Chapter 1

The Economy: Developments and Policies

The year 1991 is the second consecutive year to be dominated by the influx of immigrants which started in 1989. The picture that emerges from the principal indicators (Table 1.1) is of a second year of substantially higher investment and economic activity. Business profitability and productivity show marked improvement and there is an appreciable rise in employment. But these developments must also be judged by the needs of immigrant absorption, and by this standard the year has not been altogether successful. The tempo of economic activity slackened somewhat at the end of the year and the beginning of 1992. Moreover, most of the year's growth occurred in industries producing inputs for housing construction, whose considerable expansion is temporary; in other industries there are as yet no discernible indications of the onset of sustainable growth. Immigrant absorption encountered considerable difficulties during the year; towards its end these were being expressed in a slower inflow of immigrants and a decline in investment and economic activity.

Table 1.1
Main Economic Indicators, 1986–91

	Annual average 1986–89	1990	1991
Growth rate[a] (percent change)	4.6	6.6	7.0
Total productivity[a] (percent change)	1.2	4.3	2.4
Gross rate of return on capital[b] (percent)	11.0	12.0	14.7
Unemployment rate (percent)	7.1	9.6	10.6
Balance of payments on current account ($ billion)	0.4	0.6	–0.9
National saving rate[c] (percent)	17.1	17.5	20.0
General government deficit (–) (percent of GNP)[d]	–0.2	–2.7	–2.6
Inflation during year (percent change in CPI)	18.2	17.6	18.0

[a] In business-sector product.
[b] Business sector.
[c] The denominator is GNP *plus* unilateral transfers (converted to NIS at the official exchange rate).
[d] *The 1991 estimate is downward biased.*

The immigration raised strong hopes that, in spite of short-run difficulties, there would be a change in the trend of economic developments. They were based on forecasts of one million immigrants within the next five years—many of them with higher, chiefly technological, education—whose integration into the labor force would make a substantial contribution to productivity and economic growth. Realization of these hopes presents a challenge to both the government and the business sector.

The government decided on a strategy of abstaining from intervening directly in the integration of immigrants into employment, while giving them subsistence grants during their first year of residence. In addition, the government would be concerned with the creation of an adequate infrastructure and a more favorable and less uncertain environment in which the business sector would be able to absorb the extra supply of labor gradually. This strategy was based on the view that although in the short run direct intervention could provide jobs, in the long run it would be counterproductive, perpetuating resource misallocation and interfering with the proper utilization of human capital. Such an approach is suited to the Israeli economy of the 1990s and the markets in which it must compete, but since it does not bear fruit immediately it requires perseverance. The integration of immigrants into employment proceeds slowly at first and the rate of unemployment rises temporarily. If the process is to be speeded up, the government must improve the underlying conditions and generate business confidence. This requires a series of measures which are essential if the economy is to attain the correct growth path, but which are futile if not pursued beyond a critical minimum. The first prerequisite is to increase business profitability by cutting taxes, particularly those which reduce the propensity of firms to expand and employ more workers. In addition, government infrastructure investment must be stepped up substantially, since adequate transport and communications facilities stimulate business-sector investment and are a prerequisite for competing in the world market. The reforms needed in the labor, commodity, and capital markets are also of great importance; they should increase competition, reducing costs and thus raising business profitability.

Even before the advent of immigration this bundle of measures was called for by the economic conditions of the last few years—low business profitability, a low growth rate, and fairly high unemployment. Immigration has made the need to remedy matters far more pressing, and in fact this year the government has decided—in line with the strategy adopted—on a series of reforms, infrastructure expansion, and direct incentives. What has been done has been too limited and too hesitant, however.

The government's housing strategy, by contrast, has placed growing emphasis on its commitment to meet immigrants' housing needs in full, with greater involvement in construction, as regards its volume, location, and price. Thus the government concentrated its efforts and spending on housing, at the expense of appropriations for expanding the infrastructure and raising business profitability, impairing the ability of firms to respond adequately. Furthermore, the government's intervention in housing has induced entrepreneurs to enter this industry, with its limited growth capacity, thereby reducing the prospects of success of the strategy selected to deal with the employment problem.

