Chapter 1
The Economy: Developments and Policies

The slack in economic activity, which became evident in the previous year, deepened in 1989. The gross domestic product edged up a mere 1 percent after advancing 2 percent the year before, with industrial product declining for the second consecutive year. Domestic demand weakened following a modest rise in 1988: private consumption and investment drifted down, and public domestic consumption held steady. Exports posted a 4½ percent gain after losing ground in 1988. This shift in the composition of demand was reflected in a marked narrowing of the civilian import surplus, despite a terms-of-trade deterioration. The external current account was in surplus by about $1 billion, and the net external debt was pared.

In the labor market the deepening of the recession was reflected in a standstill in business-sector employment and a jump in the unemployment rate from 6.4 percent of the civilian labor force in 1988 to 9 percent. In addition, real wages softened after rising strongly in previous years.

Consumer price inflation accelerated from 16 percent the year before to 21 percent in 1989. This is explained primarily by the devaluation of the sheqel and the steep hiking of

Table 1.1
Main Economic Indicators, 1977–89[a]

	1977–80	1981–84	1985–87	1988	1989
Inflation during year (percent change in CPI)	80	193	21[b]	16	21
General government *deficit* (–) (percent of GNP)	–13.1	–10.3	1.6	–1.9	–6.1
Net *current account*[c] ($ billion, average)	–1.0	–1.5	0.2[d]	–0.1	1.0
GDP of business sector (percent change)	3.7	2.9	6.1	1.8	1.5
Total *productivity* of business sector (percent change)	0.6	0.5	3.8	0.6	–0.2
Unemployment rate (percent)	3.8	5.1	6.6	6.4	8.9

[a] Percent changes are annual.
[b] From August 1985.
[c] Excluding advances on account of defense imports.
[d] Excludes $1,500 million U. S. emergency aid.

controlled prices at the beginning of year, and so it did not signify a departure from the basic level of inflation of the last few years.

The economic slowdown in 1988 was preceded by two years of very buoyant domestic demand and impressive gains in domestic product and productivity, a trend that set in shortly after the launching of the economic stabilization program in 1985 (Table 1.1). These years also saw a marked erosion of business-sector profitability and structural problems whose roots go back to the period of rapid inflation but which surfaced only after inflation was brought under control. As a result, output shrank in 1988, while domestic demand still expanded moderately; in the year surveyed domestic demand weakened noticeably, aggravating the recession. At the same time, some signs that the economy was getting back on track and functioning more efficiently were already visible in 1988.

The policy measures introduced at the beginning of 1989 were designed to resolve the problems that had arisen, mostly on the supply side. The aim was to help the business sector move out of recession without exacerbating inflation or impairing the long-term objective of reducing the public sector's involvement in the economy. Fiscal policy included, in addition to the pruning of import tariffs under long-term international agreements, the cutting of subsidies, minor changes in other taxes, and stabilization of public domestic demand. The budget deficit swelled this year, but this was mainly due to the recession-related loss of tax revenue. Monetary policy was expansionary and led to a sharp drop in real interest rates. Exchange rate policy included two devaluations in 1989, by a total of 20 percent, together with a change in the management of the rate: the daily rate was now permitted to fluctuate within a band of 3 percent on either side of a fixed midpoint in response to capital movements. At the end of February 1990, the midpoint was again raised (by 6 percent) and the band was widened to 5 percent. Wage policy included a cost-of-living agreement under which the rate of wage indexation to prices was reduced.

The policy measures had only a limited impact on economic activity in 1989. In the early part of the year the slump worsened and only in the second half did the level of activity pick up a bit while business-sector employment continued downward. Business-sector profitability improved somewhat in the first months of 1989 and exports forged ahead, but the sector as a whole has not yet pulled out of the recession and fixed investment is still at a low level. Total productivity did not change significantly in the last two years.

This year's rise in profitability was modest when compared with the three preceding years' erosion. However, the sluggish response of the average level of activity can apparently be attributed also to other factors. Since the introduction of stabilization, and especially in the last two years, several segments of the business sector have managed to increase efficiency, with considerable interindustry and interfirm differences. In industries that suffered in the initial stages of stabilization (metal products and electronics, which were hurt by the cutting back of defense establishment procurements), restructuring began comparatively early, while branches that enjoyed a lively demand in 1986–87 (such as food, textiles, and clothing) were able to defer improvements in efficiency, and here the process got underway relatively late. At this stage it seems that this is taking the shape more of curtailing unprofitable activities than creating new profitable ones. New ventures generally involve the introduction of advanced technologies, and these are reflected in new investments. The headway made this year by some industrial export branches and heavier investment by a number of manufacturing industries suggest entry into new areas, but this year's smaller investment by the business sector as a whole leads to the conclusion that even if such a process has gotten underway, it is still on a small scale. Moreover, in some large economic entities (such as the Koor conglomerate, the kibbutzim, and the moshavim) that are undergoing a recovery program the financial crises have not yet been overcome and their investment is therefore limited.

