

Chapter 1

The Economy: Developments and Policies

In 1998, the economic recession continued, with a further deceleration in GDP growth and a fall in per capita GDP; unemployment rose further, and productivity was at a standstill. On the other hand, the rapid improvement in the balance of payments current account also continued (Figure 1.1). Inflation declined until August, but in the wake of dramatic financial developments, mainly from August to November, reflected in rapid local-currency depreciation, prices rose steeply from September to November. Developments in December and at the beginning of 1999 suggest that inflation has gone down again. The overall rise in the Consumer Price Index (CPI) in 1998, 8.6 percent, was close to the midpoint of the inflation target set by the government. Economic developments in 1998 and the results of economic policy should be assessed in the light of the risks faced by the economy which arose from global economic developments—the slowdown in world demand and shocks in the financial markets. Despite these shocks, Israel did not experience a financial crisis—characterized by a sharp downturn in economic activity and by difficulties in financing the balance of payments—as did many emerging economies. Fiscal and monetary policies, which in 1997–98 aimed at maintaining stability, played an important part in preventing such a crisis, as did the lowering of the economy’s vulnerability in the last few years through the steep reduction of the net external debt, efficient supervision of banks, and the adoption of a more flexible exchange-rate regime. The policy response to shocks as they occurred also contributed to preventing the crisis. Nonresidents’ investment in Israel declined in 1998, with a sharp fall in financial investment outweighing a continued rise in direct investment.

Real economic developments reflected continued slow growth of domestic demand, and in particular the decline in investment, the marked slowing of the expansion of global demand, and improvement in the terms of trade. The real exchange rate depreciated as compared to its trend in previous years. Fiscal restraint, which had started in 1997, continued. Although the public-sector deficit rose moderately, this may be attributed to the setback in economic activity. The government met the overall deficit target, although it deviated from the planned

domestic deficit. Increased employment in public services and developments in the composition of the budget in 1997 and 1998 are not consistent with directing the economy onto a path of sustainable growth.

The development of prices and the monetary variables was not uniform throughout the year. Until August, the significant slowdown—beyond what had been anticipated—in inflation and the fall in inflation expectations continued, the Bank of Israel gradually lowered the interest rate, and these developments were reflected by a rise of the real interest rate (Figure 1.2). From August till November, in the wake of the shocks in international financial markets and against the background of the narrowing of yield differentials, nonresidents' financial investments in Israel fell steeply, and residents' demand for foreign exchange rose. As a result, the NIS depreciated markedly, and the CPI went up rapidly from September to November. In November, in response to the rapid price increases and the acceleration in inflation expectations¹ following the depreciation of the NIS, the Bank of Israel raised the interest rate sharply to prevent the price rises from evolving into accelerated inflation. Following the hike in the interest rate and relative calm in international financial markets, inflation expectations declined, the CPI went down in January and February 1999, and the NIS appreciated. The Bank of Israel adopted a strategy of non-intervention in the foreign-exchange market. In 1998 there was significant progress in the process of liberalizing foreign-exchange control.

The challenge for economic policy in the next few years is to return to a path of sustainable growth, which will facilitate a decline in unemployment. The instability in world markets and the slowdown in the global economy are likely to place obstacles along this path. The achievement of these goals depends on a macroeconomic policy supportive of the creation of conditions which will improve business-sector profitability, alongside structural reforms which will help the supply side, economic stability, progress towards the long-term target of price stability, and consolidation of the improvement in the balance of payments.

1. THE BACKGROUND AND MAIN DEVELOPMENTS

Economic developments in 1998 reflected the continued wane in the expansion stage of the business cycle—a stage which had lasted since the beginning of the 1990s—and the effects of the shocks in the world economy, particularly in the financial markets, which started in the middle of 1997 and intensified from August 1998. The target facing economic policy in 1998, therefore, was to progress towards the creation of conditions for sustainable growth, and to prevent the shocks in the world economy from spilling over into a financial crisis in Israel.

