

Chapter 1

The Economy: Developments and Policies

In 1992 GDP continued to expand rapidly, as it has since the current influx of immigrants began; the inflation rate declined but the unemployment rate remained high, and actually increased (Table 1.1). Business-sector product rose by 8 percent, with exports growing rapidly. The increase in the former stemmed from the greater profitability of recent years and the continued expansion of capital and employment. The annual inflation rate declined by 5–7 percentage points (yearly average), reaching 10–12 percent according to various indexes, and the Consumer Price Index (CPI) rose by even less than 10 percent during the year. The budget deficit declined, the balance of payments on current account improved, and both the public debt/GDP and the external debt/GDP ratios fell. Against these achievements, however, the unemployment rate rose to 11 percent, and employment problems appear to have contributed to the decline in immigration.

Table 1.1
Main Economic Indicators, 1986–92

	1986–89 ^a	1990–92 ^a	1991	1992
Growth rate ^b (percent change)	4.7	7.6	7.6	7.9
Inflation during year (percent change in CPI)	18.2	14.9	18.0	9.4
Unemployment rate (percent)	7.4	10.5	10.6	11.2
Immigration ^c (percent)	0.3	3.0	3.5	1.5
Balance of payments on current account (\$ billion)	0.6	0.1	–0.3	0.1
General government deficit (–) (percent of GNP)	–1.8	–3.6	–4.3	–2.4
Total productivity (percent change)	2.8	3.0	3.5	0.5

^a Annual average.

^b In business-sector product.

^c Relative to population.

Developments in Israel's economy would seem, then, to have been mixed in 1992. On the one hand, growth rates were impressive by international standards, inflation fell back to the low rate of the early 1970s, and public finances and the balance of payments were more soundly based. On the other, the high unemployment rate was particularly disturbing in view of the challenges posed by immigration. The situation also raises

some questions about Israel's ability to sustain future growth rates similar to those of 1990–92. In the short run, the expansionary effect of residential construction had run its course by 1992, and the high annual average growth rate of GDP levelled off during the year. It is not yet clear whether the increase in exports and investment can take the place of construction, as part of the growth of exports in 1992 merely compensated for their decline in 1991, and nondwelling investment slowed. Long-term economic growth is not yet guaranteed, and depends on the continued expansion of industrial and infrastructure capital stock, on the better utilization of the human potential available, and on stepping up the pace of economic reform, which was checked somewhat in 1992.

Table 1.2
Business-Sector Growth Rate, 1986–92

	(annual change, percent)			
	1986–89	1990–92	1991	1992
Business-sector product	4.7	7.6	7.6	7.9
Tradables	3.4	6.8	3.1	11.0
Nontradables	5.7	8.2	11.0	5.7
Domestic labor inputs	1.9	5.2	4.7	8.7
Gross capital stock	2.7	2.9	2.8	4.3
Total productivity	2.8	3.0	3.5	0.5
Real unit labor costs ^a	2.1	-2.5	-6.0	-0.5
Net domestic product per man-hour	2.7	2.2	2.6	-0.9
Yield on gross capital	10.0	12.2	12.8	13.2
Gross tax rate on nonwage income	30.9	24.6	23.8	24.6

^a Deflated by producer prices.

Economic developments in the last three years have been molded to a great extent by both the mass immigration which began at the end of 1989, and the government's absorption policies. By the end of 1992 some 460,000 immigrants had arrived in the current influx—the largest since the 1950s. This figure, although high, was lower than expected; the slowdown has been particularly apparent since mid-1991 (only about 77,000 immigrants came in 1992), partly because of absorption difficulties, and employment problems in particular.

The mass immigration of 1990–92 led to a sharp rise in private consumption demand and to an even steeper increase in residential and industrial investment. It also made it necessary to expand some public services more rapidly, though the government kept the increase in other elements of public consumption low, so that public consumption rose more slowly than domestic demand and GDP. Domestic use of resources rose by an annual average of 9 percent in 1990–92, double the average rate for 1986–89. The growth rates of GDP and employment accelerated, that of business-sector product rising from an annual 4.7 percent in 1986–89 to 7.6 percent in 1990–92, and of labor input in that sector from about 2 to 5 percent (Table 1.2). Since domestic use of resources rose more rapidly than GDP in those years, the import surplus increased.

