CHAPTER I

THE ECONOMY: DEVELOPMENTS AND POLICIES

Two of the most crucial problems facing the economy became more acute in 1984: inflation accelerated greatly—prices were more than five times higher at the end of the year than at the beginning; and the difficulties in financing the balance of payments deficit persisted despite a big decrease in the private sector's import surplus. Economic growth and productivity remained flat, and the labor market slackened further. After doubling in the last quarter of 1983, t monthly inflation rate again shot up in the autumn of 1984. This persuaded the government, Histadrut (Trade Union Federation), and the employers' organization to reach an agreement (the "package deal") for stabilizing prices during a three-month period. It succeeded in restraining inflation to a remarkable degree, but the upward pressure on prices that built up during this period caused a renewed burst of inflation upon the expiration of the agreement, despite the signing of a second package deal.

The 1984 economic developments had their roots in trends that have persisted for the past several years. While some of these trends are related to external factors, for the most part they originated in the economic policy measures implemented in recent years. The perennial large fiscal deficit has had a decisive impact on the economy; it reflects a high level of public spending, over half of it on defense, and a relatively small net tax revenue, the resultant of high tax rates and a large volume of subsidies and transfer payments.

Economic policy frequently changed course in the past few years, with the stress alternating between the balance of payments deficit and inflation. Moreover, at no time was the policy a comprehensive one, and so the principal target was not always met, and in most cases there was even a retreat in the secondary target.

In 1980 the government conducted a contractionary fiscal policy, which centered on deep subsidy cuts and the erosion of public sector wages; the import surplus narrowed, but the inflation rate rose steeply. In 1981 top priority was accorded to combating inflation, by subsidizing basic goods and services more heavily and lowering direct and indirect taxes. In 1982 subsidies were again cut, and because of the war-related expenditures, direct and indirect taxes were stiffened. Toward the end of 1982 and the beginning of 1983, the stress again shifted to the inflation front, but at the end of the year it moved back to the balance of payments.

Table I–1

MAIN ECONOMIC INDICATORS, 1978–84

(Percent annual increase unless otherwise stated)

	1978	1979	1980	1981	1982	1983	1984
Resources and uses (in constant prices)							
Total uses, excl. direct defense imports	4.8	6.5	–1.5	4.8	4.5	5.5	–0.9
Gross domestic product							
Measured from expenditure side	3.7	4.7	3.5	3.2	0.8	2.0	1.1
Measured by sectoral origin	6.5	5.3	–0.9	4.0	2.6	4.4	0.2
Business sector gross domestic product[a]	3.4	5.0	4.1	3.8	–0.4	2.4	1.1
Real disposable private income[b]	5.6	2.4	1.7	12.9	–2.6	1.6	5.5
Private consumption							
Total	8.0	7.9	–2.9	10.8	7.4	7.5	–6.3
Per capita	5.7	5.3	–5.2	8.8	5.3	5.5	–8.1
Public consumption							
Total	8.4	–8.7	9.1	6.9	–8.1	–5.7	6.8
Excl. direct defense imports	–1.4	2.5	3.5	1.3	3.1	1.7	0.2
Thereof: Civilian consumption	5.4	2.1	–1.2	0.9	0.7	0.6	–0.1
Fixed capital formation	5.7	12.1	–9.8	3.7	4.2	13.0	–13.3
Public sector income[c]/GNP (percent, in current prices)	48	51	48	47	52	53	44
Subsidies and transfers to the public/GNP (percent, in current prices)	28	28	27	31	31	30	31
Balance of payments and international reserves (in $ billion)							
Imports	10.0	12.0	13.9	15.1	15.3	15.4	15.7
Exports	6.8	8.3	10.1	10.8	10.4	10.3	10.8
Import surplus	3.2	3.7	3.8	4.4	4.8	5.2	4.9
Foreign currency debt[d]	8.7	10.7	11.6	13.4	15.6	18.3	19.4
Foreign exchange reserves[e]	1.1	0.4	0.3	0.1	0.3	–0.1	–0.6
Population, employment, and wages							
Average population	2.2	2.5	2.4	1.8	2.0	2.0	2.0
Number of Israeli employed	4.6	2.3	1.1	2.0	1.4	3.2	1.5
Unemployment rate (as a percent of civilian labor force), absolute level	3.6	2.9	4.8	5.1	5.0	4.5	5.9
Monthly wage per employee post (in current prices)	54	90	123	138	117	156	385

[a] Excludes imputed residential rents.
[b] From all sources.
[c] Revenue from taxes and property income.
[d] Gross foreign currency liabilities, less net foreign exchange reserves at the Bank of Israel, liquid assets in other financial institutions, and exporters' credit to foreign customers.
[e] Gross reserves at the Bank of Israel.