For their part, firms have begun to respond, as reflected in increased investment, including a considerable inventory build-up, chiefly of imported intermediates (non-dwelling investment rose by 22 percent in 1990 and by 26 percent in 1991; the corresponding figures for imports of intermediates are 12 and 15 percent). Employment also began to rise in 1990—a trend that strengthened in 1991—and output increased substantially, but the relative profitability of construction rose because of the government's increasing emphasis on housing. As a result, a large proportion of the incremental investment and employment was in construction and allied industries. By contrast, investment, employment, and output increased little in industries with a potential for sustainable growth. These developments, the result of both government policy and unfavorable external conditions, cooled business-sector optimism and held back its growth rate.

Table 1.2
GDP and Aggregate Domestic Demand, 1986–91

	Percent of GDP			Real annual change, percent		
	1986–89	1990	1991	1986–89	1990	1991
GDP	100	100	100	3.6	5.4	5.9
Private consumption	64	64	65	7.0	5.3	7.6
Public consumption[a]	26	25	24	1.2	3.2	1.8
Gross domestic fixed investment						
Nondwelling	13	14	17	2.1	21.6	25.8
Dwelling	5	6	9	2.9	14.8	76.0
Total domestic government demand[b]	29	29	31	1.7	6.0	14.1
Domestic use of resources[a]	109	109	116	4.6	7.6	12.4
Exports						
Total	43	39	36	4.8	3.0	-2.3
Excl. diamonds, tourism, and exports to the administered areas	28	29	28	5.6	6.5	0.7

[a] Excluding direct defense imports.
[b] Public consumption (excluding direct defense imports) + general government investment + publicly initiated housing.

World trends were particularly unfavorable in 1991. The Gulf War broke out at the beginning of the year, but the adverse effects of the run-up to it were already evident in the summer of 1990. Economic activity and exports suffered—increasingly so in early 1991—the uncertainty endemic in the Middle East grew, and firms' propensity to invest declined. When the war ended it seemed likely that Israel would receive extensive aid from friendly governments, but in the event, there was only a small increase in unilateral transfers, while the U.S. government guarantees for immigrant absorption failed to materialize. In addition, the recession in the western economies further slowed down the expansion of world trade in general and the demand for Israeli exports in particular. Thus the combination of reduced world demand and lower profitability relative to construction and allied industries meant that in the export-oriented industries output and employment grew by very little.

For these reasons—and most probably also because internal events in the former Soviet Union reduced fears that emigration would be stopped—the flow of immigrants lessened, and no more than 180,000 arrived in 1991, much less than forecast at the beginning of the year. The result was to dampen economic optimism.

Business-sector gross product rose by 7 percent in 1991, about the same as in 1990. The increase was generated by domestic demand, which was dominated by the government (with total domestic government demand up by 14 percent). Most of the increase stems from construction and allied industries. The change in the composition of output is a response to the exceptional (76 percent) rise in housing demand, which was generated by massive government involvement rather than the market. Other components of domestic demand also continued to grow, and faster than last year, but their share declined. The rise in domestic demand increased GDP, but it pushed imports up by over 16 percent, compared with 9 percent in 1990. Exports other than tourism failed to increase, and total exports declined owing to the effect of the Gulf War on tourism. The combined result of these developments was a simultaneous increase in the import surplus and in relative construction prices.

Over half the increase in economic activity was generated by residential construction and allied industries, in spite of the sector's small size (it accounts for 15 percent of business-sector product). Additional capacity was needed to meet the heavy housing demand, and there was some adjustment to the capital stock; at the same time, it was clear that this level of demand would be temporary, so that full adjustment would be uneconomic. Thus in spite of a substantial rise in employment, which made a further increase in output possible, the construction sector was unable to meet the demand; part of the excess was met by imports, including commodities not previously imported due to high transport costs. At the same time, as stated, excess domestic demand raised the relative price of construction output.