To reabsorb workers laid off during the process of improving efficiency and those newly joining the labor force, a greatly increased investment is required. This has become more pressing since the upturn in immigration, which began in mid-1989, became more pronounced in the early part of 1990, and is expected to continue gathering momentum. In the short run immigration stimulates domestic demand, thereby boosting economic activity and employment while taking up the slack in production capacity. But if the influx of newcomers is to spark the economy's return to a long-run growth path, a significant expansion of capital stock is also required. Thus there is immediate need for substantial infrastructure investment by the government, as well as much heavier private sector investment. This would make it possible to provide suitable employment for both the jobless and new labor force entrants, residents and immigrants alike.

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The current recession can, as stated, be regarded as a lagged response of the economy to the stabilization program, following a steady deterioration in business-sector profitability in 1986–88 due to mounting production costs (Table 1.2). The modest growth of Israel's overseas sales despite the rapid expansion of world trade in the last two years testifies that the problem was caused mainly by internal factors. The slump was concentrated in the tradables segment of the economy. Industrial and agricultural product contracted in 1988, and the former continued downward in the following year. Construction and services, on the other hand, gained ground in the last two years, although more slowly than in 1987. The *intifada* which began at the end of 1987, is estimated to have shaved 1½ percent from business-sector GDP in 1988. The resulting uncertainty continued in 1989, and this probably goes some way to explain the sagging of investment this year as well.

Since developments in the year reviewed were part of a process discernible since the introduction of the stabilization program in 1985, we shall briefly mention its principal ingredients and the changes it has produced. The program included a shift to a stable exchange-rate regime, the reduction of government domestic purchases, the cutting of subsidies, high real interest rates, and the hiking of effective tax rates. The adjustment of

Table 1.2
Some Determinants of Business-Sector Profitability, 1981–89

(percent)

	1981–84	1985	1986	1987	1988	1989
Annual rate of change						
Wholesale prices, relative to						
United States	0	14	–15	–9	–11	6
Europe	–8	14	11	4	–8	–3
Unit labor costs	1	0	6	4	0	–4
Annual average						
Gross rate of return on capital	13	14	11	11	10	11
Tax rate on nonwage income[a]	25	27	32	31	30	26
Credit subsidy & capital transfers to firms	14	8	7	7	6	5
Real interest rate						
Short-term (average)[b]	14	17	10	20	14	11
Overdraft facilities	21	91	35	39	26	11
Real yield to maturity of bonds[c]	2	6	6	4	4	2

[a] Percent of nonwage income (see Figure 5.2).

[b] Includes short-term foreign-currency credit. The first-column figure is the 1983–84 average.

[c] CPI-indexed government bonds maturing in 5 years.

SOURCE: Relative prices—Table 6.8; labor costs—Table 4.1; return to capital and tax rate—Table 2.2; interest rates and bond yields—Table 7.3.

the business sector's behavior to the drastic changes in policy and in the economic environment is a complex process in which an increase in unemployment is probably inevitable at some stage.

When the program was initiated, the public evidently had difficulty in assessing which of the policy changes would persist, and so it did not immediately adjust its behavior to the initial containment of inflation, nor did it sufficiently revise the patterns of conduct rooted in the period of rapid inflation. Even after the initial lowering of inflation, the business sector was slow in adjusting to the new environment. A number of structural characteristics of the Israeli economy probably contributed to this: easy access of large economic units to relatively cheap credit; the assumption that the government's commitments with respect to employment would induce it to bail them out, an assumption reinforced by the government's behavior in the past; and the rigidity of wage agreements and labor mobility typical of the Israeli labor market (for details see Bank of Israel, *Annual Report 1988*, Chapter 1). The booming domestic demand in 1986–87 and the substantial growth of product and productivity in these years help explain the failure to cope sooner with the inefficiency that was probably already endemic then and delayed the appearance of overt unemployment. A lagged response of the business-sector's output to changes in the wake of stabilization is typical of similar strategies in other countries as well.

