Chapter 1
The Economy: Developments and Policies

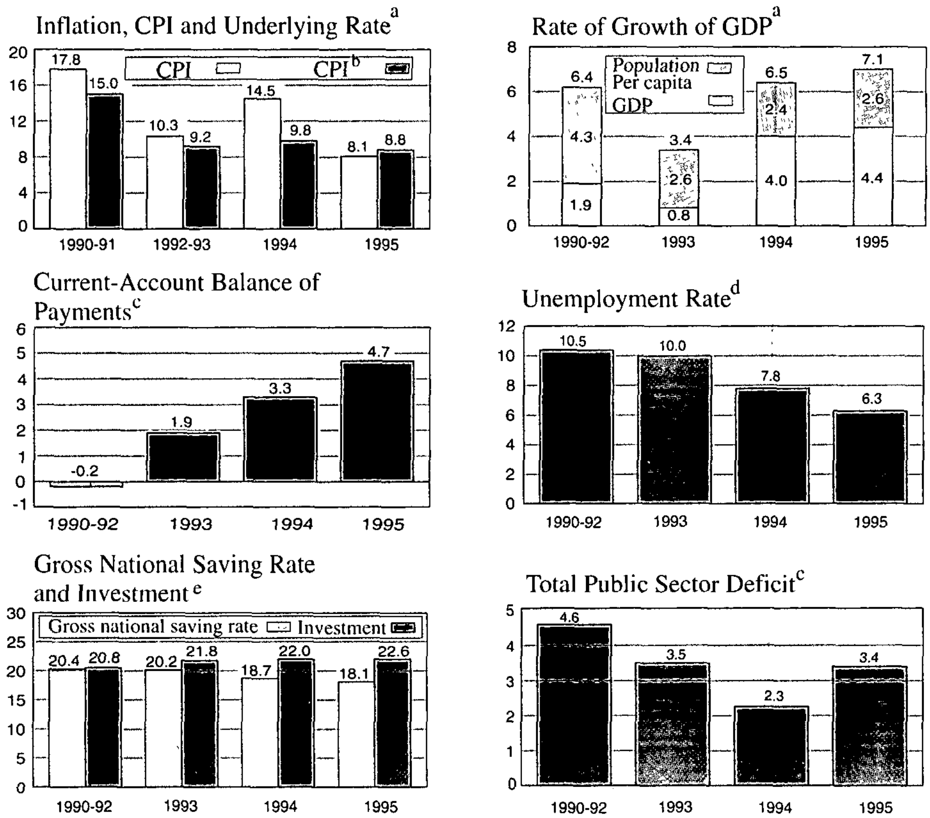
Rapid economic growth persisted in 1995, with a 7 percent increase in GDP, as capital stock continued to soar and employment to expand, resulting in a steep drop in unemployment. GDP growth responded to a marked expansion in demand, led by an increase in investment and expansionary fiscal policy. Export growth was disappointing this year in view of the growth of international trade in general, and in particular the fact that new markets opened up to Israel. These developments, which were accompanied by a deterioration in Israel's terms of trade, were expressed in a sharp rise in the current-account balance of payments deficit, which reached $ 4.1 billion. There was no difficulty in financing this deficit in 1995 because of both Israel's improved international position and the short-term capital inflow that resulted from its contractionary monetary policy. The latter also contributed to the success on the inflation front. The Consumer Price Index (CPI) rose by 8.1 percent during the year, returning to a path that is consistent with the inflation target, after deviating from it in 1994. Despite this year's impressive achievements, the composition of growth and the widening balance of payments deficit indicate that Israel's development track is not sustainable, and needs to be adjusted.

Since the beginning of the decade the economy has been growing rapidly; GDP has risen by 42 percent in the last six years. This is an impressive achievement, bringing per capita GDP to a level not far below the average in the developed countries to which Israel aspires. During this period Israel absorbed a large influx of immigrants, with considerable success regarding employment. The unemployment rate, which rose sharply at first, dropped rapidly, falling below the pre-immigration level, and displaying the characteristics of full employment. Achievements were also made in tackling inflation: the current inflation plateau of approximately 10 percent is considerably lower than the 18 percent prevailing at the beginning of the decade, even though it remains higher than the rate in developed countries.

In many respects Israel's economic vigor and expansionary potential are greater now than ever before. If the present trend could be maintained, it would be possible within a few years to close the gaps that still exist between Israel and average levels in developed countries. The questions that have to be considered are, therefore, what conditions are necessary to maintain this growth trend, and do they exist in Israel?