In the rest of the business-sector investment grew more slowly. It was particularly low—in comparison with needs—in export-oriented industries, considering the age-composition of their machinery and equipment and the structural change in hi-tech industry previously specializing in military products. Employment also grew by very little (2 percent), reflecting the weakness of demand: foreign demand for Israeli exports (especially tourism) fell off, while on the domestic side, private consumption (the mainstay of expansion in the past) did not rise vigorously enough, the major increase being in machinery and equipment, the demand for which is usually met by imports. In sum, business-sector output other than construction and allied products rose by no more than 3 percent, much less than forecast at the beginning of the year.

As immigration slowed down, it became clear that the volume of residential construction undertaken was excessive and was not yet matched by effective demand.

Table 1.3
Demand for Business-Sector Product: Tradables and Nontradables, 1989–91

(percent change over preceding year)

	Quantity			Price		
	1989	1990	1991	1989	1990	1991
Nontradables						
Total	3.2	4.0	14.6	23.3	20.0	21.5
Excl. housing[a]	3.7	4.8	20.7	19.8	15.4	18.4
Tradables						
Total	–0.3	7.6	7.0	19.7	11.8	15.3
Excl. exports	–3.3	11.1	13.5	17.5	12.2	15.0

[a] That is, excluding imputed housing services.

Excess supply is particularly marked in remote districts. Sooner or later the construction industry will presumably shrink back, in conformity with long-run trends rather than temporary changes. Economic growth can then be based mainly on other industries. The most important industries with a growth potential are those able to compete in the export market, where they can realize economies of scale and enjoy high rates of profit and growth. These industries failed to grow much in 1991, and the increase in their capital stock is not yet sufficient for the large expansion needed for economic growth and to absorb additional workers.

In addition to the limited contribution of government policy, which lacked the scope and resolution demanded by the strategy chosen, as well as to problems specific to 1991, investment is also adversely affected by the uncertainties besetting the Middle East. On the positive side, the rate of return on capital, which was very low during the 1980s, has recently begun to rise owing to streamlining in the business sector and supporting interest-rate and tax policies. It grew substantially this year, chiefly owing to the decline in real business-sector labor costs. Furthermore, Israel has a special advantage in its rich endowment of human capital, which has been greatly enlarged by the present immigration, and this too has a positive effect on investment. It is not yet clear however, to what extent the new human capital can be immediately utilized by the business sector. There is some evidence to suggest that efficient utilization means that firms must invest in training, so that from their point of view, the effective volume of unemployed immigrant labor falls short of the measured volume.

The labor market showed more signs of flexibility this year, but the remaining institutional rigidities are far from negligible. The substantial growth of the labor force exerted pressure on business-sector wages, which fell by a real 4 percent (deflated by the CPI), the greatest decline observed in recent years. Nevertheless, although real wages have now declined for three consecutive years, the exceptional rise that followed the 1985 stabilization has not yet been cancelled. Real wages failed to contract by more—in spite of the rise in the unemployment rate—due to labor market rigidities. Some of them are specific to Israel and stem from institutional factors, while others arise from the advantages of long-term employment for both employer and employee. Moreover, in some industries, the effective excess supply falls short of the measured excess supply because of differences in the human capital of Israelis and immigrants, and because the immigrants are not familiar with some of the local production processes. This also reduces the pressure of excess supply on wages. The decline in real wages did not result in higher profitability for all producers. Although average labor costs (deflated by producer prices) did fall, the decline was concentrated in the nontradables sector (chiefly construction), while in the tradables sector they rose. This intersectoral difference (which does not extend to nominal wages) primarily reflects real appreciation (whose results are explained below). Taking changes in productivity into account, the real labor cost figures indicate that the rise in 1986 and 1987 has been only partly offset.