¹ In this chapter inflation expectations refer to those derived from the capital market (see Chapter 3).

The challenge confronting economic policy was to contend with the continued economic recession and prevent the spillover of global economic shocks into a financial crisis in Israel.

The real trends which characterized the economy in 1997 persisted in 1998. Slow GDP growth in 1997–98 was mainly an expression of the convergence of the growth rates of business-sector and residential capital stocks to levels consistent with the economy's long-term growth potential, and of the effect of a restraining policy intended to maintain external stability and to progress towards the long-term inflation and budget targets set by the government (Figure 1.3). These developments reflect the effect of the correction to the path which the economy had followed from 1994 to 1996. This path, rooted in the adjustment needed to realize the enormous potential afforded by the influx of immigrants at the beginning of the 1990s and by the peace process, reflected the fiscal expansion from the middle of 1994, and was expressed by the rapid rise of the current account deficit. In 1998, the effect of the slow rise of domestic demand was heightened by slow growth of the global economy, which limited the expansion of exports and made imports cheaper, serving to increase the latter. International financial shocks also contributed to the deceleration in economic activity, as they made a more cautious economic policy necessary, and as they affected foreign investment in Israel. Global economic developments also had a positive impact on Israel, however, the improvement in the terms of trade contributed significantly to the reduction of the current account deficit; furthermore, the fall in prices of imports helped moderate the rate of domestic price increases.

Developments in prices and the financial sphere were exceptional from August to November. Until August, the significant deceleration in inflation and in inflation expectations, which had started at the end of 1997, continued, the Bank of Israel interest rate was reduced gradually, and real interest rose. In that period inflation dropped to about 4 percent, and the economy approached—faster than planned—a rate of inflation consistent with the long-term goal of price stability customary in industrialized countries. The NIS/currency-basket exchange rate remained close to the lower limit of the band, and capital inflow continued. From August, following the turbulence in global financial markets, which intensified in the wake of the economic crisis in Russia, and against the background of the contraction of yield differentials, the demand for foreign exchange surged, and the NIS depreciated considerably until the middle of November, causing the CPI to rise by 6 percent between September and November. In November, following a steep hike in the Bank of Israel's key interest rate and the return of relative calm to the international financial markets, inflation expectations fell, price rises halted, and inflation went down, approaching the level which had prevailed until August, and the NIS appreciated, trends which persisted at the beginning of 1999, too. Depreciation of the NIS during 1998 significantly exceeded the rise in domestic prices, a development which, together with the slow increase in demand, contributed to the marked moderation of real appreciation (measured as the ratio of import and export prices to the GDP deflator) in comparison to its trend in previous years (Figure 1.5).

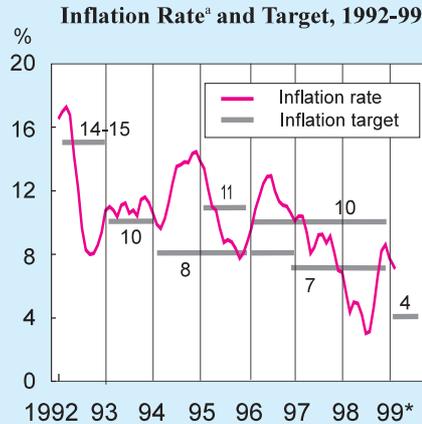
The objective of economic policy in 1998 was to consolidate the progress made in 1997 towards the long-term budget deficit and inflation targets determined by the government, and to make the economy less vulnerable to shocks in the global economy. This policy was pursued despite its possible short-term effect of prolonging the

In 1998 the effect of the slow rise in domestic demand was heightened by the effect of the slower global growth rate and shocks in international financial markets.