While many indicators reveal positive economic developments in 1995, others show that this trend is unsustainable. Alongside rapid economic growth—higher investment, a significant fall in unemployment, and the reduction of inflation—the current-account

Figure 1.1
Main Economic Indicators, 1990-95



[a] Percent, annual rates.
[b] Underlying rate: excluding housing and fruit and vegetables; annual rates.
[c] Percent of GDP, annual rates.
[d] Percentage points.
[e] Percentage of total income, annual rates.

balance of payments deficit has risen markedly, and the budget deficit has increased. Public expenditure has risen, particularly on wages, embodying a long-term commitment to remain at a high level.

Economic developments in 1995 should be judged in the context of the growth trend evident in Israel since the beginning of the decade, which was based on large-scale demographic and political changes. In the course of the process of the structural changes that were set in motion in the mid-1980s, making Israel more competitive and increasing profitability, there was a large influx of immigrants that expanded the population considerably and brought in highly educated and technologically skilled human capital. Geopolitical changes in both the global and the regional arenas, opening up new markets and making Israel more attractive, contributed to this development. In order to absorb the welcome addition to the labor force it was necessary to expand investment substantially, relying on outside financing. At the same time, Israel's increased growth potential and the reduction of geopolitical risk served to increase willingness to lend to and invest in it. Thus it was possible to realize Israel's production potential, utilizing the unique advantages of the country and its new labor force by relying on foreign borrowing, and making it possible in the future to service the additional external debt incurred at the initial stages of investment.

Indeed, in the last six years an upward trend has been clearly evident in both residential and nonresidential investment. Capital stock soared, growing by 34 percent, though it still lagged behind the increase in labor inputs (43 percent). The sizable extent of investment made it possible to absorb large numbers of employees in production; most of the incremental labor force (almost 80 percent) was employed in the business sector as the unemployment rate has fallen in the last three years. As expected, alongside the expansion of investment, the balance of payments deficit grew, reflecting the gap between investment and the national saving rate, since there is no need to finance all of the investment from current savings. As long as this gap reflects the expansion of investment at a socially adequate rate of return, Israel can continue to borrow and will be able to service these debts in the future.

Since 1994, however, economic development has been overshadowed by several worrying trends. Against the background of the deterioration in the terms of trade, there was a sharp rise in the standard of living (the share of both private consumption and public civilian consumption in total income rose by more than 3 percentage points). The rise led to the widening of the gap between investment and saving. Unlike investment, a rise in the standard of living cannot create the sources that will enable the economy to service the external debt in the future. Thus, in tandem with the rapid growth of the last two years, demand pressures were created, causing price rises to accelerate and the current-account balance of payments deficit to widen in 1994. Demand expanded in line with GDP in 1995, but the terms of trade worsened further, so that the current-account deficit grew, reaching $ 4.1 billion.

Government policy should have responded to the worsening of economic conditions, but failed to do so. The fruits of growth and the success in reducing unemployment, which was the touchstone for the success of its policy, caused the government to relax its adherence to a policy that is not easy to implement. Thus, in spite of an external situation that has been deteriorating for the past two years, and the fact that growth and lower unemployment make it easier to bear the consequences of a contractionary policy, the government did not adjust its budgetary policy, and even exceeded the deficit target for 1995. Most of the government's efforts to reduce price increases focused specifically on prices of housing (by speeding up the process of making land available for construction) and of fruit and vegetables (by partly exposing agriculture to imports).

In this context, monetary policy acted to adjust the path the economy was taking, first and foremost to return it to the inflationary target for 1995, after the target was not met in 1994. The chief achievement of monetary policy was to reverse the trend of inflationary expectations at the end of 1994 without slowing the rate of growth. Nonetheless, the object of the tight monetary policy was also to dampen demand pressures, and thus to correct some of the deviation from the current-account deficit track. Without firm support from fiscal policy, however, monetary policy alone cannot cope with the problem of the balance of payments. The greater the part played by monetary restraint, the larger the gap between domestic and foreign yields; the gap causes capital inflow, which may impair the profitability of production, and of exports in particular. Furthermore, the capital inflow resulting from this policy made it possible to finance the growing balance of payments deficit, and even increased the foreign-exchange reserves, but this should not have obscured the severity of the balance of payments problem, giving the impression that corrective fiscal policy was not urgently needed. The object of tight monetary policy is to provide support until fiscal restraint takes effect, since the latter inevitably acts more slowly and it is not advisable to rely solely on monetary restraint.