Table I-1 (cont.)

	1978	1979	1980	1981	1982	1983	1984
Monetary (in current prices)							
Money supply	45	31	98	81	111	132	352
Total liquid assets of the public	70	86	150	109	128	217	458
Bank credit to the public[f]							
December–December	80	101	110	82	138	133	516
Average level	84	80	103	103	102	129	354
Prices							
Consumer price index (Dec.–Dec.)	48	111	133	101	131	191	445
Price deflator for gross domestic product, at market prices (average level)	55	81	127	126	121	150	382
Productivity and labor cost, business sector (in constant prices)							
Total productivity[g]	3.4	0.3	–1.5	1.6	1.4	1.1	–3.0
Real unit labor cost[h]	6.7	2.5	–8.8	–0.6	6.2	2.6	–6.0

[f] Credit to the private sector, excluding the financing of fuel imports; since 1979 includes credit from overseas branches of Israeli banks.

[g] Product per combined unit of capital and labor; the product is measured by sectoral origin.

[h] The product is measured from the expenditure side.

These frequent policy shifts aggravated the problems and created mounting uncertainty in many areas of the economy, especially in 1984. Furthermore, public confidence in the government's readiness to achieve a real breakthrough waned, a situation exacerbated by the growing gap between the official and the various effective exchange rates and the imposition of more stringent restrictions on the acquisition and holding of foreign currency.

In 1984 too no overall economic policy was implemented. What is more, the government budget had an expansionary effect because of a sharp drop in net tax revenue. When fears arose during the year of a possible further tightening of foreign currency restrictions and a worsening of institutional financial savings terms, the public reacted by acquiring foreign currency at the expense of government bonds. This altered the budget deficit financing mix: Whereas in previous years the government covered the bulk of the deficit by selling financial assets to the public, in 1984 the net sale of such assets was negligible, and the public diverted most of the large government monetary injection to the acquisition of foreign exchange. Thus the deficit was actually financed chiefly by the sale of foreign currency to the public, with a consequent running down of international reserves held by the Bank of Israel.

The balance of payments difficulties that were encountered in 1984, despite the reduction of the current account deficit, were related primarily to the financing of the deficit and the aforementioned ebbing of public confidence. The large capital inflows, which financed the growth of the current account deficit in previous years (the capital imported by the private banking system in 1981–82 and for supporting bank shares in 1983), ceased this year, and the public's loss of confidence induced a heavier speculative purchase of foreign currency for portfolio purposes. Thus, notwithstanding the current account improvement in 1984, the economy again had to resort to short-term financing, and international reserves continued to dwindle.

A particularly noteworthy favorable development was the contraction of the private sector's import surplus by a formidable $1 billion in 1984, after a $1.6 billion increase in the two preceding years. This reflected a turnaround in domestic demands (private consumption, investment, and public consumption excluding direct defense imports) relative to the growth of product. After expanding rapidly for three consecutive years (6.5 percent on an annual average), domestic demands sagged 6 percent in 1984, while the domestic product increased, albeit at a mild rate (1 percent) even in comparison with the three preceding years (an average of 2 percent). The narrowing of the import surplus in 1984 was due primarily to the cutback in domestic investment, and only marginally to an increase in national saving. The rate of private saving rose strongly, but the public sector saving rate dipped sharply. Moreover, this was the third straight year that net national saving was negative, a disturbing development which implied that part of the economy's incremental foreign debt served to maintain the level of private and public consumption.

The slackening of domestic demands on the one hand and a vigorous (14.5 percent) gain in exports on the other resulted in a comparatively small growth of product. This year's better export performance can be credited to the buoyant international trade and the weakness of the home market, which was accompanied by an improvement in export prices relative to those of domestic uses. The labor market was also slack this year, as evidenced by a sluggish (1.5 percent) growth in employment, some increase in the unemployment rate, and a drop in real wages owing *inter alia* to the unexpected aggravation of inflation.