As mentioned, the timing and intensity of the problems varied between industries. Financing crises overtook agriculture and building contractors soon after the program went into effect, and they became more severe because of the prevailing high real interest. In agriculture the problems have not yet been resolved, but construction has already pulled out of its slump and is expected to expand further because of the current immigration and the expectation that it will accelerate. The government's refraining from devaluation in 1988, even though it was expected by the public and affected its behavior, aggravated the difficulties in the tradables sector and contributed to the poorer export performance that year. The picture in industry is not uniform: those branches that suffered in the early phase of the program experienced a turnaround in 1989, while those that enjoyed two years of prosperity after the program was introduced are still in the stage of dismissing workers and curtailing output. On average, industry experienced only a partial easing of the supply problems in the year reviewed, and most of the improvement occurred in export firms. The recession hit private services relatively late; until the end of 1987 they recorded exceptional growth rates, and even in 1988–89 they expanded moderately. It transpires, therefore, that the business sector adjusted only gradually to the changes in policy and economic environment, when it became convinced that the new conditions would not be transitory.

Table 1.3
General Government Deficit, 1980–89

(percent of GNP)

	1980–84	1986–87	1988	1989
Total deficit (–)	–10.9	1.8	–1.9	–6.1
Domestic deficit (–)	–11.2	–1.1	–2.9	–7.9
Domestic income	48.2	50.9	48.5	44.5
Direct domestic demand	34.3	29.6	30.6	30.5
Other domestic expenditures[a]	25.0	22.4	20.8	21.9

[a] Includes direct subsidies and credit subsidies (which declined in 1989); and transfers to households and real interest payments (which rose in 1989). For details see Table 5.2.

The general government deficit reached 6 percent of GNP this year, compared with 2 percent in 1988 and a surplus in the three preceding years. The domestic deficit came to 8 percent of GNP. This large deficit was mainly due to the recession-related shrinkage of the sector's tax revenue while its domestic demand remained unchanged. The zero growth of public domestic consumption despite the recession and rising unemployment was consistent with the target of reducing the government's role in the economy in the long run (although 8,000 new employees were added to the payroll this year, half of them were in educational services, a fact explained by the increase in school attendance). On the other hand, there is no justification for halting the growth of public infrastructure investment (such as roads), especially during a slump; on the contrary, it should be stepped up appreciably in view of the big lag in such investment in the past, the high return on it, and its importance for the future growth of the economy.

The real contraction of tax revenue can be attributed primarily to the recession—a drop in income tax receipts because of the erosion of real wages and profits, and a decline in import tax revenue due to a quantitative decrease and a change in the import mix. The amendment of the tax laws, which provided for the lowering of import taxes, was mainly a result of the international agreements signed in the past with the European Community and the United States. Other legislative changes were minor.

The fiscal deficit adjusted for the business cycle was thus significantly lower than the actual deficit. Its marginal growth over 1988 indicates that the increase due to fiscal policy, i.e. over and above that related to the recession, was quite modest this year (the calculations are illustrated in Chapter 5 and show that even though they were based on numerous assumptions, alternative assumptions yield similar conclusions).

Monetary policy in 1989 operated to appreciably dampen domestic interest rates and to narrow the gap between the lending and deposit interest rates. This policy, introduced because of the ongoing recession and the fact that interest was still high even after being reduced in 1988, significantly lowered nominal and real interest rates on local-currency credits and deposits (Tables 1.2 and 7.3) and narrowed the spread between them.

The downturn in interest was accompanied by the growth of the money supply by 5 percentage points above nominal GNP growth, and together they signified monetary expansion. The broader monetary aggregates shrank in real terms (Table 7.1), but since they include deposits whose relative return fell, the downturn in these aggregates did not contradict the general picture of expansion. Long-term interest rates also softened this year, even though demand for long and medium term assets outstripped supply. This is explained by the upturn in household saving and the flagging demand for business investment, which released more real resources than required for financing the government deficit. Monetary policy also had to offset the government's overfunding of its deficit: to prevent upward pressure on interest rates, which would have run counter to its basic policy, the Bank of Israel generally offset the effect of government overfunding on the monetary base by stepping up the discount-window facility.

A policy of lowering interest rates was adopted in the previous year too, but it was interrupted by a speculative wave of foreign-currency purchases towards year's end. Speculative cycles in the purchase and sale of foreign currency by the public are typical of countries where inflation is above the world level, and which have a stable exchange-rate regime that is adjusted from time to time. These cycles hamper the conduct of monetary policy. Policy can moderate the capital flows if it permits local-currency interest rates to respond to speculative swings: to go up when devaluation expectations arise and purchases of foreign currency swell, and to retreat after a devaluation when expectations fade and the capital flow changes direction. The limited flexibility of these interest rates, especially on bank credit, tends to retard their downturn after a devaluation.