Table 1.4
The Labor Market, 1986–91

(percent change over preceding year)

	1986–89	1990	1991
Israeli employed persons			
Business sector	2.2	2.1	5.9
Public services	1.6	2.3	6.6
Unemployment rate[a]	7.1	9.6	10.6
Real average wage[b]	5.0	–1.0	–2.0
of which Business sector	4.9	–1.6	–3.8
Labor productivity, business sector	1.4	3.8	1.6
Real labor cost, business sector[c]			
Tradables	8.2	5.1	0.9
Nontradables	3.1	–3.7	–6.5

[a] This is the unemployment rate, not the rate of change of unemployment..
[b] Deflated by the CPI. The 1991 figure does not include workers from the administered areas.
[c] Deflated by producer prices.

In these market conditions, business-sector employment rose by 6 percent. Over half the additional employed persons were immigrants, of whom close to a quarter went to occupations in which at least some of their skills could be utilized (see Table 4.16). About two thirds of the additional employment was in construction and allied industries—as mentioned, this does not reflect permanent employment.

Public services employment rose by 6½ percent, an increase dictated by the education, health, and welfare needs of the additional population. However, despite increasing unemployment, and in contrast to the business sector, real wages rose by 2 percent, an increase that hampered the response of business-sector wages to market forces.

Although employment rose substantially, it failed to keep pace with the labor supply, principally because new immigrants were quick to join the ranks of work-seekers and because they have higher specific labor-force participation rates than the established population. The unemployment rate, which rose throughout the year, reached an average of 10.6 percent. The increase was concentrated among immigrants, with an average of 39 percent, while the number of unemployed established residents declined. High unemployment rates of immigrants in their first year or two in the country reflect adjustment problems and are typical of migrations to other countries as well. However, many of the immigrants seem to have been unwilling to endure such an initial adjustment period and employment difficulties may well have played a significant role in reducing the number of arrivals in 1991 and early 1992. Interim solutions should be explored—provided they do not interfere with the desirable long-run development of investment and the ongoing reforms, and make possible a long-run solution of employment problems consistent with the strategy outlined above.

Fiscal policy, as expressed in the budget, is by and large a reflection of the government's immigrant absorption effort—as regards both what it includes and what it omits. Expenditure was increased by transfer payments to immigrants and by the provision of education, health, and social services for them, as well as by extensive spending on housing. As regards the latter, the budget so far includes only a part of the total outlay—the government's involvement and the decisions taken entail a considerable additional burden in the next few years: housing subsidies to home-buyers have been raised and new obligations have been created by giving purchase guarantees to contractors; only a small proportion of the guarantees have been paid off this year, but it is expected that the proportion called in will rise in view of the low demand by immigrants for owner-occupied housing. In particular, it is highly likely that the government will be obliged to buy in the many units erected in remote districts, and will be able to sell them off again only at a heavy loss—this could (according to some estimates) amount to as much as $1 billion (2 percent of GNP). If this were to happen, the functioning of the housing market would be impaired.

This year, too, incremental spending on infrastructure has fallen short of requirements, in spite of the considerable benefits to be gained in terms of economic growth. The situation is particularly acute in the case of roads and advanced telecommunications, where there is a large backlog due to past neglect—road traffic density rose this year in spite of the increased investment.

The rise in public spending was in part offset by increased taxes—the average tax rate rose, the net result of higher indirect tax and lower direct tax rates, the latter being chiefly a temporary measure to alleviate the burden on the business sector. The net outcome was to lower profitability (the changes which raised it had little effect because of their transience). Fiscal policy was thus inconsistent with the strategy chosen by the government to deal with the employment problem. This policy implies a deficit which appears to be larger than is consistent with stability, but is nevertheless on a downward trend (since some of the outlays are temporary, while the revenue should increase as economic activity steps up). Furthermore, towards the end of 1991, the government committed itself to a declining deficit until the budget is balanced in 1994—that is, to a fiscal policy consistent with long-run stability. This commitment increased certainty, a signal that was contradicted by the fact that the measures entailed by the policy decisions were not in fact implemented in full. The excessive housing outlays (on both construction and subsidies to home-buyers) went well beyond the sums budgeted (as stated, these amounts do not all figure in the 1991 deficit). Moreover, not a few of the government's decisions (particularly those concerned with labor-market flexibility) have been rejected by the Knesset, which has furthermore recently passed a number of laws entailing a considerable overstepping of the budget—contrary to the government's stance (see Chapter 5).

