nonresidential investment (including stocks). Public consumption rose slowly, with an increase in the share of civilian—and a decline in that of defense—consumption.

The persistently rapid increase in private consumption was due to a combination of several factors: optimism regarding the continued increase in income and expansion of employment, the larger share of wages in income, the effect of greater wealth and liquid assets—associated to a great extent with the continued stock-market boom—and the continually narrowing gap between immigrants and Israelis.

The rapid rise in private consumption led to a decline of more than 2 percentage points in the share of private and total savings in total income. The share of investment in this income fell too, because the cutback in residential investment outweighed the effect of the increase in nonresidential investment. Savings fell more than did investment, leading to a current-account balance of payments deficit (Table 1.7).

Nonresidential investment has a crucial role to play in economic growth, because it both increases the stock of factors of production and serves as a means of introducing new technologies and adapting production methods to a changing environment. Its current level makes it possible to maintain the prevailing capital/GDP ratio and the growth rates of the last few years. Technological innovation and rapid changes in the composition of demand may, however, increase the obsolescence of equipment.

Private nonresidential investment continued to rise rapidly in 1993, influenced by the cumulative effect of economic expansion, profitability, increased infrastructure investment, and the reforms of recent years. The stock-market boom also appears to have helped create an environment favorable to investment.

Government investment in the infrastructure continued to rise. Although investment in roads soared in 1993, congestion still increased. The reduction of this overcrowding could encourage economic activity, improve the quality of life, and alleviate housing shortages in urban centers. In addition, infrastructure expansion will stimulate private investment, with a further positive effect on growth.

Private-sector demand for housing swelled as the government's large-scale residential investment came to an end in 1993. This was the result of demographic developments and the increase in immigrants' demand. The demand for housing was also affected by the stock-market boom, the reduction of interest rates on mortgages, and expectations of continued increases in real-estate prices. The rise in this demand pushed housing prices up rapidly, making an appreciable contribution to inflation.

According to various estimates, demographic developments will keep demand for housing high in the next few years, too. Consequently, plans designed to increase the supply of housing should be implemented, bearing in mind considerations of efficiency and quality of the environment. The experience of the past few years shows that the supply of housing should be expanded by removing obstacles from the path of increased private construction, rather than by government-initiated construction. The change in the zoning of land which this requires may help to solve the problem of the debt of the *kibbutzim* (see the section on Agriculture in Chapter 2).

The trend of unemployment, which had been rising even before the influx of immigrants began, reversed in 1993. Unemployment had reached 9 percent in 1989 due to the combination of cyclical economic contraction, restructuring processes, and structural change which followed the 1985 economic stabilization program (ESP). The massive immigration which started at the end of 1989 increased the labor supply substantially. Although it provided an impetus for accelerated growth, with a rapid increase in employment and erosion of real wages, it prevented the reduction of unemployment, even edging it up to 11.2 percent in 1992.

The decline in unemployment in 1993 reflects a 6 percent increase (100,000 persons) in the number of employed Israelis, alongside a rise of almost 5 percent in the labor force. The latter indicates, among other things, a higher participation rate, and is greater than the average rate which can be expected in the coming years even with the continuing immigration and growing proportion of persons of working age in the established population.

Table 1.4
The Labor Market, 1986–93

(annual change, percent)

	1986–89	1990–91	1992	1993
Average population	1.6	4.7	3.5	2.6
Participation rate[a]	51.1	51.6	52.0	52.9
Israeli employed persons				
Business sector	2.2	4.0	4.7	7.2
Public services	1.6	4.5	3.2	3.5
Unemployment rate[a]	7.1	10.1	11.2	10.0
Real average wage[b]				
Per employee post	5.0	–2.0	1.3	0.5
of which Business sector	4.9	–3.3	1.7	0.3

[a] Actual rate, not the rate of change.
[b] Deflated by the CPI.