Although the increase in demand led growth in 1990–92, supply conditions also had an appreciable effect. When demand began to increase, the country was suffering from high unemployment, low profitability, and excess capacity. The growth of GDP in those years was made possible by, first, greater utilization of existing capacity, along with higher labor and total factor productivity and, second, the expansion of production capacity through increased capital stock and accelerated labor-force expansion. The pressure on wages exerted by unemployment, together with measures adopted by the government and the Bank of Israel as regards taxation, investment, and monetary policy, increased profitability and helped to expand both current production and investment. This last will in turn serve to raise future production.

In 1991 expansion seems to have been restrained to some extent by limited capacity in the nontradables sector. The damage caused by the Gulf crisis, and the slower development of world trade, also hampered the full utilization of capacity in the tradables sector. Since domestic use of resources rose faster than GDP, and demand was concentrated in the nontradables sector, there was real appreciation in 1991, i.e., prices of tradables (imports, exports, and their domestic substitutes) rose more slowly than those of nontradables, and of construction in particular.

While the demand for construction levelled off in 1992, demand for Israel's exports grew, more than offsetting the effect of the Gulf crisis. The greater increase in demand for tradables than for nontradables, together with the more balanced expansion of domestic use of resources and GDP, slowed real appreciation down. In the second half of 1992 there was even some real depreciation, and this might have been felt more acutely had it not been for the rigidity of the labor and commodity markets.

One of the outstanding features of 1990–91 was the rapid rise in investment, providing the impetus for the acceleration of demand and economic activity. The composition of the increase in investment only partially met long-term growth needs, however.

The main increase in investment was in housing, especially in government-initiated construction. The government encouraged dwelling investment, which it regarded as one of the principal components of immigrant-absorption, offering incentives to contractors, granting larger mortgages, and improving their terms. But the geographical distribution of construction and the size of the units built did not fully accord with either the needs of potential purchasers or employment opportunities. In addition, the employment situation also discouraged potential purchasers from taking on mortgages, and demand for housing contracted further due to the slowdown in immigration. The upswing in residential construction was halted in 1992, and activity focused on the final stages of construction. In August the new government decided to reduce the program of government-initiated residential construction.

Particular importance is attached to increasing industrial investment which, in addition to having an immediate effect on economic activity and contributing to the expansion of productive capital stock, serves as one of the main channels for introducing technological innovations in production. This kind of investment increased in 1990–92 at an annual

average rate of 19 percent as a result of increased business-sector profitability, the measures adopted by the government to encourage investment, the decline in real interest rates, and expectations of rapid growth. These last were influenced inter alia by the improved political climate in the region. Increased industrial investment served to accelerate the expansion of gross capital stock in the business sector from an annual 2.7 percent in 1986–89 to 5 percent during 1992. The increase in private industrial investment slowed down in 1992.

Table 1.3
GDP and Aggregate Domestic Demand^a, 1986–92

	(annual averages)				Percent of GDP 1992
	Real annual change, percent				
	1986–89	1990–91	1991	1992	
GDP	3.6	6.2	6.2	6.6	100
Private consumption	7.0	7.0	7.4	8.3	63
Public consumption	1.6	2.5	1.5	3.3	25
Gross domestic fixed investment					
Nondwelling	1.9	18.6	23.8	8.8	15
Dwelling	2.9	27.2	74.2	-0.9	9
Domestic use of resources ^a	4.7	9.1	12.2	7.0	115
Exports	4.7	4.9	-1.5	14.4	34
Imports ^b	6.8	12.2	15.4	13.0	48
Business-sector use of resources					
Nontradables	5.1	11.7	22.9	4.0	31
Domestic use of tradables	6.4	11.1	11.7	11.2	54
Total use of tradables	5.5	8.6	6.3	12.4	88

^a National accounts figures.

^b Excluding direct defense imports.

Public investment in the infrastructure (electricity, water, transport, and communications) has also risen in recent years. The intensity of infrastructure stock use remained high, however, and went up in certain sectors (roads and electricity, in particular), hampering production, private investment, and the standard of living.