Although there was no difficulty in financing the balance of payments deficit in 1995, a large part of it was financed by short-term capital imports—a situation which is unsustainable. Moreover, an analysis of the factors behind the deficit indicates that much of it reflects a rise in living standards, and this cannot persist on the basis of further foreign borrowing. While investment has soared, helping to create the balance of payments deficit, it does not entirely reflect a socially adequate rate of return, since a considerable part of it is subsidized by the government. In addition, as will be shown below, the composition of growth in 1995 has not fulfilled Israel's potential, as it was not led by a surge in exports, whose increase this year was disappointing. These indicators may have negative implications, raising doubts as to Israel's ability to maintain the growth rates evident since 1990. Consequently, the current track, which is based on a large current-account balance of payments deficit, is unsustainable, and must be amended by means of tight fiscal policy, which will also make it possible to ease the contractionary monetary policy.

In order to obtain a better understanding of developments in 1995, a more detailed economic analysis follows, and the chapter concludes with policy recommendations for achieving the course which will help to close the gap between Israel and western countries.

* * *

GDP grew by 7 percent in 1995, and business-sector product by more than 8 percent. The steep rise responsed to the rapid expansion of domestic demand, led by an 11 percent increase in investment, and in residential construction in particular (19 percent). There was some slowing in the growth of exports, and of goods in particular (non-diamond goods exports rose by less than 4 percent). This slowdown is disappointing, especially in the context of the acceleration of international trade (which rose by 8 percent), the opening up of new markets to Israeli exports, and the massive investment in the economy of the last few years.

Table 1.1
GDP and Aggregate Demand, 1990–95

	Real annual change, percent				Percent of GDP
	1990–92	1993	1994	1995	1995
GDP	6.4	3.4	6.5	7.1	100
Private consumption	6.9	7.2	8.9	7.2	62
Public domestic consumption	3.9	0.4	4.0	2.7	27
Gross domestic fixed investment					
Nonresidential	19.8	16.6	18.3	6.0	17
Residential	26.7	–23.7	3.1	18.7	7
Domestic use of resources[a]	9.2	5.0	8.1	7.2	114
Civilian imports	11.8	12.4	13.7	9.3	46
Exports	4.9	10.7	11.5	10.1	32
of which Goods[b]	5.1	18.1	14.0	3.8	17

[a] Excluding direct defense imports.
[b] Excluding diamonds and Judea, Samaria and Gaza.

The rapid expansion of demand reflects Israel's continued utilization of its growth potential on the one hand, and expansionary fiscal policy on the other. The rise in demand was not accompanied by an increase in excess demand (the share of the import surplus at constant prices remained more or less steady). Consequently it cannot explain the 4 percent decline in the price of exports relative to GDP in 1995, after real appreciation of some 6 percent in 1994 (the appreciation in the price of exports relative to business-sector product was more moderate). Beyond the trend of real appreciation in Israel as a result of the growth process, the real appreciation of 1994 also reflected the increase in excess demand. In 1995 real appreciation was reflected solely by exports, while in the price of imports relative to GDP there was even some slight depreciation—largely connected with the development of world prices, which worsened Israel's terms of trade. The slowdown in the rate of depreciation does not appear to have led to the significant real appreciation of exports, its main effect being felt only towards the end of the year (in the second half of 1995 export prices appreciated substantially).

For the second successive year the development of world prices worsened Israel's relative position, and its terms of trade (prices of imports relative to prices of exports) deteriorated by 7 percent in that period. This development, which harms the economy by reducing national income, was not accompanied by an equivalent reduction in the standard of living; on the contrary, since 1994 there has been a rapid rise in per capita private consumption (in 1993 and 1994 this was accompanied by a sharp drop in private saving, while in 1995 it rose slightly). The government also failed to respond to the external shock to the economy, even though it has persisted for two years. Not only did the government not take measures to offset some of the private-sector expansion, it even increased domestic demand, both directly and indirectly. GDP responded to increased demand by expanding notably, alongside a sharp rise in the gap between imports and exports in the last two years. In 1995 this gap, *less* unilateral transfers from abroad, amounted to 4.2 percent of national income—a rate that is not sustainable.