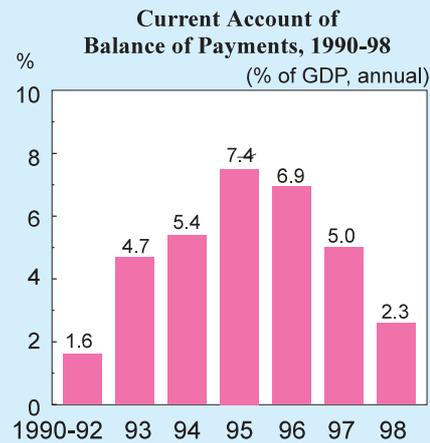
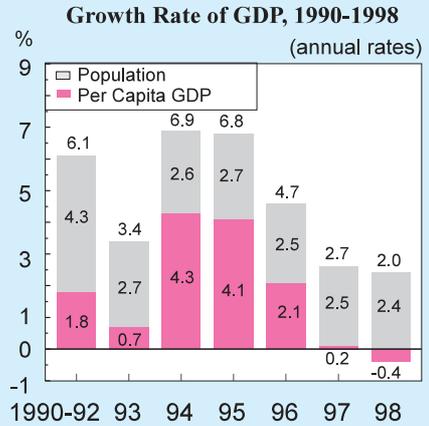
Global economic developments also had a positive impact on Israel via improved terms of trade, and the fall in import prices in particular.

At the beginning of the year the inflation environment declined to 4 percent, approaching the long-term target of price stability faster than planned.

Figure 1.1: Key Economic Indicators



^a Inflation rate calculated as change during last 12 months.
 Target for 2001: inflation rate as in OECD countries.
 * Latest figure, February 1999.



^a The Central Bureau of Statistics definition and sample were changed in 1995. See Table 4.1.

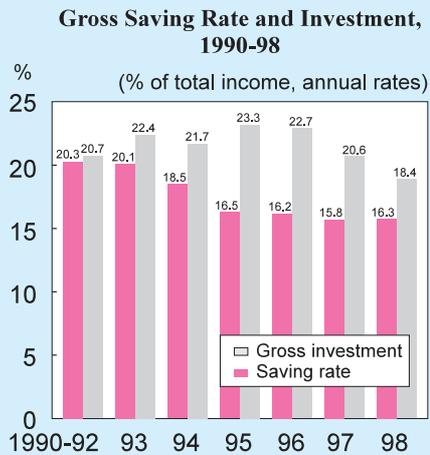


Table 1.1
Israel: Basic Economic Data,^a 1986–98

	1986–89	1990–91	1992–95	1996	1997	1998
Mean population ('000s)	4,405	4,803	5,330	5,685	5,829	5,968
Population growth rate (percent)	1.6	4.7	2.7	2.5	2.5	2.4
Israeli persons employed ('000s)	1,422	1,535	1,809	2,013	2,040	2,076
GDP (NIS billion, 1998 prices)	229.7	261.7	310.3	355.1	364.7	372.0
Growth rate of GDP (percent)	3.7	6.0	6.0	4.7	2.7	2.0
Per capita GDP (\$'000s, current prices)	8.7	11.6	13.7	16.8	16.9	16.4
Unemployment rate (percent)	7.1	10.1	9.0	6.7	7.7	8.6
Inflation rate (percent)	18.2	17.8	10.8	10.6	7.0	8.6
Current-account deficit (percent of GDP)	—	1.3	4.9	6.9	5.0	2.3
Current-account deficit (old definition, ^b percent of GDP)	1.5	–0.5	2.7	4.8	2.7	0.5
Foreign-exchange reserves (\$ billion)	5.5	6.9	7.3	11.9	20.8	23.0
Net external debt (percent of GDP)	44.7	28.0	24.9	18.4	14.9	15.5

^a Annual averages.^b Including capital transfers (see box in Chapter 6).

SOURCE: Based on Central Bureau of Statistics data.