Unemployment rates in the 1980s and early 1990s contrasted sharply with those of the late 1960s and the 1970s, when Israel seemed to be able to maintain a long-term unemployment rate of 3–4 percent. The rate rose to 5–7 percent in the 1980s, however, as a result of the development of unemployment-benefit and income-guarantee mechanisms (which tend to lower employees' incentives to return to work), the increased participation of women, the effect of the wage-negotiation process on real labor costs, lower recruitment of employees in the public services, and the reduction of government support for labor-intensive enterprises. As a result of the economic

slowdown of 1988–89, the unemployment rate had risen to 9 percent before the mass immigration began.

The influx of immigrants swelled the labor force, and in 1992 the number of immigrant participants averaged 155,000, 110,000 (about 70 percent) of whom found work, though only a minority in their previous professions. The difference between the occupational structure of the immigrants and the composition of demand for workers in Israel, in conjunction with the immigrants' problems in adapting to a new economic environment, restricted the economy's ability to utilize their human capital. In addition, the immigrants encountered an unemployment rate which was already high, and pushed it up to 11.2 percent in 1992 (Table 1.4). As the average period of time immigrants had spent in Israel rose, their unemployment rate fell from 39 percent in 1991 to 29 percent in 1992.

Table 1.4
The Labor Market, 1986–92

	(percent change over preceding year)			
	1986–89	1990–92	1991	1992
Average population	1.6	4.3	6.1	3.5
Participation rate ^a	51.0	51.7	51.7	52.0
Israeli employed persons				
Business sector	2.2	4.2	5.9	4.7
Public services	1.6	4.0	6.6	3.2
Unemployment rate ^a	7.4	10.5	10.6	11.2
Real average wage ^b				
Per employee post	5.0	-1.0	-3.0	1.1
<i>of which</i> Business sector	4.9	-1.7	-5.0	1.7

^a This is the actual rate, not the rate of change.

^b Deflated by the CPI.

Although some unemployment—especially that associated with the entry of the immigrants into the labor force—was structural, pressure was exerted on wages, and in 1990–92 this was reflected by a 3.5 percent decline in real wages per Israeli employee in the business sector. Real unit labor costs in that sector fell by 7 percent, after a steep rise following the 1985 economic stabilization program (ESP). Wages per employee post rose slightly in 1992, and the decline in the hourly wage rate and in real unit wages persisted.

The rise in the unemployment rate in the last few years reflects a gap between the growth rate of the labor force (an annual 5 percent) and that of employed Israelis (an annual 4 percent). The growth rate of employed Israelis was lower than that of GDP, principally because of the rise in labor productivity. The increased unemployment of the last few years involves a longer average period of unemployment and poorer employment prospects for labor force entrants.

The inflation rate was far lower in 1992 than it has been in the last few years. Two main trends emerged in the wake of the ESP (Table 1.5); first, price-increases steadied at an annual average of 18 percent, with mild annual variations, and secondly, prices of tradables rose at rates commensurate with price-increases abroad and local-currency devaluation, while prices of nontradables rose faster, reflecting real appreciation and causing the general price-level to rise more rapidly.

Table 1.5
Prices, 1987-92

	(average annual change, percent)			
	1987-89	1990-92	1991	1992
Consumer prices (CPI)				
All items	18.8	16.0	19.0	11.9
Excl. housing	18.1	13.7	15.7	12.2
Excl. housing and controlled commodities	17.3	12.3	14.1	11.3
<i>of which</i> Tradables	13.0	12.0	13.4	10.9
Nontradables	23.6	12.7	15.0	11.7
Business-sector ^a				
Gross product prices	18.4	14.7	19.7	11.2
Nominal unit labor cost	19.7	10.3	12.2	10.1
Export prices ^a	17.0	11.5	15.1	7.9
Import prices (excl. direct defense imports)	15.7	9.8	9.0	7.5
Exchange rate (against currency basket)	10.1	11.1	12.3	10.2

^a National accounts figures.