Table 1.2
Indicators of Business-Sector Production, 1990–95

	1990–92	1993	1994	1995
Annual change, percent				
Business-sector product	7.9	3.6	7.6	8.6
Domestic labor inputs	5.3	4.8	8.7	7.2
Gross capital stock	3.1	5.4	6.9	8.8
Total productivity	3.2	–1.4	–0.5	0.8
Real unit labor costs[a]	–2.9	2.3	2.9	1.3
Yield on gross capital[b]	13.8	14.5	13.4	12.6

[a] Based on net product at factor prices.
[b] Before tax.

From the beginning of the influx of immigrants (at the end of 1989) to the end of 1993 the government maintained fiscal discipline. Although conditions required increased expenditure in order to absorb the immigrants, a law reducing the budget deficit was introduced in 1992 and strictly adhered to as the share of government expenditure in GDP and the tax burden declined. In the last two years this discipline has been relaxed, and this has been reflected not only in the budgetary sphere, as described below, but also in the slowing of structural economic reforms subject to the opposition of various lobbies.

The expansionary fiscal policy adopted in 1994 was reflected principally in the composition of government expenditure, and especially in the agreements granting wage-hikes to public-sector employees on an unprecedented scale over a period of several years. Nonetheless, discipline was maintained with respect to the budget deficit in 1994, and the internal debt/GDP ratio continued to decline. The expansionary trend of government expenditure persisted in 1995, and this was evident not only in the rise in wage payments but also in the growth of transfer payments, increased government involvement in health, and a heavier defense burden. Furthermore, the budget deficit rose considerably and the internal debt/GDP ratio did not decline. A supplementary budget was submitted, at the end of 1994, for the first time since the massive immigration began; thereafter the budget deficit exceeded its legal limit, but is not yet fully reflected by the data because the government postponed part of it technically to 1996. The domestic budget deficit rose in 1995, reaching 4.4 percent of GDP and embodying public-sector dissaving (0.8 percent of GDP).

Table 1.3
General Government Deficit, 1990–95

(annual change, percent of GDP)

	1990–92	1993	1994	1995
Total deficit (–)	–4.6	–3.5	–2.3	–3.4
Domestic deficit (–)	–7.8	–5.2	–3.3	–4.4
Domestic revenues	45.5	46.2	47.0	47.7
Domestic expenditure	53.3	51.4	50.3	52.1
Total public debt (net)	110	102	95	92
of which Internal public debt (net)	91	81	75	75
Government domestic deficit[a]	5.2	2.4	2.0	3.5

[a] Excluding credit.

Public-sector dissaving caused both directly and indirectly, through its components, a decline in the national saving rate, bringing it down to a relatively low level; prominent in this was the steep rise in wage payments to public-service employees, which served to increase private consumption. The low saving rate prevents maintaining a high investment level in the long term. Note that had it not been for the unfavorable external conditions of the last two years, the fiscal policy described above would have caused only a moderate increase in the current-account balance of payments deficit and a slight slowing of the rate of growth. However, as stated, the deterioration in Israel's terms of trade in that period exacerbated the policy's negative effect.

Furthermore since the increase in government expenditure in the last two years incorporates a commitment to maintain a high level, it will limit the potential for reducing the tax burden in the future. By doing this, the government has failed to utilize rapid economic growth to promote its policy of reducing its economic involvement. This could have been reflected by a reduction in the public expenditure/GDP ratio, combined with an increase in expenditure. Opportunities to reduce the tax burden, which the government undertook to do, have not been utilized either, and the realization of the economy's growth potential has been impaired.

As stated, economic growth responded to public and private demand, and was based on the extensive investment of earlier years, which vastly increased capital stock, as well as on the marked expansion of employment. Appreciable investment in R&D, as well as massive government infrastructure investment, contributed to this. Productivity did not increase at all, however, and has not risen in line with the expectations arising from the entry into the labor force of highly-educated employees; these expectations now appear to have been exaggerated. In addition, the massive absorption of new capital stock and the large incremental labor force hamper any significant increase in productivity in the initial stages.