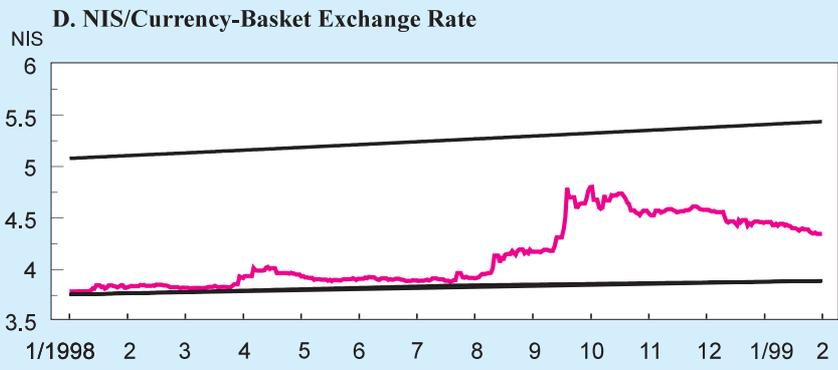
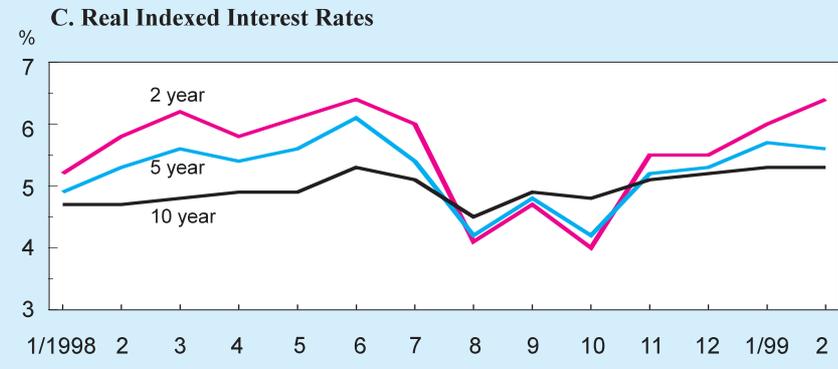
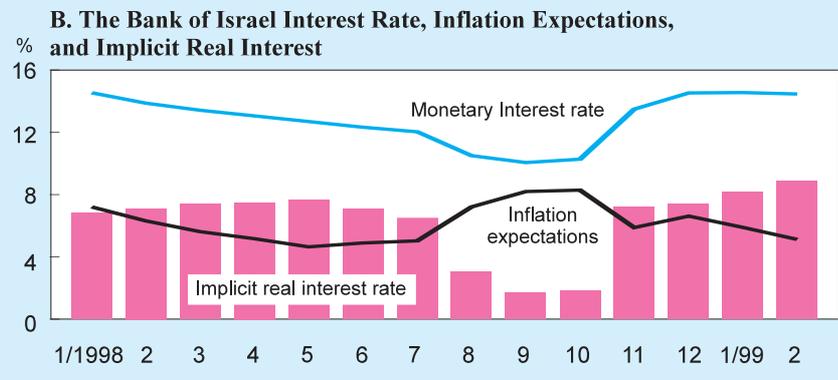
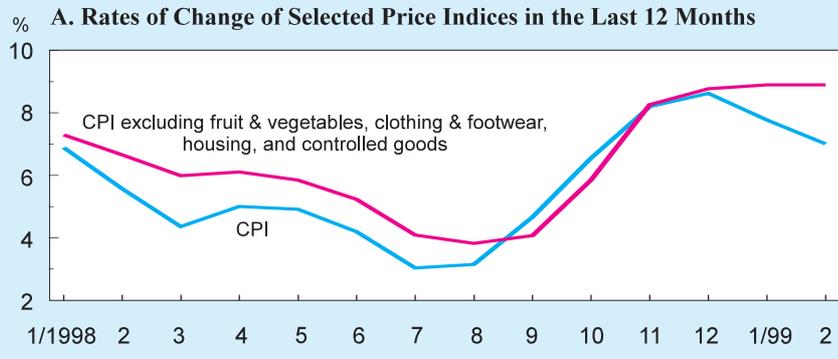
slowdown in economic activity and raising unemployment. The government's deficit target was attained, although its domestic deficit rose, and employment in the public services increased sharply,² a development which may impede further progress towards fiscal consolidation. In addition, the composition of public-sector expenditure does not bode well for the renewal of growth. Monetary policy acted via the interest rate to consolidate the rapid reduction in inflation in accordance with the government's long-term objective, against the background of moderate domestic demand. At the same time, the policy acted to maintain the yield differentials between Israel and abroad, against the background of instability in global financial markets, the growing openness of the economy to capital flows, and the misgivings regarding 'contagion' by the crises experienced by several emerging economies in 1997–98.