In accordance with its reform decisions, the government made efforts to speed up privatization, being aware of the importance of signalling—at home and abroad—its intention of reduce its business-sector involvement. Moreover, at a time of high deficit-funding requirements, the proceeds of privatization can be used to prevent an excessive rise in the public debt; here, too, not all the decisions have been implemented—in particular, the sale of the Arrangement bank shares, which is taking too long. In fact, the government's increased involvement in credit represents a retreat from capital-market reforms already implemented.

Table 1.5
General Government Deficit, 1986–91

(percent of GNP)

	1986–89	1990	1991
Total deficit (–)	–0.2	–2.7	–2.6
Domestic deficit (–)	–2.5	–5.5	–5.4
Domestic income	48.9	45.2	44.2
Direct domestic demand	29.7	29.7	28.4
Other domestic expenditures[a]	21.7	21.0	21.3

[a] Includes direct subsidies, credit subsidies, transfers to households, and real interest payments.

The budget deficit amounts to 2.6 percent of GNP, similar to last year, and the domestic deficit to 5.4 percent of GNP. This is below the planned figures for 1991, and may reflect the effect of slower immigration. As stated, the figures do not cover a good part of the outlays to be incurred as a result of decisions taken during 1991. Furthermore, government credit to the private sector expanded this year, the incremental-credit/GNP ratio amounting to 2.1 percent, a much higher figure than in the past, so that the government's financing requirements rose steeply. Funding was mainly by domestic borrowing, thereby raising the interest rate on government bonds.

Along with the rise in long-term interest rates, share prices and housing prices rose steeply, particularly in the first three quarters of 1991; these rises were fuelled by expectations connected with the influx of immigrants, which raised the expected yield on these assets. Interest rates on short-term assets did not rise, although the decline of the preceding three years ceased. The divergence between short- and long-term rates is attributable to monetary policy, which was geared to supporting economic activity—as long as there is no danger of an appreciable drain on the foreign reserves. Accordingly, the monetary aggregates and short-term bank credit were allowed to expand in accordance with demand, and they rose at roughly the same rate as nominal GDP. Nevertheless, real short-term interest rates were still high in 1991 and impaired profitability. In the fourth quarter, foreign-exchange purchases stepped up (owing to devaluation expectations and the approaching date of redemption of the Arrangement bank shares), and the Bank of Israel enabled interest rates to rise appreciably in order to prevent a substantial increase in the exchange rate. Interest on bank credit did not fall back to its former level until early 1992, after revision of the exchange-rate mechanism and considerable sales of foreign exchange.

Table 1.6
Monetary Indicators, 1986–91

(percent)

	1986–89	1990	1991
Monetary aggregates (average change)	77	27	28
M1	64	25	35
M2	31	23	28
M3	35	24	27
Short-term bank credit			
Nominal interest			
SROs (CDs)	15	13	13
Short-term bank credit	33	23	26
Foreign credit[a]	8	8	6
Nominal GDP (average rate of change)	32	22	29
CPI (average rate of change)	26	17	19

[a] Three-month Eurodollar rate.

The events of the fourth quarter of 1991 illustrate the dilemma that has confronted monetary policy for the last six years. On the one hand, the exchange rate serves as the anchor for the price level; this helped to stop the very high inflation of the early 1980s. On the other, Israel has a higher rate of inflation than its trading partners, and over-rigid adherence to this anchor is liable to injure exports and increase imports. Defense of the exchange rate entails maintaining the level of reserves and, in periods of speculative capital exports, is reflected in a rise in interest rates, with adverse effects on current economic activity and investment.