The increase in the number of employed Israelis was greater than in 1992, despite the slowdown in the rate at which GDP rose. This was because labor productivity declined and Israelis replaced workers from the administered territories as a result of the closure (which reduced the average number of workers from there by 30,000). The lower productivity was due to changes in the composition of demand and of employment (including the increased proportion of new immigrants), and to the subsidization of incremental employment, which enabled it to expand even though productivity was falling.

The number of employees for whom employers received temporary subsidies rose from 39,000 in 1992 to 53,000 in 1993. The main test of employment subsidies is in their contribution to preparing employees for permanent employment once the subsidies have come to an end. In the short run they may help to check the development of hard-core unemployment, from which it is very difficult to emerge. The rise in the number of long-term unemployed indicates the extent of this problem.

Employment expanded during the year, and in the final quarter unemployment among Israelis declined to some 9 percent, even though at that time most of the workers from the administered areas who had been employed in Israel prior to the closure had returned to work.

Real wages per employee post in the business sector have fallen by a total of about 6 percent since 1989, after rising rapidly in the first three years following the ESP. (The reduction in the hourly wage was even greater.) The decline in real wages reflects both the effect of unemployment on wage demands and the changes in the structure of the labor force. Since 1989 unit labor costs have been declining as a result of wage erosion, increased productivity, and lower taxes on wages. This development helped to improve profitability, expand employment, and increase output and investment. At the same time, these forces acted to create conditions favorable for slowing the inflation rate.

Despite the improvement in employment in 1993, real wages did not rise in the business sector. Unit labor costs rose, *inter alia* because of the reduced share of construction, where labor costs are low. In view of the subsidization of incremental employment, the rise in actual labor costs to employers was smaller. Despite this subsidization, profitability declined slightly in 1993.

Real wages in the public sector rose steadily from 1989 to 1992, with a one percent increase in 1993. During the year, however, and at the beginning of 1994, new agreements were signed which will significantly increase real wages in some segments of the public services in the next few years. There are fears that this wage increase will spill over into the business sector, hampering the expansion of employment and continued reduction of inflation.

Table 1.5
Prices, 1987–93

(annual average change, percent)

	1987–89	1990–91	1992	1993
Consumer prices (CPI)				
All items	18.8	18.1	11.9	10.9
Excl. housing	18.1	14.5	12.2	8.5
Excl. housing and controlled commodities	17.7	12.8	11.3	7.6
of which Tradables[a]	13.0	12.5	10.9	7.3
Nontradables[a]	23.6	13.2	11.7	7.8
Business sector				
Gross product prices	18.6	15.6	11.4	9.9
Nominal unit labor costs	21.6	10.4	10.7	12.8
Export prices[b]	15.9	12.0	7.5	9.7
Import prices[c]	14.2	10.2	6.7	9.8
Exchange rate (against currency basket)	10.1	11.5	10.2	12.1

[a] See definition in note to Table 1.2.
[b] Excluding diamonds.
[c] Excluding direct defense imports and diamonds.

In 1993 the inflation rate remained at the new 10–11 percent level attained in 1992 as the result of a combination of factors, the first two of which have been active since 1990. First, there was a slowing of domestic price increases in tradables (imports, exports, and their domestic substitutes). These prices devolve from the exchange rate—which plays a crucial role in determining domestic prices—and from prices abroad and import taxes. The main causes of the slowdown were the lower inflation rate abroad and the reduction of taxes, while the average annual depreciation of the local currency against the basket of currencies remained more or less stable. Second, real wages fell in the context of unemployment. This decline weakened one of the principal sources of the rigidities responsible for the relative increase in prices of nontradables before 1990.

Third, the pressure of demand on capacity slackened in 1992; this had focused mainly on (nontradable) construction. This removed another obstacle to the reduction of the inflation rate.

Fourth, at the end of 1991 the government and the Bank of Israel began announcing annual inflation targets and adjustments of the exchange-rate band. When supported by appropriate policy, these measures affect expectations and play a crucial part in determining inflation. The rate at which prices of controlled goods and the budget were adjusted was also brought into line with this target.