The slackening of domestic demands and the narrowing of the import surplus began in mid-1983, and became more pronounced in the fourth quarter of that year following the collapse of bank share prices; this diminished the public's wealth and especially its liquidity. These developments led to another switch in policy emphasis. As already pointed out, in 1981 the government initiated a strategy designed primarily to curb inflation, even at the cost of a balance of payments deterioration. It raised subsidies, lowered commodity import taxes, and beginning in September 1982 slowed the depreciation of the sheqel relative to the rate of domestic inflation. These measures, however, failed to reduce inflation, and their negative impact was expressed in an ensuing fiscal expansion, a real appreciation of the currency, and expectations of a corrective devaluation. These factors, together with the world market slump, resulted in the widening of the import surplus, which is largely financed from short-term sources that cannot be taken for granted in the long run. The protracted real appreciation of the sheqel stimulated speculative demand for holding foreign currency on the one hand, and depressed demand for alternative financial assets, including bank shares, on the other. Given the longstanding practice of some of the leading banking groups of supporting their shares, this reshuffling of the public's financial portfolio led to the discontinuation of this practice and the plunging of bank share prices in October 1983.

After this crisis economic policy again focused on the balance of payments, and sought to quickly reduce the import surplus, even if this involved a worsening of inflation. In October 1983 a sizable devaluation was implemented and the subsidies on basic items were cut. Subsequently exchange rate policy again switched to a faster depreciation of the sheqel in an attempt to preserve as much as possible of the real October devaluation. These steps gave a strong boost to inflation, doubling the monthly rate compared with the four preceding years, and eroding much of the real devaluation. This reversal of policy arrested the speculative purchase of imported consumer and capital goods, which had been stimulated, as stated, by the relatively low exchange rate and mounting devaluation expectations. This development, along with the shrinkage of the public's wealth and its liquidity, the slackening of the public sector's direct demands, and the lowering of the high real interest rates in the economy, depressed total domestic demands and imports. Private consumption slumped by an unprecedented 6 percent, with purchases of consumer durables falling off 32 percent and other items by 2 percent. The downturn in domestic demands apparently helped to check the acceleration of inflation—which stabilized at a 13 percent monthly rate—and to achieve a certain real depreciation of the sheqel. It is important to note that the diminution of the public's wealth and its liquidity, which had a dampening effect on private consumption in 1984, was short-lived. In the course of the year the public began to rebuild its financial portfolio as a result of asset accumulation generated by the government deficit, and of the real depreciation of the sheqel against the dollar.

The government's declared policy, which aimed to reduce the import surplus, was not supported by a restrictive fiscal policy capable of sustaining the achievements in this area. The public sector had an expansionary effect on the economy in 1984, when its demand surplus nearly doubled because of an unprecedented decrease (40 percent in real terms) in net tax absorption (taxes less subsidies and transfer payments). The sector's direct domestic demands, on the other hand, edged down 2 percent, as civilian and domestic defense spending held steady and nondwelling investment was severely cut back.

The smaller net tax absorption was due to an especially precipitate drop in tax receipts and a renewed increase in subsidies immediately prior to the Knesset elections and during the package deal period. The 14 percent real decrease in tax revenue was caused by a number of factors, headed by the shrinkage of customs and purchase tax receipts because of a smaller purchase of imported consumer durables (which are heavily taxed) and the escalation of inflation, which aggravated the erosion of tax receipts. Such a sharp real drop in tax revenue points up the need for an extensive revamping of tax legislation and the tax collection system.

As stated, inflation accelerated to a very worrisome degree, from 191 percent in 1983 to 445 percent this year. The deterioration began with the reversal of economic policy in October 1983 because of the swelling of the current account deficit and the external debt after the bank share crisis. The government implemented a large devaluation, sharply hiked the prices of subsidized products, and decided to trim its spending. These changes, together with the drastic reduction of the public's financial portfolio after the collapse of bank share prices, dampened domestic demands and generated forces that produced a small real depreciation of the sheqel. But the government tried to achieve a larger real depreciation and to maintain it by stepping up the current nominal adjustment of the exchange rate. As a result, inflation accelerated strongly. The structure of Israel's financial market, in which the bulk of the public's holdings is linked to the consumer price index or the exchange rate, and the incremental liquidity pumped into the economy by the government and Bank of Israel generally permit the almost full translation of cost increases into higher prices without greatly harming real activity. But the weakening of domestic demands in the fourth quarter of 1983 and during 1984 and the less-than-full adjustment of financial asset holdings and credit to the mounting costs let only part of the cost pressure find expression in the inflation rate; consequently there was a 4 percent real depreciation of the sheqel in the fourth quarter of 1983, which was preserved during 1984, with some variations around election time. In retrospect, it seems that such a real rate of depreciation could have been achieved through much smaller nominal adjustments than were actually made, which would have largely restrained the acceleration of inflation.