The trend of real appreciation since the ESP was largely due to pressure of demand—particularly for nontradables—which rose faster than production capacity, and to labor- and commodity-market rigidities, which kept factor returns high in the nontradables sector at the cost of excess capacity.

Although the rigidities have not disappeared, the increase in unemployment of the last few years has weakened them. The rise in unemployment also exerted downward pressure on real wages, and was reflected by a slower increase in nominal unit wage costs—which have ranged from 9 to 12 percent since 1990—as well as by the slowing of price-increases for most goods, with the exception of housing and controlled goods, to annual rates of 14 percent or less since 1990. These developments appear to have affected expectations of inflation.

There was no corresponding slowing of the inflation rate in 1990 and 1991, in fact it accelerated in 1991 because of increased demand, particularly for (nontradable) housing and construction investment.

Although it is still too early to determine precisely why inflation fell steeply in 1992, it would seem to be attributable to a combination of low nominal wage increases—

continuing the trend of recent years—and the weakening of demand pressures, especially for construction. Housing prices increased more slowly, exposing a levelling-off in general price increases—a process which had begun in 1990. Expectations adapted to this relatively quickly.

Other developments also served to reduce inflation. First, the increase in tradables prices was lower in 1992 than the average for previous years, chiefly because of the development of prices abroad.

Second, the government and the Bank of Israel announced a maximum inflation target as well as adherence to a policy for the exchange rate and controlled prices which would be consistent with it. Although the inflation rate actually turned out to be lower than the target, the fact that for the first time a firm commitment was made to price-stability, and that the target set appeared to be attainable, served to moderate inflationary expectations by reducing the probability that inflation would surpass the target. This was particularly important in view of the pressures exerted on the Bank of Israel and the government to accelerate devaluation.

Third, the government reduced the rate at which prices of controlled goods rose; though this was higher than average price increases, it acted as a check on inflation. Price increases were lower in the course of 1992 than the year-on-year average, and some indexes rose by less than 10 percent (including the CPI, which rose by 9.4 percent). The CPI accelerated somewhat at the beginning of 1993, however, led by housing prices.

The rapid expansion of demand and economic activity was also reflected by international transactions. In 1992 the growth rate of GDP was the same as that of domestic use of resources, so that the import surplus/GDP ratio remained unchanged. Both exports and imports rose rapidly, reflecting Israel's further integration into the world economy and helping it overcome the limitations of the small domestic market. The removal of trade barriers also serves to increase production efficiency, which is essential for attaining economic growth and improving the standard of living.

Exports rose by 15 percent, after falling in 1991. This rapid increase, which partly compensated for the adverse effects of the Gulf crisis in 1991, was based on the increase in the profitability of production in the last few years and the acceleration of international trade. In 1992 there was an especially rapid increase in exports of manufactured goods, tourism, and transport. Civilian imports grew by about 13 percent, the rapid rise in private consumption goods and intermediates being especially notable.

In 1992 the entire import surplus was financed by unilateral transfers to the government and the private sector. These amounted to some \$7 billion, compared with \$6.7 billion in 1991 (Table 1.6). The current account showed a small surplus of \$90 million, compared with a deficit of \$340 million in 1991. The net external debt fell by some \$400 million to \$15.1 billion, while the net external debt/GDP ratio continued to decline, shrinking to 23.5 percent, compared with 80 percent in the mid-1980s. The debt-servicing burden also continued to contract. It can be said, therefore, that Israel did not suffer from financing difficulties in 1992.

Table 1.6
Balance of Payments, 1986–92

	(\$ billion)			
	1986–89	1990–92	1991	1992
Import surplus	4.6	6.4	7.1	6.9
Unilateral transfers	5.1	6.5	6.7	6.9
Current account	0.6	0.1	-0.3	0.1
Civilian import surplus	3.1	4.8	5.1	5.4
Civilian imports	17.7	24.6	24.3	26.9
Exports	14.8	19.8	19.2	21.5
Industrial exports (excl. diamonds)	5.9	8.2	7.9	8.9
Implied private capital imports	-0.1	-0.5	0.0	-2.1
Foreign reserves ^a	5.2	6.1	6.4	5.3
Net external debt	17.7	15.4	15.5	15.1

^a At end of period.