The dilemma confronting monetary policy in the last two years because of these speculative capital flows was also associated with the slack in economic activity during this period. Allowing interest to move up steeply in order to dampen purchases of foreign currency was liable to aggravate the slump, while expanding liquidity so as to avert a jump in interest was liable to intensify the outflow of capital to such an extent as to make a devaluation inevitable and to force its timing on the authorities.

The exchange rate was not adjusted in 1988, and monetary policy acted to depress interest rates by expanding the money supply while demand for money apparently slackened. In the fourth quarter of that year devaluation expectations mounted and foreign-currency purchases shot up; the Bank of Israel therefore allowed interest rates to rise. Because of the strength of the devaluation expectations during this period, purchases of foreign currency abated only when a devaluation was implemented (at a cumulative 13 percent rate, in two steps—toward the end of December 1988 and in early January 1989). In the first quarter of 1989 the public sold foreign currency to the Bank of Israel in an amount roughly equal to its purchases in the predevaluation quarter. The January 1989 devaluation was accompanied by a change in exchange-rate management: a midpoint rate was fixed, but the actual rate was permitted to fluctuate within a 3 percent band on either side in order to moderate short-term capital flows.

The deepening of the slump at the beginning of 1989 and the belief that real interest rates at the end of 1988 were still too high were the chief factors prompting the authorities to continue the policy of speedily reducing interest in the local-currency segment of the economy, along with the expansion of the money supply. Toward mid-year, when devaluation expectations again arose, the exchange rate was immediately raised by 6 percent and interest continued downward (Figure 7.1). This time, in contrast to previous devaluations, expectations did not ebb after adjustment of the exchange rate, and in fact they became more pronounced in the last quarter of the year, although not as much as at the end of 1988; they weakened only at the beginning of 1990. In late February 1990, about eight months after the previous devaluation, the midpoint rate was raised again by another 6 percent, and the band was widened from 3 to 5 percent. Exchange rate policy since the beginning of 1989 has thus been characterized by more frequent adjustments than in the previous two years and sharper short-run fluctuations of the rate (Figure 6.2). Such a strategy can moderate the speculative capital movements, but in the short run it weakens the exchange-rate effect on inflationary expectations. Monetary policy, in its broad sense, reflected some shift of emphasis from a further lowering of inflation to stimulating economic activity.

The wage agreements for 1989 were more flexible than in previous years, reflecting adjustment of the wage system to a moderate rate of inflation. The biennial agreement in the business sector for 1988–89 did not provide for any wage hikes. In February 1989 a new cost-of-living allowance (COLA) agreement was signed which stipulated that compensation was to be paid once every six months; this automatic adjustment compensates for 85 percent of price increases in excess of half of one percent a month (3 percent per half year). At the current rate of inflation, the automatic compensation falls about 8 percent short of the rise in prices; thus there is more room than in the past for disparate pay increases at the plant level.

Table 1.4
Prices, 1987–89

(percent change during year)

	1987	1988	1989
Consumer Price Index	16	16	21
Price-controlled commodities	15	20	28
Housing	16	23	35
Fruit and vegetables	–7	19	4
Other items	21	13	16
Import prices (local currency)	18	3	22
Industrial wholesale prices	21	16	20

SOURCE: Tables 3.1, 3.4, and 3.5.

Inflation remained at roughly its level since the introduction of the stabilization program. Prices went up 21 percent during the year, compared with 16 percent in 1988, but this was due primarily to the timing and intensity of the exchange-rate adjustments and the exceptionally steep increase in controlled goods and services prices, mainly at the beginning of the year. In addition, the relative price of housing went up, but fruit and vegetables became relatively cheaper.

The data on production costs in the year reviewed reveal that the prices of imported intermediates rose faster than in 1988 because of the 20 percent devaluation and mounting world fuel prices, while business-sector wages rose more moderately this year (for the first time since 1986 they declined in real terms), and interest rates softened.

After a substantial price increase in the wake of the policy measures introduced in early 1989, inflation fell back to its level of the past few years. In view of the slump, inflation could have been expected to slow more than it did, and it was not until the first quarter of 1990 that the recession made itself felt in prices.