The results of economic policy should be assessed with reference to the significant developments in the global economy, particularly in the light of Israel's increasing openness to international commerce and capital flows, which increase its exposure to the effects of external developments. Despite the shocks in world markets, no financial crisis—indicated by a sharp decline of economic activity and by difficulties in financing the balance of payments—developed in Israel, as it did in many emerging economies. Several factors helped to prevent the crisis: progress towards macroeconomic stability

The prevention of a financial crisis was aided by progress towards macro-economic stability beginning in 1997 and the decline in Israel's economic vulnerability in recent years.

² Data on employment in the public services from the labor force surveys include—in addition to those employed directly by the public sector—workers in the private sector who provide what are essentially public services, such as education, health, and nursing. Nevertheless, a significant part of these private organizations' activities are wholly or partly financed by the public sector.

Figure 1.2



in 1997–98, including the reduction of the public-sector deficit and lowering the vulnerability of the economy in recent years, reflected in a marked decline of the net external short-term debt; efficient supervision of banks; and greater flexibility of the exchange-rate regime. The policy response to the shocks as they occurred also helped to prevent a crisis. Nevertheless, the shocks felt in Israel were severe in comparison with those in economies with a similar level of per capita income, which in the last few years have been economically stable with low rates of inflation.

2. REAL ECONOMIC DEVELOPMENTS

The main real trends evident in 1997 continued in 1998. The economic recession, signs of which have been visible since the middle of 1996, persisted, with a further decline in the rate of GDP growth compared with 1997, and a fall in per capita GDP. Unemployment continued rising, and productivity was at a standstill. On the other hand, the significant improvement in the current account also continued (Figure 1.1).

In 1998, GDP increased by 2 percent, a rate well below the potential growth rate derived from the rise in the capital stock and in the labor force, and represents a 0.4 percent fall in per capita GDP (Table 1.1). The rise in business-sector output also slowed, from 2.6 percent in 1997 to 1.8 percent in 1998. The reduction in per capita GDP, following a 0.2 percent rise in 1997, expresses the persistent effect of the slowdown in domestic demand (estimated via domestic uses of resources), which increased by 0.7 percent, slower than in 1997, as well as of the slower expansion of economic activity world wide, and political and security-related uncertainty. GDP supply was affected by the standstill in total factor productivity (TFP), following its continued decline since 1992. On the other hand, the reduction of prices of imported inputs and the (slight) fall in unit labor costs served to increase GDP (Table 1.2)

The decline in per capita GDP in 1998 reflects the continued slow rise in domestic demand and the deceleration of global economic activity.

Table 1.2
Conditions of Business-Sector Activity, 1990–98

	(annual change, percent)						
	1990–92	1993	1994	1995	1996	1997	1998
Business-sector output	7.4	3.4	8.0	8.7	5.6	2.6	1.8
Domestic labor inputs	5.5	5.5	9.5	7.5	4.7	1.7	-1.0
Proportion of nonresidents in business sector	9.0	8.0	8.0	9.6	10.8	11.4	11.4
Gross physical capital stock ^a	3.1	5.4	7.0	8.5	8.3	8.9	7.7
Total factor productivity (TFP)	3.0	-1.9	-0.6	0.8	-0.3	-1.4	0.0
Yield on gross capital ^b	13.6	14.3	12.8	12.4	11.3	10.1	10.2
Average business-sector wage	-1.6	0.3	-0.4	0.6	1.5	3.5	3.0
Unit labor costs (business sector)	-3.0	2.8	2.3	0.9	2.3	2.2	-0.2
Real minimum wage	-1.8	-1.6	1.6	2.3	2.5	6.1	5.4

^a At the beginning of the year.