Table 1.4
The Rate of Saving, Investment, and the Balance of Payments on Current Account, 1990–95

(percent of income)[a]

	1990–92	1993	1994	1995
Gross national saving	**20.4**	**20.2**	**18.7**	**18.1**
General government	–0.9	0.1	0.4	–0.7
Private	21.2	20.1	18.3	18.7
Gross investment	**20.8**	**21.8**	**22.0**	**22.6**
of which Nonresidential	12.4	14.6	15.6	15.3
Transfers on capital account	0.4	0.3	0.3	0.3
Net balance of payments on current account	**0.0**	**–1.3**	**–3.0**	**–4.2**

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

The extensive investment evident since the influx of immigrants began is reflected by the rapid expansion (some 9 percent) of business-sector capital stock in 1995. This encompassed almost every industry, and in construction it was even more pronounced. The capital/labor ratio, which slumped when the influx of immigrants began, has been rising steadily since then, and is approaching its previous level. The rise in long-term interest in 1995, as a result of tight monetary policy, on the one hand, and the gap between savings and investment, on the other, brought the interest rate on investments almost into line with the interest rate the economy is facing, helping to make the investing process more rational. However, some of the capital stock that has accumulated in the last few years, especially in industry, resulted from the Encouragement of Capital Investments Law, which subsidizes investments inefficiently, and some of them to a significant extent (almost 40 percent). There was some logic in extending substantial subsidies for a limited period for purposes of immigrant absorption, in order to ensure that high unemployment did not become a permanent feature, as has happened in many other countries. In the last two years, however, after unemployment plummeted and Israel's international standing improved substantially, there was no need to persist with such high rates of subsidy, especially by a process that gives rise to distortions. In addition, given the current state of the economy, and the excess demand, these subsidized investments put further pressure on the balance of payments, while their return may well be lower than the interest the economy pays on them.

The rapid expansion of domestic employment (labor input rose by 6.7 percent) was most notable in the business sector, but was evident in the public sector too, despite the government's decision to cut employee posts (the public sector accounted for one percentage point of both the increase in employment and the reduction in the unemployment rate in 1995). Increased employment, accompanied by reduced unemployment, was based to a growing extent this year on foreign workers, especially—but not solely—in agriculture and construction. No reliable data are available on the extent of this employment, but even estimates which tend to understate it indicate that it is of a magnitude which may cause future social problems. Thus, although the phenomenon may serve to make the Israeli labor market more flexible, its positive contribution should be weighed against the damage it may bring in its wake, particularly in view of the alternative to cheap labor, i.e., technological improvements.

Table 1.5
The Labor Market, 1990–95

(annual change, percent)

	1990–92	1993	1994	1995
Mean population	4.3	2.7	2.6	2.6
Participation rate[a]	51.7	52.9	53.6	53.8
Israeli employed persons				
Business sector	4.2	5.2	7.1	6.5
Public services	3.8	3.9	4.6	4.4
Unemployment rate[a]	10.5	10.0	7.8	6.3
Real average wage[b]				
Per employee post	–0.9	0.6	2.3	2.1
of which Business sector	–1.6	0.3	–0.4	0.2

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

Expanded employment was reflected by a marked reduction in unemployment in 1995—down to 6.3 percentage points, from 7.8 percentage points in 1994. The economy thus reached a high level of employment, exhibiting the characteristics of full employment, in which the attempt to attract additional workers exerts upward pressure on real wages.

Real business-sector wages hardly rose in 1995, so that they have not changed for two years, after falling by about 5 percent since 1990. The moderate rise in 1995 reflects the weakening of the traditional link between increases in public-sector wages and those in the business sector. The cumulative difference between wage developments in the two sectors in 1994 and 1995 was 16 percent, due entirely to wage hikes in the public sector arising from the 1993/94 wage agreements. The relaxation of this link reflects the greater flexibility of the labor market, which is based on trends in labor supply, as well as on the way wages are determined in Israel. Thus, a closer relationship developed between profitability and the labor market, on the one hand, and changes in business-sector wages, on the other. Due to reduced profitability in 1994 and 1995, public-sector wage increases were not emulated in the business sector, thus preventing further damage to profitability and growth. Nonetheless, the minimum wage, which in the past served as one of the channels linking the two sectors, is expected to be raised by some 13 percent in April 1996, so that the threat posed by a certain degree of wage 'trickle down' has not disappeared. Moreover, the moderate rise in the real wage in 1995 represents a greater increase in real wage costs, despite a reduction in employers' contributions to health insurance. Real wage costs rose by 3 percent, and this is equivalent to a 1.3 percent increase in unit labor cost, reducing profitability. Export-oriented industries were hardest hit, due to the deterioration in the terms of trade, and this to some extent explains the slowdown in exports.