The decision to hold early elections to the Knesset triggered renewed expectations of a large devaluation and the adoption of tough measures after the elections. This spurred another wave of speculative foreign currency purchases. The new government opted for another bout of cost increases to alleviate the balance of payments strain in the short run. In August the sheqel was again devalued, the prices of subsidized items were raised, and administrative restrictions were imposed on imports. Since these steps were not accompanied by a corresponding decline in domestic demands, and given the structure of Israel's money market, the inflation rate again shot up. The expectation that the government would freeze prices under the package deal induced producers to raise their prices even more steeply.

The failure of the measures introduced in August and the fear that they would generate hyperinflation prompted the government, Histadrut, and employers (represented by the Coordination Bureau of the Economic Organizations) to sign an agreement providing *inter alia* for the freezing of prices for a three-month period beginning in November. The package deal succeeded in drastically curbing the rise of prices for a short period: between the signing of the agreement and its expiration prices moved up at a relatively mild 4 percent monthly rate. Among the contributory factors in this favorable development were the recognition by all parties concerned of the need to reduce inflation, and the expectation that during this three-month period the government would formulate a comprehensive economic plan. It should nevertheless be noted that the receding of inflation can be partly attributed to the hiking of many prices on the eve of the deal in anticipation of the freeze.

Despite the success of the first package deal, it generated suppressed upward pressure on prices, mainly because the sheqel was depreciated faster than the rise of commodity prices. The effective exchange rate for imports went up more slowly during this period owing to the freezing of import taxes, but it still outpaced the actual rise of prices by 12 percentage points. This gap arose because of uncertainty regarding the extent to which the package deal would succeed in reducing inflation, and the fear of a real appreciation of the sheqel if prices should not slow down in line with the depreciation of the currency. Since the package deal was not preceded by any budget cuts with a view to creating the conditions for such a high real depreciation, and since taxes, which had been frozen under the agreement, returned to their original high level upon its expiration, the nominal depreciation of the sheqel engendered renewed upward pressure on prices. Furthermore, confidence in the deal gradually faded as the government failed to present a comprehensive economic program, and also because the subsidies on basic items, which were already very high, continued to grow. Thus it is no wonder that the target set in the second package deal was not met, and that inflation soared to 13 percent a month in February and March 1985. This led to the introduction of technical changes in the agreement, but they failed to prevent a dramatic 19 percent jump in the consumer price index in April.

The temporary success of the first package deal and the lack of success of the next two testify that it is impossible to harness inflation by administrative means alone. Without an overall plan, which will totally freeze all costs and monetary aggregates, together with a significant pruning of the budget, the price level cannot be stabilized for any length of time.

The nominal expansion of financial assets and bank credit accelerated strongly this year. The real balance of the various monetary aggregates also rose rapidly, with all the increase concentrated in the fourth quarter. This year's monetary developments were influenced primarily by the bulging government deficit and the difficulties encountered in financing it through the sale of financial assets to the public because of the anticipation of a real depreciation of the sheqel and some loss of confidence in government financial assets. The faster nominal growth of the various aggregates was also influenced by the escalation of inflation toward the end of 1983.

The government deficit in relation to GNP reached 16 percent, compared with 11 percent in 1983 and 15 percent in 1982. This year's increase was entirely due to the much lower tax collection and higher subsidy bill. The injection generated by the government's operations rose more modestly than the deficit because of a decrease in government credit to the private sector. The Bank of Israel injection also drifted down in 1984 and amounted to about 2 percent of GNP; this was due to the reduction of directed credit and discount-window lending to the commercial banks. The total external injection of the government and Bank of Israel as a proportion of GNP fell by 1 percentage point to stand at 12 percent.

Until 1983 the government deficit was financed primarily through the sale of financial assets to the public, and only fractionally by private sector purchases of foreign currency. As a consequence, the government's internal debt swelled to extraordinary proportions. Because of the huge internal debt and the expectations of a real devaluation generated by the exacerbation of the balance of payments problem from 1981, in the last two years the public preferred to acquire foreign currency rather than government assets. In 1983 the public's preferences were expressed by a heavy purchase of imported consumer goods and a drop in purchases of government bonds; in 1984 there was no net purchase of government bonds, the acquisition of consumer durables fell off, and a large part of the government deficit was financed indirectly through the purchase of foreign currency by individuals for their portfolios and for repaying foreign liabilities.

The preference for foreign currency over domestic assets linked to foreign currency is explained by the public's assessment that the risk associated with government bonds was growing. This was because of the enormous internal debt, to which was added last year a possible future government liability in connection with the arrangement worked out after the bank share crisis, and also because of the fear of an adverse change in the terms of the debt due to the balance of payments deterioration. The public therefore altered the composition of its financial portfolio on the margin (i.e. it slightly reshuffled its portfolio by significantly changing the composition of its incremental assets). Such a variation in the public's preferences obviously has negative implications for the foreign exchange reserves held at the Bank of Israel, and also regarding the need and ability to borrow from abroad.