^b Yield before tax.

The fall in fixed investment reflects mainly the gradual conclusion of the process of rehabilitating the capital stock/GDP ratio, after this had declined in the early 1990s.

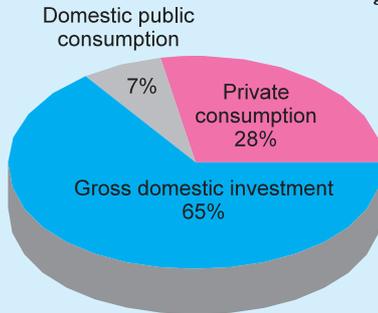
Despite the fall in investment, business-sector capital stock continued to rise rapidly in 1998.

The slower rise of domestic demand reflects the faster decline in investment than in 1997, the more moderate rise in private consumption, and a small acceleration in public consumption. In 1998, the main factor in the slowdown of domestic demand was again a fall in investment (Figure 1.3): in 1998 it went down by 7.6 percent, after declining by 6.1 percent in 1997. The fall in investment in fixed assets is mainly an expression of the approach to the completion of the process of the rehabilitation of the capital stock/GDP ratio following its decline in the early 1990s with the influx of immigrants. Investment in inventory also declined steeply. The recovery of the capital stock/GDP ratio in 1998 was accompanied by stability in the return on capital, against the background of the standstill in TFP and the rise in the real wage. The decline in the share of investment in GDP, with a stable rate of saving and return on capital, was expected to lead to a fall in real long-term interest rates. However, due to the rise in real short-term interest, affected by monetary policy and the rapid fall in inflation, the difficulty of raising capital abroad (because of the international financial crises), and the rise in the share of the budget deficit financed via the domestic capital market—long-term interest rates actually rose.³ This development, together with the direct effect of the rise in short-term interest,⁴ apparently made the decline in investment even greater. Despite the fall in investment, however, business-sector capital stock continued to rise rapidly in 1998, by 6.6 percent, significantly faster than the rise in the labor force and in GDP, albeit not as fast as the 7.7 percent rise in the capital stock in 1997. As capital stock increased more slowly, investment in the principal industries (excluding ships and aircraft) declined more moderately, by 0.3 percent, after a reduction of 3.9 percent in 1997; investment in machinery and equipment actually rose. In contrast, investment in residential construction plunged by 7.2 percent, the first decline since 1993. This reflected the phasing out of the effect of the influx of immigrants on housing demand, also indicated by the fact that the rate of home ownership among immigrants who arrived in 1990–92 is now equal to that among the veteran population. Other factors which had a moderating effect on housing demand were the rise in mortgage interest, the erosion in the value of subsidized mortgages available to eligible persons, and the expectation that mortgages would be updated during the year. Despite the slowdown in 1998, construction output per capita was still about 50 percent higher—and the ratio of housing prices to the CPI was 60 percent higher—than in 1989, before the mass immigration of the early 1990s.

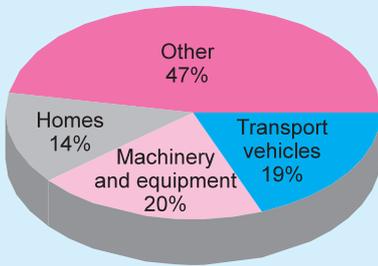
³ The yield to maturity on 10-year government bonds rose from 4 percent in 1997 (annual average) to 4.8 percent in 1998, and on 5-year bonds, from 3.9 percent to 5 percent. The effect of monetary policy on real interest can be seen in the slope of the yield curve, which declined during most of the year as residual maturity increased, and in the correlation between changes in short-term and long-term interest rates (Figure 1.2).