These announcements undoubtedly made a substantial contribution to the shift to a lower inflation rate, since they helped to convince the public that the authorities were in earnest about this policy. The announcements were perceived as credible in view of the stabilizing economic policy of the preceding years, the transition to long-term budgetary planning, the introduction of the Budget Deficit Reduction Law, and the central bank's demonstration of its ability to withstand the pressure of speculative foreign-currency purchases.

The reduction of the annual rate of inflation from about 18 percent in 1986–91 to 10–11 percent in 1992 and 1993 constitutes a significant step away from the level typical of economies which have managed to emerge from high, chronic inflation, and towards that prevailing in the west.

Several factors served to consolidate the new level of inflation in 1993. These included: the additional credibility gained from the reduction of inflation in 1992; the announcement of a new, lower annual inflation target of 10 percent, backed up by the reduction of the slope of the exchange-rate band to 8 percent and the appropriate adjustment of prices of controlled goods; and the liberalization of trade, which served to increase competition and reduce the gap between prices to importers and to consumers.

These factors served to maintain the slowdown in inflation, but renewed pressure on the housing market (see above) worked in the opposite direction. This demand, affected in part by expectations connected with the peace process and the rapid expansion of the money and capital markets towards the end of the year, led to the renewal of rapid price-increases in this market. In addition, domestic prices of imports and exports and unit labor costs rose slightly faster than in 1992.

During 1993 the CPI rose more steeply than the target rate (by 11.2 rather than 10 percent). This is disappointing as it may undermine future credibility. Note, however, that the annual average rate of increase of the CPI has been reduced, and other price indices indicate stability or a further slight reduction from 1992.

In the first third of 1994 the CPI rose at an annual rate of 13.5 percent. This reflected seasonal factors, among others, and was lower than the rate of increase in the equivalent period in 1992 (some 17 percent). Housing prices continued to soar (at an annual rate of 35 percent), while the CPI excluding housing rose by an annual 9 percent.

Both imports and exports continued to expand rapidly in 1993, attesting to the process of Israel's integration into the world market. This brings benefits in efficiency of prod-

Table 1.6
Balance of Payments, 1986–93

($ billion)

	1986–89	1990–91	1992	1993
Import surplus	4.7	6.2	6.7	8.1
Unilateral transfers	5.1	6.3	6.9	6.7
Current account	0.6	0.1	0.2	–1.4
Civilian import surplus	2.9	4.5	5.2	6.0
Civilian imports	17.8	23.5	26.7	28.9
Exports	14.9	19.0	21.5	22.9
Industrial exports (excl. diamonds)	5.9	7.9	8.9	10.2
Implied private capital imports	–0.4	0.2	–2.4	1.1
Foreign reserves[a]	5.2	6.4	5.3	6.7
Net external debt	18.5	15.1	15.2	15.7

[a] Held by central monetary institutions, at end of period.

uction and a higher standard of living in the long term, even though it exposes the economy to international shocks. Alongside the greater volume of trade, the import surplus also increased—the mirror-image of the gap between the rise in domestic resource use and GDP (see above).

Exports (excluding capital and diamonds) rose in real terms by almost 13 percent in 1993. This is slightly less than the 1992 growth rate, but is impressive in view of the slowdown in world trade and the fact that part of the 1992 increase was compensation for the decline in 1991, the year of the Gulf war. In the composition of exports, there has been a steep increase in metals, machinery and electronics, which are human-capital-intensive, as well as in chemicals and tourism. With regard to destination, the penetration of new markets is notable, having been made possible largely by the improvement of Israel's international standing and political developments in East Europe.

On the supply side, the rapid expansion of exports reflects the increasing competitiveness of Israeli products as a result of the structural economic changes, investment, and liberalization of the last few years. Israeli exporters, who operate out of a small market and have acquired experience in breaking into new niches, appear to be able to adapt better than some of their competitors to the specific demands of the new markets.

Part of the growth of exports in 1993 was due to large, nonrecurring transactions, but even allowing for this factor there was an impressive increase. Note, however, that in manufacturing there was no concomitant increase in current production for export, so that some of these exports were from stocks.