At the end of 1992 the US government approved an initial guarantee of \$ 2 billion (out of a total amount of \$ 10 billion over 5 years) against loans to be raised by Israel to finance immigrant absorption. At the beginning of 1993 the first tranche of \$ 1 billion was raised within this framework.

Monetary developments during 1992 illustrate the constraints under which monetary policy operates in an open economy when international capital movements are undergoing liberalization.

The liberalization of the private sector's international financial transactions continued during 1992 as part of the reforms intended to improve the efficiency of Israel's capital market and bring it into line with international markets. The private sector responded to these opportunities and diversified its portfolio by investing abroad; to a great extent this was done through mutual funds.

In December 1991 the Bank of Israel introduced a new exchange-rate system—the sloping band. Under this regime the midpoint rate is adjusted on a daily basis at a predetermined rate, and the actual rate is allowed to move ± 5 percent around it. When the new arrangement was introduced, the midpoint rate against the currency basket was raised by 3 percent, and the Bank announced that the daily adjustment would be equivalent to an annual rate of 9 percent. In November 1992 an additional 3 percent upward adjustment was made in the midpoint rate, and the annual rate was set at 8 percent.

The new exchange-rate regime reduced uncertainty, thus creating the basis for a more efficient anti-inflationary policy, helping to ease the business activities of exporters and importers, and allaying fears of the sudden erosion of unindexed local-currency assets (and weakening expectations of making capital gains by holding foreign-currency indexed assets). At the same time it also increased certainty about the local-currency yield

on foreign assets and the expected local-currency cost of foreign credit. This certainty, together with liberalization, increased the substitutability of assets and liabilities in Israel and abroad, made capital movements more sensitive to interest-rate differences, and encouraged the public to diversify its portfolio by including a larger foreign-currency component. In the second half of 1992 substantial net foreign-currency purchases were made by the public and the banking system.

At the beginning of 1992 the Bank of Israel acted to reduce short-term local-currency interest rates—which had risen considerably at the end of 1991—and bring them into line with the decline in the inflation rate. Between March and December 1992, the nominal interest on the Bank of Israel's discount-window loan was about 11 percent, compared with 14 percent in the first three quarters of 1991. In 1992 the gap between interest on local-currency credit and deposits was narrowed. Real interest on local-currency credit as evaluated by borrowers was lower than in 1991, while depositors benefited from a higher real rate. Long-term real interest remained the same as in 1991.

The combined effect of interest-rate developments and exchange-rate policies increased the expected profitability of foreign-currency vis-à-vis local-currency assets. This, in addition to portfolio-adjustment by the public following the liberalization of foreign exchange, was reflected by the private sector's considerable accumulation of net assets abroad (including debt-repayment). Calculations based on the difference between the private sector's foreign-currency purchases from the Bank of Israel and its current account show that in 1992 the private sector accumulated net assets abroad amounting to some \$ 2 billion. Most of these capital exports occurred in the second half of the year, and were apparently influenced by the dollar's increased strength.

Foreign-currency purchases by the public from the Bank of Israel tend to reduce the money supply and raise interest rates, thus checking capital exports. In 1992 the Bank of Israel compensated for the leakage due to such purchases by increasing the discount-window loan, thereby preventing interest rates from rising.

Private-sector foreign-currency purchases were partly offset by capital imports by the public sector, and financed in part by drawing down the foreign reserves from \$ 6.4 billion at the end of 1991 to \$ 5.3 billion at the end of 1992. As private-sector purchases of foreign currency from the Bank of Israel persisted at the beginning of 1993, the Bank allowed domestic interest rates to rise, so that the public began to sell foreign currency to the Bank and the reserves rose.