What is more, after the real appreciation of the sheqel in recent years, one might have expected that a cumulative 20 percent devaluation in a sluggish economy, together with a more flexible wage determination, would result in real depreciation. In this context a distinction should be made between two aspects of real depreciation or appreciation: one has to do with the economy's competitiveness in foreign markets, and the second with competition between the tradables and nontradables sectors within the economy. As regards Israel's competitiveness abroad, a drop in the real unit labor cost of industrial exports indicates that exports became a little more profitable in 1989 (Figure 6.8). Another indicator of the country's competitiveness is the ratio between the prices of industrial output for domestic use and the prices of industrial goods abroad (translated into sheqalim at the effective export exchange rate); this indicator shows that Israel became more competitive in the United States but less so in Europe.

On the other hand, when the price movements of goods traded internationally—exports, imports, and locally produced import substitutes—are compared with those of nontradables, the indicators reveal that there was no real depreciation this year, and at most the real appreciation trend of previous years was checked. Export prices (excluding diamonds) went up this year at about the same pace as the prices of domestic resource use; import prices (excluding rough diamonds) advanced more moderately, as could be expected following the reduction of import tariffs; the price increases of nontradables in the CPI basket (excluding housing and controlled items), while lower than in the previous year, remained higher than those of tradables.

We cannot fully explain the sluggish adjustment of prices to the recession and the absence of a significant real depreciation in 1989. It seems that the basic inflation rate is affected more by long-run trends in policy and economic conditions than by short-run fluctuations in the various cost components. Thus the steadying of inflation at around 16 percent in recent years has generated mechanisms for the persistence of this rate, for the public has adapted to this level of inflationary expectations by adjusting its various payments arrangements: the terms of unindexed deposits and credit, wage agreements and the COLA arrangement; the frequency and rates of price adjustments, etc. These tend to stabilize inflation at its projected longer-run rate, and to moderate the public's response to specific policy measures. Such behavior patterns may explain why prices went up faster than warranted by rising costs in 1988, as well as the somewhat diminished impact of costs on prices at the beginning of 1989 and the mild, lagged response of prices to the slack in economic activity this year. It was only in the first quarter of 1990, after more than two years of recession, that the advance of prices slowed.

The movement of *wages* and employment since the stabilization program is a key factor in understanding both the difficulty of further toning down inflation and real developments—the boom of the first two years and the downturn in the next two. After a real decline in 1985, wages rose appreciably in 1986–87 and continued upward in 1988 at a more modest pace despite the sluggish economy; only in the second year of recession did real wages fall, and then at a relatively moderate rate compared with their increase in previous years. There is no simple answer to the question of why it took so long for wages to adjust, and why unit labor costs in the business sector did not decline in 1988, when it was clear that their high level was aggravating the recession.

Table 1.5
Wages and Labor Productivity—Business Sector, 1985–89

(annual average change, percent)

	1985	1986	1987	1988	1989
Nominal wages per employee post	268	66	31	22	18
Real wages per employee post[a]	–6	9	8	5	–2
Labour productivity (product per man-hour)	5	4	3	2	0
Real unit labor cost[b]	0	6	4	0	–4

[a] Deflated by CPI (Table 4.1).
[b] Deflated by implicit price index of business sector gross product at factor cost (Table 4.1).

The data indicate that nominal wages went up from year to year at a decreasing rate (during 1989 they further decelerated to 14 percent). This was consistent with the tendency of behavior patterns in the labor market to respond sluggishly to changing economic conditions, as well as with the slow, gradual growth of confidence in the stability of the new inflation rate and in the sustainability of the government's tougher stance.

Besides the long time it has taken workers and employers to learn what pay hikes were feasible after stabilization, other compelling factors were at work in the labor market in these years to drive up wages excessively: wide interindustry and interplant differences in the firms' financial situation and their ability to raise wages, trade union influence in some industries, the minimum wage law, the effect of other automatic wage components, and the unemployment insurance law. The differential ability of industries and firms to boost wages stems from the disparate conditions in which they operate in the commodity market; this affects average wage awards in the business sector because of the interdependence between wage rises in the different branches, particularly in periods of surging demand for labor. Industries and sectors also differ in the degree of unionization, and this too has a bearing on pay increases, especially when the economy is slack. Thus in a period of growing demand in the commodity and labor markets, wages can be expected to move up faster in sectors that are less affected by international trade, for they will raise prices in response to the heavier demand. In the tradable sector the incremental demand can be met by stepping up imports, and so their ability to raise prices is more limited. However, as stated, there is considerable interdependence between wage rises in different industries; therefore when wages were increased in services in 1986–88 following a rise in their prices, this pulled up wages in industries less able to afford it. As a result, average labor costs in the business sector went up faster than productivity.