⁴ Yaacob Lavi (1990), in 'The Effect of Interest Rates on Investment in the Principal Industries in the Business Sector in Israel, 1962–88,' *Economic Quarterly* No. 143, found that short-term interest had a significant effect on investment. Research in other countries has shown a link between investment and long-term interest, too. The large share of the reduction in investment in inventory in the total reduction of investment in 1997–98 (Figure 1.3) supports the argument that the rise in short-term interest acted directly to reduce investment in this period.

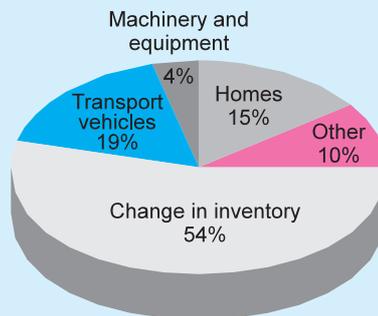
Figure 1.3



Contributions of the Various Uses to the Slowdown of the Rate of Growth of Domestic Uses, 1997-98 vis-à-vis 1990-96



Contributions of the Components of Investments to the Reversal of the Trend of Investment in Fixed Assets, 1997-98 vis-à-vis 1996



Contribution of the Components of Investment to the Change in the Level of Gross Investment, 1998 vis-à-vis 1996

The increase in consumption in 1998, 3 percent, close to the 3.4 percent rise in 1997, and remained higher than that in GDP and in national income. The composition of the rise in consumption changed in 1998, however: private consumption rose more slowly in 1998 than in 1997, by 3.3 percent compared with 4.1 percent, while public consumption rose faster than in 1997, by 2.3 percent compared with 1.9 percent (see below). The decline in private consumption, which led to a small increase in the rate of private saving, may have been due to the rise in unemployment, which caused greater uncertainty about future income in some households, and to the rise in real interest, which caused consumption to be deferred.

World trade grew by 3.3 percent in 1998, compared with 9.9 percent in 1997, alongside a decline in prices, especially of raw materials.

The balance-of-payments deficit on current account fell from 5.0 percent of GDP in 1997 (and 6.9 percent in 1996) to 2.3 percent in 1998.

The significant deceleration in the expansion of world trade also contributed to the continued slowing of GDP growth: world trade increased by 3.3 percent in 1998, after rising by 9.9 percent in 1997, with a fall in prices, mainly of raw materials. The effect of global developments was most evident in the acceleration of the volume increase of imports (excluding defense, ships, aircraft, and diamonds), from 2.1 percent in 1997 to 3.5 percent in 1998, as their relative price fell. The marked fall of import prices due to the slowdown in world trade had opposing effects: on the one hand it led to an acceleration of the volume of imports, thereby halting the transfer of some unutilized domestic production capacity to the tradable goods sector; on the other, as imported intermediates became cheaper, the profitability of production improved, stimulating economic activity. The 10.9 percent rise in exports in 1998 (excluding diamonds, capital, and exports to the Palestinian Authority), similar to the rise in 1997, is an indication that the damage caused by the slowdown in the world economy to Israel's economy was limited. Nevertheless, in the light of the recession in domestic demand, the slowdown in world demand may have prevented resources from moving to the tradable goods sector. The real depreciation (relative to the trend), which was evident at the beginning of the year and intensified towards its end, also served to offset the adverse effects on exports of the slowdown in the expansion of world trade. The increase in exports was again led by the high-tech industries, whose exports surged by 16 percent. Another notable development in 1998, however, was the recovery of exports of the traditional industries, which rose by 1.8 percent, after falling in 1996 and 1997.