The volume of civilian imports, excluding diamonds and capital services, increased by 11 percent. The rapid growth of capital goods imports and of expenditure on outgoing tourism are particularly notable. The civilian import surplus grew by about $ 800 million, reaching $ 6 billion (Table 1.6).

The increase in the import surplus which accompanied the influx of immigrants was not reflected by a current-account balance of payments deficit until 1993. The reason for this was that alongside the rise in the import surplus, the flow of unilateral transfers from abroad to the private and public sectors also increased. The special transfers received by the public sector with the onset of the influx of immigrants and as a result of the Gulf war contracted from 1991 to 1993. As a result of the increase in import surplus, the current-account deficit (defined as an import surplus not financed by unilateral transfers from abroad) was $ 1.4 billion in 1993.

The current-account balance of payments deficit can be financed by either net investment from abroad or the net external debt. In recent years there has been an increase in investment by nonresidents, particularly through purchases of Israeli shares abroad. There was no sizable direct investment in Israel by nonresidents, however. At the same time, investment overseas by Israelis increased, reflecting in part portfolio adjustment made possible by the liberalization of capital movements, and in part direct investment in firms abroad, which may facilitate the entry of Israeli companies into international markets. After peaking in 1992, financial investment overseas by residents plummeted in 1993, apparently due to the greater attractiveness of investing in shares in Israel. Net investment in Israel from overseas remained negative, so that the current-account deficit was financed entirely by an increase in the external debt.

The net external debt rose by some $0.5 billion in 1993 to 25 percent of GDP, compared with 80 percent in the mid-1980s. The question that arises is, to what extent has this debt been used to finance domestic investment which enables its eventual repayment. As Table 1.7 shows, the increase in the share of the current-account deficit in total income since 1986–89 is similar to the increase in the share in income of nonresidential investment. Since the long-term real interest rates facing investors are now similar to the international cost of capital, it can be assumed that the yield on investments will make it possible to service the debt, and so the additional debt will not impose a burden on the economy in the future.

The financing of the increase in the debt did not raise any problems in view of Israel's good international economic standing and the political situation. In 1993, alongside the creation of the current-account deficit, Israel began to utilize the long-term guarantees given by the US.

Since the 1985 ESP there has been a continuous effort to establish a budget structure and level which fosters growth. Initially, tax rates and the share in GDP of public consumption were reduced, as were subsidies on domestic production. As a result of the influx of immigrants, extensive resources were allocated to their absorption and to residential investment. During this process, which has passed its peak, the government temporarily undertook projects with which it should not concern itself under normal circumstances. These included undertaking credit transfers, initiating housing construction, and implementing relief work. In order to ensure that increased government expenditure resulting from the mass immigration would not lead to a perm-

Table 1.7
The Rate of Saving, Investment, and Balance of Payments on Current Account, 1986–93

(percent of income)[a]

	1986–89	1990–91	1992	1993
Gross national saving	**17.5**	**19.4**	**21.5**	**19.5**
General government	1.6	–0.7	1.9	1.8
Private	15.9	20.1	19.6	17.7
Gross investment	**16.4**	**19.9**	**21.7**	**21.3**
of which Nonresidential	11.4	12.0	13.0	14.6
Transfers on capital account	0.4	0.4	0.6	0.3
Net balance of payments on current account	1.5	–0.2	0.3	–1.4

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

anent increase in the deficit, the Budget Deficit Reduction Law was passed in 1992, setting a relatively rapid rate for its reduction.

In 1993 the share in GDP of government demand remained at a level similar to that of 1992, with an appreciable increase in nonresidential investment—especially in the roads infra-structure—a moderate rise in civilian consumption, and a decline in domestic defense consumption. At the same time, the tax/GDP ratio rose by some 2 percentage points, because of the reduction of producer subsidies and transfer payments, and the increase in income from property. The reduction of government-initiated construction and the sale of housing units purchased by the government from contractors under the purchase guarantees played an important part in this. In all, general government activity had a moderating effect on demand, and there was a 2 percentage point decline in the domestic deficit. The total deficit was about 0.5 percent of GDP lower than in 1992.