The massive purchase of foreign currency left only about a quarter of the total government and Bank of Israel injection in the economy, compared with a half to three quarters in previous years, while three quarters of the injection was diverted to the acquisition of foreign currency by the public. The incremental domestic liquidity was channeled entirely to the narrow money base, mainly because of the Bank of Israel's policy of promoting the sheqel segment.

The much smaller accumulation of domestic assets squeezed the sources of credit expansion, especially long-term sources. At the same time, credit demand rose strongly because of an increase in the expected yield on foreign currency investments, and also because of the collapse of bank shares (which had been perceived as a liquid asset by individuals and many firms) and the subsequent discontinuation of their support. As a result, the real interest on bank credit went up, while its real volume did not grow from the end of 1983 until November 1984. In December, however, there was a big expansion of bank credit despite a further rise in its cost. To some extent the increased cost was probably due to the expectation that inflation would be higher than during the first package deal period. Outstanding bank credit rose 10 percent in real terms during the year, but the average level was 3 percent lower than in 1983.

This year's steep rise in real interest also reflected the Bank of Israel's credit policy, which was implemented primarily via the discount-window loans and the discount rate. The Bank of Israel let real interest go up mainly in order to discourage borrowing for financing the speculative purchase of foreign currency, and also to restrain demand for goods and services. But it should be emphasized that if real interest rates stay at such a high level for any length of time, it is liable to harm economic activity and growth.

Another factor that greatly influenced the nominal expansion of the monetary aggregates in 1984 was the jump in the inflation rate toward the end of 1983, since a large part of the financial assets and credit is linked to the consumer price index or the exchange rate. The net outcome of all the aforementioned factors—the external injections, balance of payments absorption, bank credit, and the value-linkage mechanism—was a much more rapid nominal expansion of total financial assets, with the average monthly growth rate going up from 7 percent in 1983 to 16.5 percent in 1984. This represented a 14 percent real increase over the year, which was concentrated mainly in the final months, and this after financial asset holdings had shrunk 21 percent in 1983. These data do not include the accumulation of foreign currency by individuals, which continued this year as well. It should be remembered that the shrinkage of the public's financial portfolio at the end of 1983 was one of the principal causes of the slackening of demands this year. The renewed growth of the public's wealth in the wake of the swelling government deficit makes imperative a more significant cutting of government spending, which would also permit a further improvement in the balance of payments.

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The gravity of the problems confronting the economy and the inability to overcome them in recent years through partial measures call for an overall, consistent policy designed to quickly reduce inflation and simultaneously achieve a structural improvement in the balance of payments. As the Bank of Israel has stressed in the past, a necessary condition for the success of the government's economic policy is the dampening of domestic demands by reducing the fiscal deficit. This target can be met by rehabilitating the tax system, revamping transfer payments and subsidies, and above all, by significantly reducing government demand. By rehabilitating the system of taxation we refer not to the stiffening of taxes, but primarily to a reform in business sector taxation and a more efficient collection. Most direct and indirect taxes are very high, and this spurs tax evasion and even has a work disincentive effect. It is therefore desirable to lower taxes, especially on labor, and concurrently to reduce transfer payments and the subsidization of basic products. This would restore net tax revenue, which has eroded in recent years, without impairing the equality of income distribution. Restraining demands is to be preferred, for unlike the raising of indirect taxes and the lifting of subsidies, it does not generate upward pressure on prices.

In recent years, in response to the balance of payments deterioration, levies have been imposed on commodity and service imports, export incentives have been granted, and trade and payments flows have been restricted. These measures have created a system of multiple effective exchange rates, which cause economic distortions and encourage the foreign currency black market. Improving the balance of payments by reducing the government deficit would make it easier to unify the exchange rates and to lift the administrative restrictions on trade and payments flows.

Narrowing the fiscal deficit would lead to a better national saving performance and a smaller import surplus, besides bolstering confidence in the government both here and abroad. Credibility is necessary in order to restore confidence in Israel's capital market and to change the deep-rooted inflationary expectations. An appropriate reduction of the fiscal deficit would enable the government to stop borrowing from the Bank of Israel. Greater government reliance on tradable bonds for rolling over the internal debt would enable the Bank of Israel to operate in the open market and to control the nominal monetary aggregates. But in view of the inertia that characterizes the inflationary process and its strength in the Israeli economy, the government must formulate an overall plan centering on significant budget cuts and a freeze of the principal monetary aggregates and costs.