Institutional arrangements in the labor market, which make it hard to dismiss workers, render the wage system even more rigid and strengthen the trade unions' hand in keeping wages from falling even in the face of unemployment. Moreover, the minimum wage law apparently pushed up wages in the low brackets by more than was warranted by other factors. Added to this was the effect of unemployment insurance, which enables job-seekers to prolong their search, thus helping to moderate the downward pressure of unemployment on wages. The weak response of wages to the economic slowdown in 1988 may also have been due to the belief that it would not last long.

When the recession deepened in 1989 and unemployment continued to climb, real wages and unit labor costs declined, but much less than their rise in previous years. The decrease occurred mainly in construction and services, while in industry, where trade-union influence is apparently stronger, unit labor costs dipped slightly. Contributing to the downturn were the new COLA agreement (from February 1989), which provided for a smaller compensation for price rises than in the past, and the collective wage agreement for 1988–89 which did not stipulate any general pay adjustments. Wage determination thus shifted more to the enterprise level.

Table 1.6
Employment and Unemployment, 1985–89

(percent rate of change)

	1985	1986	1987	1988	1989
Israeli employed persons					
Business sector	0.3	1.7	3.9	3.2	0.0
Public services	1.7	0.7	–0.4	4.2	1.9
Total labor input[a] (man-hours)	0.1	2.2	3.8	0.3	1.4
Unemployment rate[b]	6.7	7.1	6.1	6.4	8.9

[a] Including man-hours of residents of administered territories employed in Israel.
[b] Percent of labor force (not rate of change).
SOURCE: Table 4.1.

Employment and unemployment were also affected by the structural change in the economy in the last two years. In 1989 business-sector employment was flat on an annual average, a slight rise in the first half of the year being offset by a fall in the second half. This stagnation masked a noticeable intersectoral disparity—a decline in industry and agriculture during the past two years and an increase in services. The downtrend in industry reflected the continued tendency to improve efficiency, which involved the dismissal of workers and the closing of unprofitable plants and production lines. The absorption of workers in existing activities and the creation of new ones is still on a small scale, and the expansion of investment, which is essential for completing the structural change and the renewal of growth, is still dragging. Together with the standstill in business-sector employment, the second half of the year saw an upturn in the public sector. The increment here, half of which was in educational services, is explained by the larger number of pupils this year and the government's decision to restore the previous years' cuts in teaching hours. All in all employment of Israelis edged up by a mere half of one percent in 1989.

The marginal growth of employment was reflected in a rise in the unemployment rate to 9 percent, for the labor force expanded by an appreciable 3 percent this year. The latter development resulted from such demographic factors as a change in the age structure of the population and from an increased participation rate in response to the recession, especially among women. Examination of additional characteristics of unemployment in the year reviewed reveals a high percentage of new labor force entrants among the jobless, a small percentage of youths aged 14–17, and a marked deepening of unemployment (15 days on a monthly average), which was probably connected with unemployment insurance benefits. The high labor force participation rates are hardly likely to recede to their former level when the economy moves out of the slump, and so unemployment can be expected to drift down slowly, even when GNP and employment turn up.

The contraction of *domestic demand* in 1989 was a major factor in the worsening of the recession. A 4½ percent export advance moderated the domestic demand effect of

GNP. Private consumption inched down 1 percent, after rising 4 percent in 1988. The downswing was mainly a compensatory response by households to the surge in private consumption in 1986–87. The reversal of trend began in 1988, when the slowdown in business-sector GDP became apparent—a development due, as stated, to supply-side factors. When it became clear in 1989 that this trend was continuing, that unemployment was accelerating, and that real wages had begun to decline, the public cut back its consumption spending more sharply, and the saving rate rose marginally after it had dipped noticeably since the introduction of stabilization. As expected, the downturn in private consumption was paced by durable goods, just as they led the growth of consumption in boom years.

Nondwelling investment was down 9½ percent in 1989, with motor vehicles plunging 32 percent; excluding this item the decline was 1½ percent. Private sector investment (excluding vehicles) was cut back 5½ percent. The weight of nondwelling investment in GNP has been decreasing for several years, resulting in a sluggish growth of capital stock; the stepping up of such investment in 1987 in response to booming demand and product after the stabilization program went into effect was short-lived and did not carry over into 1988. The stagnation in 1988 was the outcome of a whole string of supply-side problems, which were not rectified and were reflected in a steady drop in the return to capital, financial crises in many industries, and the general atmosphere of uncertainty, which was also connected with the recession and the *intifada*. In 1989 business profitability picked up somewhat and interest rates declined, but there was still no recovery in investment. The reasons were apparently the modest degree of improvement in profitability compared with its erosion in previous years, the continued recession and attendant uncertainty, the time required for planning and implementing investments, and the fact that some large entities which in the past had led investment were still in the process of recovery and had not yet overcome their financial difficulties.