Since the deficit was lower than required by the Budget Deficit Reduction Law, and taking unemployment into account, infrastructure investment could have been expanded more rapidly or taxes reduced, increasing the deficit within the limit permitted by the law. This might have enabled more moderate monetary expansion.

The Budget Deficit Reduction Law was amended at the end of 1993; the reduction was made more gradual and its term was extended by two years. The amendment arose from the view that the deficit could be allowed to contract more slowly, considering unemployment, the increase in government saving and in public nonresidential investment, and the rapid decline in the external debt/GDP ratio.

It is vital that within the framework of this law, changes that stimulate growth should continue to be made in the structure of the budget—especially permanent reductions in taxes and continued infrastructure investment.

Two important monetary processes have been evident since 1985—the decline in interest rates (nominal and real), with a reduction of the spread, and the rapid expansion of monetary aggregates and credit, especially those denominated in local currency.

The reduction of interest rates has gradually brought the local-currency interest rate closer to the price of international capital facing Israel. A level of interest that reflects the true cost of capital to the economy is vital for ensuring that the decisions of economic agents are based on this cost. Over time, as world interest rates have fallen, the price of capital facing Israel has declined. At the same time, the gradual liberalization of capital movements has narrowed the possibility of maintaining local-currency interest rates which are out of line with international interest rates, the exchange rate, and inflation differentials.

Table 1.8
General Government Deficit, 1986–93

(percent of GDP)

	1986–89	1990–91	1992	1993
Total deficit (–)	–0.9	–3.9	–2.4	–1.9
Domestic deficit (–)	–3.3	–6.8	–5.7	–3.5
Domestic revenues	49.6	45.5	46.7	47.5
Domestic expenditure	52.9	52.3	52.4	51.0
of which Direct domestic demand	29.4	29.4	29.1	29.1
Total public debt	134	110	101	99
of which External public debt	29	18	21	21

The expansion of the monetary aggregates and credit was due in part to the process of adjustment to a lower rate of inflation, the reduction of its variance, lower interest rates, narrower spreads, greater confidence in Israel's economy, less intervention by the government and the Bank of Israel in the money and capital markets, and the stock market boom of recent years.

The reduction of interest rates and the liberalization of the money and capital markets created conditions which made economic activity more efficient, and increased investment and growth. It is nonetheless evident that beyond a certain point, excessive reduction of interest rates or expansion of monetary aggregates and credit could lead to speculative capital movements, a reduction of the foreign reserves, instability in the money and capital markets, inefficient investment decisions, and the reinforcement of inflationary pressures. It is in this context that monetary developments and policy in 1993 should be examined.

Monetary aggregates and credit grew at a particularly rapid pace this year, alongside a 3.5 percentage point decline in interest on local-currency credit, and a moderate reduction of the interest on deposits (Table 1.9). To a great extent, the monetary expansion was due to the increase in the monetary loan (discount-window) extended by the Bank of Israel to the banks and the public, which was greater than the decline in the public-sector injection. The monetary expansion, most of which occurred at the end of the year, was not accompanied by an increase in foreign-exchange purchases by the public, apparently because of the attractiveness of investing in the stock market at that time.

At the beginning of 1993 the Bank of Israel acted to raise interest rates in order to reduce the profitability of foreign-exchange purchases for the export of capital. Following the slower rate of price-increases in the middle of the year, the government and the Bank of Israel announced a reduction in the 1994 inflation target, and the slope of the exchange-rate band was adjusted accordingly from 8 to 6 percent (with a 2 percent shift). At the same time, the Bank of Israel lowered the local-currency interest rate.

The stock market surged in August, followed by the rapid expansion of financial assets, credit, and the discount-window loan. These developments can be attributed to the joint effect of the optimistic economic climate arising from the progress towards peace, the revival of economic activity, and the favorable interest rates set by the Bank of Israel. Towards the end of the year it was feared that the monetary expansion would exert pressure on prices or the foreign-exchange reserves and distort the money and capital markets. It was in this context that the Bank of Israel acted to raise interest to some extent, though it was still lower than at the beginning of the year.