Table 1.6
Balance of Payments, 1990–95

($ billion)

	1990–92	1993	1994	1995
Import surplus	6.4	7.9	9.4	11.1
Unilateral transfers	6.5	6.7	6.9	7.0
Current account	0.1	−1.3	−2.5	−4.1
Civilian imports	24.7	28.8	33.2	39.4
Exports	19.9	23.0	25.4	29.7
Implied private capital imports	−0.7	1.0	1.4	6.4
Foreign reserves[a]	6.5	7.1	7.3	8.7
Net external debt	15.2	16.8	17.7	19.2

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

The deterioration in the terms of trade reflects changes in the cross rates of the main foreign currencies and in relative world prices. Much of Israel's exports consist of goods whose prices are indexed to the dollar, which has weakened since 1994, whereas imports consist mainly of goods from Europe, whose currencies strengthened, raising the relative prices of these goods (almost 40 percent of the deterioration in the terms of trade in 1995 was caused by trends in world exchange rates). In addition, prices of the raw materials which Israel imports surged in 1994–95. As a result of these developments the terms of trade have deteriorated by 7 percent since 1994, accounting for some 35 percent of the increase in the import surplus in 1994, and 60 percent in 1995. Prices of imports relative to those of domestic products rose, while those of exports relative to domestic products fell considerably. The rate of growth of both imports and exports slowed: the former rose by 9 percent, compared with annual increases of 12–15 percent in 1991–94, and the latter rose by a modest 3.8 percent. This last development is particularly disappointing in view of the 8 percent expansion of world trade, and of assessments that Israel's export markets had expanded even faster (even taking into account the special adverse effects on Israel's defense exports).

Most of the deterioration in Israel's terms of trade was exogenous, but it is still not clear if it is permanent. Caution obliges policy-makers in small open economies such as Israel's not to adopt a passive stand, because their balance of payments tends to be a vulnerable front. Although the external debt is not large (and the debt/GDP ratio did not rise in 1995), and despite the fact that Israel has a credit line which it has not yet fully utilized (the US government guarantees), this problem should be addressed, as short-term capital flows, which can reverse direction, may be large and exceed the extent of this source.

Israel has not yet encountered difficulties in financing the widening gap in the balance of payments. The greater need to borrow abroad to finance large-scale investment has been matched by international willingness to lend to—and invest in—Israel because, as stated, it was expected that the proceeds of these investments would in future service the loans. With Israel's improved economic standing, reflected by its risk rating, this willingness became even more pronounced, and foreign investments increased. In 1993–94, by far the greatest part of the current-account deficit was financed by long-term capital imports, mainly by the government. In 1995 long-term capital imports totaled $2.2 billion, most of it—$1.6 billion—by the nonfinancial private sector, which is unprecedented. Large amounts of short-term capital also flowed into the economy, most of which can be explained by interest-rate differentials between Israel and abroad. These differences were the outcome of monetary policy, which aimed at maintaining a high level of domestic interest in order to help achieve the inflationary target. This policy also helped finance part of the current-account balance of payments deficit. However, this temporary finance must not be allowed to detract from the urgency of adopting a corrective fiscal policy.

The extent of capital imports due to the interest-rate gap was affected not only by the level of short-term domestic interest, but also by the Bank of Israel's policy of intervention on the foreign-exchange market. For most of the year the central bank intervened in order to minimize the negative repercussions of the fall in the exchange rate on production and exports. This intervention moderated the nominal appreciation of the NIS, however, and the exchange rate remained below the midpoint rate throughout the period. By reducing risk, this encouraged capital imports. The extent of intervention was reduced in the second half of the year, with the widening of the crawling band from 10 percent to 14 percent, although it was not uniform during the whole period. The intervention, together with the continued deviation of the actual exchange rate from the midpoint rate, appears to have reduced the importance of the role of the latter in generating expectations regarding the rise of the exchange rate within the horizon of a year. Although this helped to slow inflation (see below), its price was increased capital imports, with the possibility that in the context of large deficits in the budget, and especially in the balance of payments, these flows could reverse direction if the public were to revise its expectations regarding foreign-currency investment.

The tight monetary policy prevailing since the end of 1994 kept nominal interest high, the object being to hold actual inflation to the target level set by the government and the Bank of Israel. This followed the inflation of 1994 which exceeded the inflation target, due *inter alia* to exceptional wage increases and the rapid expansion of money (M1) in the second half of 1993 alongside low nominal interest. Since then monetary policy has succeeded in offsetting this monetary expansion, bringing M1 back onto a path consistent with the inflation target. After rising by only 5 percent during 1994, money increased by 16 percent during 1995, in line with the growth of nominal GDP.