Investment in residential construction also expanded in 1989, by 6 percent. This was

Table 1.7
GDP and Aggregate Domestic Demand, 1986–89

(real change, percent)

	1986	1987	1988	1989
GDP	3.7	5.5	2.1	1.3
Private consumption	14.7	8.5	3.8	-1.0
Public consumption[a]	-2.4	3.1	3.5	0.4
Gross domestic fixed investment				
Nondwelling investment	2.0	15.5	-0.6	-9.5
Dwellings	-5.9	8.3	-0.1	6.2
Domestic use of resources[a]	9.1	6.2	2.7	-0.9
Exports	5.6	10.7	-2.1	4.6

[a] Excluding direct defense imports.

SOURCE: Tables 2.1 and 2.2.

due to an increase in housing starts in previous years, whereas in 1989 the volume of starts fell (a precipitate drop at the beginning of the year followed by a rise). Construction activity is characterized by long cyclical swings, and the relative price of housing fluctuates widely. The past decade witnessed a general declining trend in construction activity, owing first and foremost to demographic developments and the shrinkage of immigration (described in Chapter 2). The growth of immigration in late 1989 and the big increase expected in 1990 should give a strong boost to the construction industry in the coming years.

To round out the picture of aggregate demand we shall examine the development of *exports*. As already pointed out, the world market expanded greatly in each of the last three years, and so Israel's poorer export performance in 1988 and the modest gain in 1989 cannot be attributed to weak demand abroad. The cause lay in domestic developments, chiefly sagging profitability, which affected GDP as a whole. In 1988 some of the problems were more acute in the tradables sector, notably exports, owing to

Table 1.8
Balance-of-Payments Indicators, 1982–89

($ billions)

	1982–84	1986	1987	1988	1989
Current account[a]	–1.8	1.0	–0.1	–0.1	1.0
Civilian import surplus	3.3	2.6	3.3	3.1	2.5
of which Net capital services	1.2	1.7	1.6	1.6	1.4
Net external debt	17.2	18.2	18.2	18.8	16.4
Relative price of exports[b] (1980 = 100)	93	82	79	75	74

[a] Surplus (+), deficit (–). Adjusted for advances on defense imports.
[b] Export prices (excluding diamonds) relative to implicit price index of domestic use of resources.
SOURCE: Table 6.1.

the exchange-rate freeze that year while the public continued to expect devaluation and consequent domestic price rises. The corrective measures introduced at the beginning of 1989 improved profitability, and overseas sales began to recover ground. Over the year as a whole the growth of nondiamond exports was only a little below its long-run trend. Nevertheless, considering the buoyant international trade and the flagging domestic demand, exports could have been expected to make rather more headway. The factors preventing this are described in connection with the development of GDP at the beginning of this chapter. It seems that the process of recovery and improving efficiency has not yet run its course; this is inherently a protracted and complex process, during which there is some shift in production from the home to the overseas markets, especially in industry. The export share of industrial production (excluding diamonds), which exhibits a long-run uptrend, expanded strongly in the last two years, when industrial production fell off while industrial exports advanced 4 percent in 1988 and 9 percent in 1989.

The development of *imports* this year reflected the general slack in economic activity, with the decline being steepest in consumer durables and the transport equipment component of investment, and mild in other consumer and investment goods. Imports of intermediates, excluding fuel and rough diamonds, were 4 percent up on their 1988 level, and fuel import prices soared 22 percent after falling to a similar extent in the previous year (Table 6.4). Domestic prices of imported consumer and investment goods moved down relatively in 1989 following the cutting of average taxes on these items. This included a sharp reduction in customs tariffs under long-term agreements with the United States and the European Community, a step that was also consistent with the long-run target of more uniform exchange rates for the various categories of exports and imports. Toward this end the exchange-rate insurance premium was raised by 2 percentage points in January 1989, by another point in June, and yet another point at the end of February 1990, all this concurrently with changes in the exchange rates. In contrast to the paring of import taxes in recent years, imports are still subject to numerous administrative restrictions. These impede the achievement of a more efficient resource allocation and the functioning of the exchange rate as an anchor for the price level. All told, civilian imports (excluding interest) declined 1½ percent, net interest payments abroad also fell, and the civilian import surplus as a whole shrank by $600 million despite a terms-of-trade deterioration. Foreign transfer payments to the private sector were higher this year. The external current account was in surplus to the tune of about $1 billion, and the net external debt was whittled down appreciably, both in dollar terms and as a percentage of GNP.