The stock-market boom increased the proportion of shares in the public's financial portfolio, and made it possible to raise substantial amounts of capital on this market; offerings accounted for 4.6 percent of GDP in 1993, compared with 2.6 percent in 1992 and 1.1 percent in 1991. One quarter of all offerings were by government companies.

Share prices continued to rise in January 1994, but plunged by about 25 percent in February and March. In April and early May these prices fluctuated within a range which was some 15 percent lower than at the end of 1993. The monetary aggregates continued to expand in the first few months of 1994. As a result of this, and in view of price developments, it was decided to raise interest rates slightly in May.

As stated, the process of reform which began in 1985 has played a vital role in generating the conditions for sustainable growth. Since then, progress has been prominent in some areas and less evident in others. Restrictions on transactions in the money and capital markets, including the export of capital, have been considerably relaxed. The process of removing import tariffs in the framework of agreements with the European Union and the US has continued, and has recently been extended to the EFTA countries. Nontariff barriers to imports from third countries have been removed, being replaced by a tariff which is to be reduced gradually, at a pre-set rate. The special exchange-rate insurance for exporters, travel tax, and the surcharge on imported services were all abolished in 1993. Nonetheless, there was some retreat this year from the liberalization process, expressed in the extension of the period over which the textiles and glass industries are to be exposed to competing imports, and in the discriminatory provisions of the Mandatory Tenders Law.

Private-sector wage agreements have become far more flexible in recent years. Unemployment insurance has also been changed to encourage work-seekers to adapt themselves better to the market. There was, however, only limited progress in improving the structure of wages in the public services and government corporations, even when this rigidity had serious implications for profitability and employment.

Greater exposure to competing imports made it possible to relax price controls. Steps were also taken towards opening the communications and air transport markets to greater competition. But there are still many spheres in which there is too little competition.

Table 1.9
Monetary Indicators, 1987–93

(annual change, percent)

	1987–89	1990–91	1992	1993
Monetary aggregates (average change)				
M1[a]	40	27	19	27
M2[b]	38	30	24	40
M3[c]	25	27	24	36
Short-term bank credit	28	22	23	33
Public-sector injection[d]	–0.9	3.2	3.1	1.3
Bank of Israel injection[d,e]	1.3	–1.1	1.8	2.4
Private-sector foreign-currency sales[d]	–0.0	–1.5	–4.4	–2.6
Nominal interest				
SRO (CD)[f]	14.2	13.1	10.3	9.7
Unrestricted credit[g]	41.8	26.4	19.9	16.4
Average currency-basket interest rate	7.5	8.2	6.0	4.5
NIS/currency-basket exchange rate[h]	11.5	11.3	14.9	8.0
Real yield to maturity on 5-year bonds	3.4	1.7	2.3	2.8
Nominal average share yield	38.0	50.6	56.1	49.9
Nominal GDP (average rate of change)	24.4	25.3	19.0	15.1
CPI (average rate of change)	18.8	18.1	11.9	10.9

[a] MI = currency in circulation and demand deposits.
[b] M2 = M1 + interest-bearing, local-currency deposits and Treasury bills.
[c] M3 = M2 + foreign-currency-denominated deposits.
[d] As percent of GDP.
[e] Contribution to monetary expansion.
[f] Self-renewing overnight deposits.
[g] In local currency.
[h] Annual change.

Additional government companies were privatized, and sales of their shares to the public continued, but progress in the transfer of their control to the private sector is unsatisfactory, particularly with regard to large government corporations. One of the major problems impeding this process is the delay in defining the framework for future government supervision of monopolistic or strategically important companies.

The government is still in indirect control of most of the Arrangement banks, even though there was some progress in their sale in 1993. Some headway was also made towards reorganizing the functioning of the banking system, but a framework which will ensure adequate separation between the various functions of the banks—sorely needed in order to minimize potential conflicts of interest—has still to be approved.