Table 1.7
Prices, 1990–95

(annual average change, percent)

	1990–91	1992–95	1993	1994	1995
Consumer prices (CPI)	18.1	11.3	10.9	12.3	10.0
CPI excl. housing	14.5	9.7	8.5	9.4	8.8
CPI excl. housing and fruit and vegetables	15.1	9.7	9.0	8.7	9.3
Tradables	12.4	8.5	7.3	7.8	8.1
Nontradables	21.4	12.9	12.8	15.1	11.4
Export prices[a]	12.1	7.1	9.8	5.8	5.4
Import prices[b]	10.2	8.5	9.7	7.4	9.8
NIS/currency-basket exchange rate	11.4	8.6	12.1	7.8	4.6
CPI (during the year)	17.8	10.8	11.2	14.5	8.1

[a] Excluding diamonds.
[b] Excluding direct defense imports and diamonds.

These processes reflect a change of emphasis in monetary policy; whereas previously it focused on the exchange rate and, by maintaining its path, affected all price rises, it now concentrates on setting the rate of interest on the central bank's sources at a level intended to achieve the inflation target. Nonetheless, prices are still evidently greatly affected by the exchange rate. The main change, therefore, is the effect on inflationary expectations, which play a major role in determining prices. Expectations are now influenced directly by interest policy and the message it conveys, not just by the exchange rate and the slope of the exchange-rate band.

The longer tight monetary policy continues, and the more effective the gap between domestic and foreign interest rates, the greater the effect on inflationary expectations. When the process started, a rise in interest rates raised inflationary expectations, but at the end of 1994 significant hikes in interest were followed by reduced expectations.

The CPI rose by 8.1 percent during 1995, following its 14.5 percent increase in 1994. This slowdown overstates the reduction of inflation in 1995. The relative prices of fruit and vegetables, whose link with monetary policy, the exchange rate, and expectations is slight, made a sizable contribution to the change in inflation between the two years. Adjusting for this item, inflation in 1994 was 12.7 percent, and in 1995—10 percent.

The relative price of housing has also changed markedly in recent years. Although it is affected by monetary policy, the overriding factors were excess demand in the industry in the wake of the influx of immigrants and of geopolitical developments, as well as the fact that the government made land available and construction accelerated in 1995. Hence, the relative price of housing rose by 10.2 percent in 1994 and by only 6.7 percent in 1995, and its contribution to the CPI fell from 2.6 percentage points in 1994 to 1.7 percentage points in 1995 (in 1992 the relative price of housing declined by 4.7 percent, and in 1993 it rose by 15 percent).

Underlying inflation—measured on an annual basis by approximation, using the CPI excluding fruit and vegetables, and housing—was 9.8 percent and 8.8 percent in 1994 and 1995 respectively. Since 1992 this index has remained close to 10 percent, supporting the assessment that since then the economy has been at an inflationary plateau of 10 percent, with small upward and downward deviations (in 1994 and 1995 respectively). Other price indices support this finding, but the index in terms of which the inflation target is defined—which serves as the basis for indexation, is published monthly, and is most commonly referred to—is the CPI. The significant moderation of this index starting from the beginning of 1995, when fruit and vegetable prices declined, also helped to lower inflationary expectations, a process led by monetary policy. In the context of reduced unemployment, wage increases in the public sector, and a higher budget deficit, the success of monetary policy in preventing the 1994 level of inflation from persisting, is notable.

Monetary policy affects inflation not only through inflationary expectations but also by influencing the exchange rate. Tight monetary policy expressed in the form of high domestic interest tends to cause capital inflow, a slower rise of the exchange rate, and even appreciation. If it persists, this process can also moderate inflation, but economic

Table 1.8
Monetary Indicators, 1990–95

(annual change, percent)

	1990–92	1993	1994	1995
Monetary aggregates (average change)				
Money (M1)	25.6	24.0	21.0	8.0
Total nondirected bank credit	33.7	44.9	28.1	26.2
Nominal interest				
Bank of Israel	14.2	11.3	13.4	15.6
SROs/CDs[a]	12.1	9.7	11.6	13.3
Nondirected local-currency credit	24.2	16.4	17.4	20.1
Currency basket (average)	7.7	4.7	4.8	5.4
Real interest on 5-year bonds	1.9	2.8	2.9	4.1
Nominal average share yield	52.5	49.9	–10.4	–13.9