The *balance of payments on current account* is conceptually equal to the difference between national saving and total investment The national saving rate edged up 1 percentage point in 1989, with a 5-point rise for the private sector outweighing a 4-point decline for general government. This change in the sectoral composition of national saving can be largely attributed to the smaller tax revenue in the year surveyed (Table 2.6). A comparison of the two halves of the 1980s highlights the stability of the national saving rate over the decade on the one hand, and the conspicuous change in its sectoral composition on the other—a precipitate drop in the private saving rate and a rise in that of general government. The shift from large government dissaving until 1984 to positive saving is one of the major achievements of the stabilization program. In the second half of the 1980s the ratio of investment to GNP also fell, owing partly to the smaller investment in housing and partly to the contraction of nondwelling investment in recent years, as described above. These changes in saving and investment found expression in the shift of the current account from chronic deficits to a surplus. The surplus contained both an element of long-run improvement, since the rise in the public saving rate is not fully offset by the decline in private saving, and a transitory element stemming from the reduction in the investment /GNP ratio. It can reasonably be assumed that a turnaround in dwelling investment, which is expected in view of population trends and the growth of immigration, will be accompanied by an increase in the private saving rate, as well as by some increase in the external debt. Revival of nondwelling investment will also be accompanied by heavier net foreign indebtedness. If the investment incentives are granted according to sound economic criteria, the growth of the external debt will be only temporary, and it will reverse direction when the new investments begin to bear fruit.

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The years ahead confront Israel with a tremendous challenge—absorbing a large immigration the like of which has not been seen since the early 1960s. Besides being a paramount national objective, the immigration will be a boon to the economy, enabling it to move quickly from recession to long-run growth, provided the newcomers, who have a relatively high educational level, find suitable employment. The large initial outlay on their absorption can therefore be perceived as an investment that will give a strong boost to product and productivity in the coming years.

Upon their arrival the immigrants increase domestic demand to satisfy their immediate needs in current consumption, housing, education, etc., and this stimulates economic activity and employment. A further spur to activity and employment can be expected with the gradual entry of the newcomers into the labor force and their integration into employment. To transform this potential into long-run growth, most of the immigrants should be absorbed in the business sector, and this necessitates greatly increased investment. The government can help achieve this objective by creating the macroeconomic conditions required for the business sector to expand and absorb the large potential increment to the work force, Israelis and immigrants alike.

While the most important condition for absorbing immigrants is the availability of employment, the most urgent problem is housing, for the present scope of residential construction and the capacity for expanding it in the short run will not satisfy the expected incremental demand. A major reordering of the economy's priorities is therefore called for in order to allocate the resources required for the initial absorption of the new arrivals, at the expense of other government outlays, and the bottlenecks hindering the expansion of residential construction and business investment must be eliminated.

The government must refrain from actively intervening in the construction of homes for the immigrants and the creation of jobs for them, but it can help indirectly by making more land available for building, reducing taxes and other restrictions on building materials, fostering the expansion of the rental housing market, providing mortgage loans, and alleviating contractors' uncertainty (by committing itself to buy part of the unsold dwellings). As for employment, the government can help by greatly stepping up its infrastructure investment (roads, telecommunications, R&D, etc.), streamlining bureaucratic procedures in connection with investment, and lowering business-sector taxes, especially on labor. Here too it can help diminish uncertainty in the sector by participating in the risks confronting entrepreneurs. In the changed circumstances, increasing importance attaches to completing the reforms begun in previous years—in the financial and capital markets, in the methods of encouraging investment, in direct taxation, in achieving more flexible wage determination and greater labor mobility, liberalization of the country's international trade and capital movements, and privatization of government companies. Continuing with these reforms would be essential even in the absence of immigration, and much more so in the new environment. They will contribute to the growth of business investment and help attract foreign investors.

Despite uncertainty about the future volume of immigration, at present it seems that it may run to hundreds of thousands within a comparatively short period. In these circumstances, even with an extensive reordering of budget priorities, the required extra outlay on immigration absorption and infrastructure investment will result in a much heavier government spending in the coming years. This could drive up the country's external debt during this period. If immigration exceeds present forecasts, the current-account deficit could, in the short run, exceed the easily accessible sources of financing. Nevertheless, Israel's sound balance-of-payments position in recent years permits a controlled rise in foreign indebtedness; the resulting long-term growth of GNP would make it possible to reduce the debt after a few years.