The money supply (M1) increased in 1992 at a similar average rate to that of nominal GDP, while other monetary aggregates and credit rose slightly faster (Table 1.7). The value of the public's nonbank share portfolio rose steeply in 1992, continuing the trend of previous years. This should be seen in the context of several factors which have been at work in recent years, including accelerated growth of business-sector product, increased yield on capital, reduced tax rates, the sharp drop in real interest rates since 1988, the smaller supply of new Treasury bonds, and the reduced reserve requirements regarding investment in approved securities by institutional investors. Lower expectations of capital gains on the housing market also appear to have been at work in

1992. The commercial banks also contributed to share-price increases by extending credit for share-purchases, in some cases even encouraging such purchases. The rise in share prices was checked at the beginning of 1993, after interest rates had risen and policy-makers had warned of the dangers of share-price fluctuations.

Table 1.7
Monetary Indicators, 1987-92

	(annual change, percent)			
	1987-89	1990-92	1991	1992
Monetary aggregates (average change)				
M1 ^a	40	25	28	19
M2 ^b	38	28	35	24
M3 ^c	16 ^d	26	29	24
Short-term bank credit	28	22	24	22
Public-sector injection ^d	-0.7	3.1	3.0	3.1
Bank of Israel ^{e,f}	1.6	0.4	0.5	2.3
Private-sector foreign-currency sales ^e	-0.8	-3.5	-3.5	-5.9
Nominal interest				
SROs (CDs) ^g	14.2	12.1	12.9	10.3
Unrestricted credit ^h	41.5	24.2	26.4	19.9
Average currency basket interest rate	7.5	7.5	7.4	6.0
NIS/currency basket exchange rate (during period)	11.5	12.5	11.6	14.9
Real interest on 5-year bonds	3.4	1.9	2.1	2.3
Nominal average share yield	28.5	51.1	58.3	52.2
Nominal GDP (average rate of change)	24.4	23.6	28.9	18.9
CPI (average rate of change)	18.8	16.0	19.0	11.9

^a M1 = 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 1988-89 only.

^e As percent of GDP.

^f Contribution to monetary expansion.

^g Self-renewing overnight (on-call deposits).

^h In local currency.

As share-prices soared and public-sector borrowing declined, the private sector purchased share issues amounting to an unprecedented NIS 3.6 billion (some 2 percent of GDP), and flotations by public-sector corporations rose steeply.

One of the basic elements of the ESP was the drastic reduction of the budget deficit, since large deficits tend to crowd out investment, hamper growth, exert upward pressure on prices, and cause balance-of-payments problems. In view of the need to absorb the mass immigration, which can be regarded as an investment, the government and the

Bank of Israel decided that the budget deficit would be increased temporarily. To ensure that this would not lead once again to persistent large deficits, the authorities initiated legislation requiring that the domestic budget deficit be gradually reduced from 6.2 percent of GNP in 1992, and eliminated by 1995.

The deficit of the general government (the government, local authorities, and Jewish Agency) declined in 1992, reaching 2.4 percent of GNP (4.3 percent in 1991, Table 1.8). The decline is due largely to the reduction of the domestic deficit following an increase in tax receipts. On the expenditure side, the government incurred high outlays arising from purchase guarantees paid to contractors upon completion of apartments built at the government's initiative, and for which there was no demand.

Table 1.8
General Government Deficit, 1986-92

	(percent of GNP)			
	1986-89	1990-92	1991	1992
Total deficit (-)	-1.8	-3.6	-4.3	-2.4
Domestic deficit (-)	-4.1	-6.6	-7.3	-5.7
Domestic income	48.9	45.5	44.7	46.0
Domestic expenditure	53.0	52.1	52.0	51.7
<i>of which</i> Direct domestic demand	29.7	29.2	29.2	28.6
Total public debt	130.6	97.6	94.0	91.2
<i>of which</i> External public debt	30.5	18.9	17.0	18.7

In August 1992 the government decided to stop almost all such construction and increase infrastructure investment. While the latter expanded in 1992, it was not enough to compensate for the past shortfall. The continued neglect of infrastructure investment and preparation of blueprints harms both the economy's capacity for future growth and the government's ability to adopt a flexible fiscal policy without undermining long-term credibility.

The government continued to make funds available for mortgages to the private sector through the banking system. This intermediation constitutes an unwelcome departure from the spirit of capital-market reform.