The Encouragement of Capital Investments Law has not yet been amended, despite its many inconsistencies and the fact that a public committee has submitted recommendations for more efficient ways of stimulating development regions by investment in the transport infrastructure, and in local education and public services. These should serve to improve the quality of life in those regions without creating economic distortions.

* * *

Our review of economic developments during the year leads us to conclude that the slowdown in GDP growth in 1993 represents a nonrecurring adjustment arising from a change in the composition of demand, and does not indicate that Israel lacks the potential to continue its economic expansion.

Nonetheless, the question as to how economic growth will be affected by the weakening of the stimuli deriving from the influx of immigrants must be asked; this applies to both the overall and per capita growth rates, as population growth is expected to slacken with the decline in the net contribution of immigration.

In 1990–93 GDP rose by an annual average of 5.6 percent, though the increase in per capita growth was only 1.6 percent, compared with one percent in 1974–85 and 1.9 percent in 1986–89. Thus, the rise in the per capita growth rate in the last few years was not exceptional; it should be noted, however, that it was attained in spite of the shocks which accompanied the process of absorbing mass immigration. Note, too, that there are benefits which derive from an increase in total GDP—a larger market, the smaller proportion of defense expenditure in GDP, etc.

In 1990–93 the effect of reforms introduced earlier was felt, and producers generally benefited from a high level of demand, but factors were also at work which tended to dampen the increase in productivity and per capita growth. These included sharp and frequent shifts in the composition of demand, the large-scale employment of new workers—the skills of many of whom were unsuited for the needs of the market—the reduction of capital stock per employee, and greater intensity of infrastructure use, especially roads. Many of these difficulties came to a peak in 1993, thus partly accounting for the decline in productivity this year.

With regard to the future, there is clearly a potential for improvement which can help raise per capita growth. This derives, first of all, from the moderation of the sharp fluctuations in the composition of demand which accompanied the influx of immigrants.

Second, the participation rate is rising and the quality of the labor force improving due to the large-scale entry into the work force of the children of the baby boom generation—who are better-educated and whose skills are more suited to the needs of the market.

Third, as the new immigrants gain experience in the Israeli labor market, the quality of their labor improves and their human capital is better utilized. (The rise in productivity with length of stay in Israel was one of the factors accounting for high productivity prior to the early 1970s.)

Fourth, the rise in private and public nonresidential investment has already reached proportions which are reflected in increased per capita capital stock. Developments in 1993 indicate that the optimism of private investors has been maintained, though obviously the persistence of a high level of investment depends on an environment of confidence and expectations of further high profitability. Appropriate economic policy and the continuation of the reforms will have a key role to play in creating these conditions.

As far as investment financing is concerned, there appears to be a permanent decline in the private saving rate (see Chapter 2), but this may be offset, at least in part, by a gradual increase in the public saving rate resulting from the reduction of the public-sector deficit and the growth of the investment component of public-sector expenditure. Over and beyond this, beneficial external conditions confronting Israel could encourage outside financing of investments which offer an attractive yield.

Even though the impressive rise in exports in 1993 was partly due to temporary factors, elements appear to exist which will enable it to continue. The rapid rise in exports will facilitate a faster increase in productivity, quicker entry into the world market, and the reduction of fluctuations due to internal developments.

Economic policy has a vital role to play in fostering growth. In spite of short-term pressures, it must give priority to generating an atmosphere of confidence and producing a budget structure which focuses on reducing the tax burden and increasing infrastructure investment, while continuing to reduce the debt/GDP ratio and proceeding with economic reform.

Israel's situation does not require that all the reforms be introduced within a short period, regardless of cost. There is, however, a danger that if they are introduced too slowly, in an attempt to avoid controversy, the process will be stifled and die. The completion of the process of reform would increase certainty regarding the economic environment.

Israel currently has the potential for sustained and rapid economic growth, enabling it to find its place in the international business community and utilize the opportunities which are likely to become available as the peace process advances. This will have further positive consequences, making it possible to expand employment and improve its structure, continue to raise living standards, and ensure a positive immigration balance.