The exchange-rate regime has been altered several times in the last few years. Until 1989 there was a fixed rate with periodic adjustments. A band was then introduced (and later widened); changes in the midpoint rate did not entail a rise in the actual exchange rate. These changes were designed to moderate the speculative cycles and their real cost by reducing the expected profit from discrete changes in the exchange rate. The midpoint rate adjustment of March 1991 departed from this pattern inasmuch as it did raise the actual rate, thereby reinforcing the speculative cycle of the third quarter. Once this cycle had turned down, a further change was made, with the introduction of the 'diagonal' (as distinct from horizontal) band. Accordingly, the midpoint rate (together with the upper and lower limits of the band) changes daily at a rate which cumulates to 9 percent over the year. This innovation should further restrict the speculative element of capital movements; it should also extend the business sector's planning horizon, since it signals the expected rate of change of the exchange rate and thereby reduces the uncertainty which was a feature of previous regimes. In addition, it will be judged by its success in preventing any recurrence of the rapid inflation of the past. It must not, however, constitute a barrier to a substantial decline in the rate of inflation once domestic economic conditions permit this.

Table 1.7
Prices, 1987-91

(annual change, percent)

	1987–91	1989	1990	1991
Business-sector wages per employee post	22.9	18.3	15.4	12.5
Consumer prices (CPI)				
All items	18.5	20.2	17.2	19.0
Excl. housing	16.7	17.8	13.4	15.7
Excl. housing and controlled commodities	15.8	16.8	11.6	14.1
of which Tradables	12.8	13.5	11.7	13.4
Nontradables	19.4	20.9	11.4	15.0
Business-sector gross product prices	17.6	18.5	12.8	20.1
Exchange rate[a]	10.6	16.1	10.6	12.3
Export prices	15.6	22.8	11.3	15.8
Import prices (excl. direct defense imports)	14.2	20.8	13.0	10.4

[a] Against the currency basket.

The 1991 rate of price increase did not diverge from that prevailing since the successful stabilization program of 1985 (ESP). This year too, the price rise was dominated by the rate of increase of the actual exchange rate, the slack labor market, the prices set by the government, and the housing market. The interaction of these nominal factors with the price expectations of economic agents also played a part. These expectations are affected to a great extent by the steadiness of the rate of inflation since stabilization, and they influence not only the behavior of firms, but of policy-makers too. Thus the Bank of Israel's exchange-rate management was influenced by expectations, a prominent instance being the midpoint devaluation of March 1991, at a time when the actual rate was at the lower edge of the band. Expectations played a part in the average development of the exchange rate of the last few years and this year's rise did not depart from that of the preceding five years (Table 1.7), as is also the case with the average increase in the CPI (19 percent). In the last quarter of 1991, however, the rate at which the CPI rose declined steeply, to less than that of the exchange rate. This decline reflects the pressure of unemployment, on the one hand, and the currently weak housing market, on the other. It is still too early to say whether there has been a genuine change of trend. In any event, a more flexible labor market and the institution of the 'diagonal' band call for a policy designed to reduce inflation without incurring significant real costs.

Such real costs were incurred in the first few years of stabilization (until 1988), when the exchange rate was the leading factor in the convergence of rates of price increase to a low level. The failure of nominal wages to slow down sufficiently reduced the profitability of business-sector output, principally exports and other tradables. Since then, the situation has been exacerbated by the current influx of immigrants, which from the outset raised the profitability of producing for the housing market, thereby reducing the relative profitability of other output. This occurred at a time of generally improving profitability, particularly this year, although the level of previous high-growth periods has not yet been restored. The last two years' decline in the relative profitability of exports, though temporary, has reduced the propensity of export-oriented firms to invest and expand. At the same time, it appears that Israel's recent export performance (a slowdown in 1990 and a fall in 1991) is due primarily to the decline in world demand—specifically, in view of Middle East tension, for Israeli exports, so that Israel's share of the world market has shrunk. The question arises whether—given slack demand abroad and high unemployment at home—raising the exchange rate any faster would have done anything to improve export performance. Past experience suggests that the little to be gained by faster devaluation is conditional on the ability to reduce real wages. And even if there were short-term gains, the price could be loss of confidence in the exchange-rate regime and more rapid inflation, with all its attendant dangers.