The budget deficit fell below its planned level as delineated in the legislation referred to earlier. The moderating effect was stronger than is indicated by the reduction of the deficit, since some of the outlay constituted payment of purchase guarantees for past construction and does not directly encourage current demand. The public sector's saving turned positive in 1992 (Table 1.9), i.e., its expenditure on capital account exceeded its deficit.

In 1992, then, Israel was able to record impressive achievements in maintaining economic growth and reducing inflation. Like many other Western countries, however, Israel still faces the problem of high unemployment. Although this is expected in periods

of mass immigration, it may persist. The question thus arises whether Israel's economic policy in 1992 did enough to increase short-term employment and create the conditions for higher long-term employment while making the economy more efficient and raising living standards in the long run.

Table 1.9
The Rate of Saving, Investment, and Current-Account Balance of Payments, 1981-92

	(percent of GDP)				
	1981-85	1986-89	1990-92	1991	1992
Gross national saving ^a	17.0	17.3	20.1	20.8	21.8
General government	-6.3	1.1	0.0	-0.5	2.0
Private	23.3	16.2	20.1	21.2	19.8
Gross investment	19.5	16.2	20.4	22.0	21.9
<i>of which</i> Nondwelling	12.3	11.3	12.3	12.6	12.7
Transfers on capital account	0.7	0.4	0.4	0.4	0.3
Net balance of payments on current account	-1.6	1.5	0.0	-0.9	0.3

^a As percent of all income.

More could have been done to create the conditions for growth and long-term employment. The structure of the budget should have been altered so as to further increase infrastructure investment—particularly in transport, communications, and sewage—and reduce business-sector taxation. The tax reductions should have been of a permanent nature, ensuring their efficiency and helping to raise profitability and encourage employment. However, any further increase in investment incentives might have caused capital to be substituted for labor.

Further reforms should have been encouraged, easing the functioning of the productive sector and encouraging domestic and foreign investors. Not enough was done in 1992 to increase privatization, expand competition, and reduce labor-market rigidities. Competition should have been increased in communications, public transport, and banking. Reform of the banking industry was acutely needed in order to make it more competitive, while reducing potential conflicts of interest and maintaining the banks' stability. (Some steps in this direction have been taken in 1993.) A special effort is required to enhance labor-market mobility, both by moderating institutional rigidities and by expanding vocational training frameworks.

Reforms intended to enhance long-term economic efficiency often arouse opposition and raise problems of adaptation. If the net balance of reforms is positive, there is nothing to be gained by postponing them; they should therefore be introduced as soon as possible, at the same time adopting measures intended to ease adjustment.

Some of the changes required by long-run considerations may also help to encourage short-term economic activity and employment. The question remains, however, whether

more should not be done to encourage short-term economic activity through monetary, budgetary, and employment policy.

In 1992 the liberalization of the financial and capital markets was enhanced and the exchange-rate regime amended, enabling these markets to become more efficient, and making the adoption of anti-inflationary policies easier. But these reforms prevent interest rates from deviating substantially from international ones. Similarly, any departure from the exchange-rate policy could seriously harm credibility as regards the reduction of inflation, which is crucial for ensuring efficient economic functioning and creating an atmosphere which encourages foreign investment. The potential damage caused by deviating from the exchange-rate policy surpasses the temporary and limited gains of accelerated devaluation.

As regards fiscal policy, in the special conditions of 1992 the scope of tax-reductions and infrastructure investment could have been expanded while increasing the budget deficit as far as—but not beyond—the point permitted by legislation.

More direct initiatives could have been made in the employment field in 1992, while avoiding the creation of long-term distortions. One possibility which should have been examined was the creation of temporary employment through projects financed from unemployment funds, serve the economy in general, and do not discourage participants from seeking appropriate employment.

The experience of 1992 once again underlines the importance of adopting an efficient and credible budgetary policy that can cope with short- and medium-term problems without damaging basic long-term aims. Such a policy should address the level, composition, and financing of government expenditure. Decisions on these issues should give due regard to the employment situation, the importance of government investment in the infrastructure, and the reduction of pressure on private sources of finance achieved by a lower public debt/GDP ratio. Only through a long-term budget planning framework, which is based on these principles and adheres to stable macroeconomic policy, can the goal of sustainable growth be attained.