[a] Self-renewing overnight (on-call deposits).

rigidities can harm profitability in the tradables sector. In view of fears that a large deviation of the exchange rate from the midpoint rate of the crawling band could erode the profitability of exports, monetary policy moderated the reaction of the exchange rate to the supply of foreign currency, and to some extent moderated the rate of appreciation. That was the rationale behind the Bank of Israel's purchase of a large share of the capital imported between the end of 1994 and the end of 1995, offsetting it by using monetary instruments. Thus only part of the capital inflow affected the exchange rate, which rose by less than the slope of the band. By contrast, international trade prices—which are relevant to the prices of Israel's tradable goods—rose unexpectedly, helping the economy to cope with the slower rise in the exchange rate. In fact, the rate of increase of prices of tradables in the CPI, which is closely related to the exchange rate and world prices, moderated slightly.

The Bank of Israel's exchange-rate policy in 1994–95, which did not accommodate to the exceptional rate of inflation in 1994, and which allowed capital imports to affect the exchange rate, albeit to a limited degree, preserved the parameters of the crawling band. This policy succeeded on the inflation front in 1995, and adherence to it may prevent inflation from accelerating. It would be a mistake to make assumptions regarding the continuation of this policy from the developments in 1995, if a contractionary fiscal policy is not adopted. Although in 1995 monetary policy did not contribute significantly to the slowdown in exports, its effect in this field is likely to increase the longer the policy is adhered to. Thus, if insufficiently supported by other policy tools, continued adherence to this policy in order to reduce inflation is likely to lead to a greater burden on the economy in the production of tradable goods.

In conclusion, despite encouraging developments regarding growth, employment, and inflation, Israel will not be able to continue along the path it followed in 1995, as regards both the size and the financing composition of the current-account balance of payments deficit. The openness of the economy and its wide exposure to international trade and capital flows oblige policy-makers to take probable future shocks which could affect the economy into account. Although there are as yet no significant unfavorable indications, caution demands that the risks to the economy be minimized. Hence, there is urgent need for a reformulation of policy which will allow the economy to develop in the right direction.

To enable progress towards Israel's long-term targets, and to narrow the gap between it and other western economies, the first priority of economic policy must be to return to a sustainable track. To do this the policy mix must be altered: fiscal restraint must be introduced, consistent with low inflation targets and with necessary fiscal reforms, including reducing the relative size of the public sector, on the one hand, and a less contractionary monetary policy, on the other. This will both enable a balance between the various nominal aggregates to be achieved, and calm the financial markets.

Together with the adjustment of Israel's economic path, policy-makers must continue with the structural reforms which will make Israel's economy more competitive. This is vital to enable the economy to utilize its potential since, due to its relative size, it must base its future growth on external markets. Israel will thus continue to be relatively more exposed to external shocks, and internal conditions must be improved to overcome this relative disadvantage.

The reforms required relate mainly to enhancing the efficiency of the business sector. Great strides have been made in this respect, but the process must continue and industries subject to government intervention must be made more competitive. This especially concerns infrastructure industries such as transport, communications, and energy. At the same time, business-sector efficiency can be increased by further reducing the tax burden and making the encouragement of capital investment more rational, requiring that the current law be replaced by new instruments. The new framework should distinguish between encouraging population dispersal and stimulating investment, while reducing the subsidy on the latter. Enhanced business-sector efficiency will increase productivity, which is vital for continued growth. In this context, the contribution of higher education to productivity, and the importance of continued government support for it, should be noted.

Another area in which great progress has been made, but where further improvement is required, is the capital market, especially with regard to strengthening the link between savers and investors. Despite significant capital market reforms and increased liberalization, not enough has been done in this respect, and in fact there was even a reverse trend due to government decisions concerning pension funds. As a result, Israel's capital market does not function as an advanced economy should. On the one hand, this limits the options open to savers, while on the other, it impairs efficient investment financing. The banking system, which serves as an important bridge between savers and investors, is not competitive enough despite the positive changes it is undergoing, and potential conflicts of interest still exist.

Improved efficiency in the manufacturing and financial sectors will enable the economy to flourish. The enormous potential of the economy can be fulfilled if stable conditions are achieved through long-term fiscal discipline as regards both the deficit and the composition of expenditure. This will help combat inflation, bringing it down to western levels. It will also make it possible to complete the liberalization of foreign currency, making the shekel a fully convertible currency.