Table 1.8
Balance of Payments, 1986–91

($ billion)

	1986–89	1990	1991
Current account	0.4	0.6	–0.9
Import surplus	4.6	5.1	7.0
Unilateral transfers	4.9	5.7	6.2
Civilian import surplus	2.9	3.6	5.2
Civilian imports	17.8	22.7	24.6
Exports	14.9	19.1	19.4

This year's decline in exports increased the import surplus, but a more important factor here was the rise in imports due to a shift of demand. The civilian import surplus rose by $1.6 billion (compared with $1.1 billion in 1990), to stand at $5.2 billion. A rise in import surplus is typical of the first few years of large-scale immigration. This year, however, since nondwelling investment has not yet reached the desired level, the rise was not as great as it would otherwise have been. The increase in the external debt/GNP ratio expected in the first few years of immigration has therefore not yet materialized; in fact the ratio declined again this year, partly because of improved terms of trade and partly because of statistical problems (see next paragraph).

The import surplus was financed without a rise in interest rates paid abroad. This year it is especially difficult to identify the sources of balance-of-payments financing, a type of problem common in countries which have liberalized the capital market and deregulated foreign exchange, since this reduces the quality of the credit data available. Gradual liberalization continued this year, with a series of relaxations which reinforce the ties between domestic and foreign financial markets, thereby enhancing business-sector functioning. However, liberalization increases the opportunities for speculative capital movements, as occurred in the third quarter of 1991.

Table 1.9
The Rate of Saving, Investment, and the Current Account, 1981–91

(percent[a])

	1981–85	1986–89	1990	1991
Gross national saving	**17.7**	**17.3**	**17.5**	**20.0**
General government	–4.3	1.7	–0.5	1.1
Private	22.0	15.5	18.1	18.9
Gross investment	**19.1**	**16.1**	**16.8**	**21.6**
of which Nondwelling investment	12.3	11.3	11.2	12.5
Current account	**–1.4**	**1.1**	**0.7**	**–1.6**

[a] The denominator is GNP *plus* unilateral transfers.

Liberalization also induced portfolio adjustment, and investment abroad by Israelis increased. The converse flow, typical of economies in the course of reform and with improving prospects of economic growth, has not yet started, however. There has never been much foreign investment in Israel, and the dramatic rates of growth of the past were sustained mostly by domestic investment financed by foreign loans or grants. This situation is explained primarily by geopolitical risk, which causes investors to demand higher rates of return than in growth countries in less tense parts of the world. In view of this, it is the government's duty to create an adequate infrastructure and pursue a stable economic policy that minimises uncertainty.

This year's developments show that in this area, too, not enough has been done. The country's capacity for sustained growth is founded in utilizing its comparative advantage in human capital, on the one hand, and exploiting the large export potential, on the other. Such growth cannot be achieved by government intervention. It is the task of government to substantially improve the environment in which the business sector operates and enable it to realize its growth potential. In addition to direct measures, which include low taxes and a suitable infrastructure—particularly in transport and communications—the reforms begun in the labor, commodity, and capital markets must be pursued more energetically. One sphere which must be given higher national priority is R&D—both pure research undertaken by research institutes and universities, and applied research carried out by firms. Some of the measures that the government must take require legislation or simplification of procedures, while others entail public spending. It should be stressed again, however, that there can be no departure from the deficit path to which the government is committed. It follows that other outlays must be drastically reduced. This can only be done by re-ordering priorities.