The slowdown in the rise of domestic demand relative to GDP, and the improvement in the terms of trade, enabled the current account deficit to be reduced, from 5 percent of GDP in 1997 (and 6.9 percent in 1996) to 2.3 percent in 1998,⁵ significantly below the level of capital transfers and nonresidents' investment in the economy. This allowed the financing of the deficit and the concomitant reduction of the net external debt

Table 1.3
Balance of Payments, 1990–98

	(\$ billion, annual rates)						
	1990–92	1993	1994	1995	1996	1997	1998
Import surplus	6.3	8.6	9.5	12.0	12.7	10.9	8.2
Current-account deficit	-1.0	-3.1	-4.1	-6.4	-6.6	-4.9	-2.3
Implied capital imports ^a	0.6	4.6	4.1	7.5	10.0	14.2	3.9
Capital transfers	1.1	1.4	1.8	2.0	2.1	2.2	1.8
Investment in Israel by nonresidents ^b	0.3	0.9	0.9	2.3	2.8	3.6	2.5
Rise (-) in foreign-exchange reserves ^c	0.3	-1.5	-0.1	-1.1	-3.3	-9.3	-1.6
Foreign-exchange reserves ^d	6.5	7.1	7.4	8.8	11.9	20.8	23.0
Net external debt	16.5	17.1	17.8	19.6	17.9	14.6	14.2

^a Including errors and omissions.

^b Before 1994, excluding investment through the secondary market abroad.

^c Excluding revaluation gains.

^d Held by central monetary institutions at end of period.

⁵ In accordance with the new definition of the current account which does not include capital transfers (see Box 6.1).

(Table 1.3). An examination of the various components contributing to the improvement (Table 6.3) shows that the volume changes in imports and exports were responsible for about two-thirds, and the changes in trade prices for the other third of the improvement. An analysis based on the investment savings balance indicates that the main improvement in the current account derived from the decline in investment by about 2.2 percent of total income, and the rest, by a 0.5 percentage point increase in national savings (Table 1.4). The reduction of the current account deficit brings it close to the level prevailing at the end of the 1980s and at the beginning of the 1990s. In the light of the high level of investment, viewed in a long-term perspective, and the rapid rise of the capital stock, it seems that the improvement in the current account is maintainable, and that there may even be further improvement with the completion of the process of adjustment of the capital stock. Furthermore, the low rate of national saving (both in a long-term perspective, and by international comparison) may reflect a GDP level lower than its potential, and may therefore rise with the recovery from the recession. In addition, in 1998 foreign direct investment continued to increase, and reached \$ 2.1 billion. Nevertheless, due to the lack of stability of foreign financial investment as a source for finance, as was evident in the most recent crises in emerging economies and in the reduction of foreign financial investment in Israel in 1998, and against the backdrop of the lack of certainty regarding the permanence of the improvement in the terms of trade, it cannot be stated with confidence that in the future it will be possible to finance the entire deficit by foreign investment.

The unemployment rate continued to rise in 1998, reaching 8.6 percent, up from 7.7 percent in 1997 and 6.7 percent in 1996. The rise reflected the recession in activity, expressed in continued slow growth of employment of only 1.7 percent, against an increase of 2.8 percent in the labor force. The rise in unemployment does not fully express the sluggish activity in the business sector, in which the number of employed persons increased by only 0.2 percent, and the number of hours worked actually fell, as employment in the public sector rose by 5.7 percent, faster than in 1997, and faster than the rise in the labor force for the second year in succession (Table 4.1) Although the public sector did thus contribute in the short term to the moderation of the rise in unemployment, this trend, which may lead to a permanent expansion of the public

The rise in unemployment does not fully reflect the decline in business-sector activity, as employment rose by only 0.2 percent, compared with a steep increase in public-services employment.

Table 1.4
Saving, Investment, and the Current Account, 1990–98

	(percent of income, ^a annual rates)						
	1990–92	1993	1994	1995	1996	1997	1998
Gross saving rate	20.3	20.1	18.5	16.5	16.2	15.8	16.3
Public	-0.9	0.4	0.7	-0.8	-1.7	-0.5	-0.5
Private	21.2	19.7	17.7	17.2	17.7	16.3	16.8
Gross investment	20.7	22.4	21.7	23.3	22.7	20.6	18.4
of which Business sector	12.4	14.5	15.3	15.3	15.4	14.1	13.5
Current account of the balance of payments	-0.3	-2.3	-3.3	-6.9	-6.5	-4.8	-2.1

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

sector, impedes the process of structural change in the economy which would result in an increase in the number of employed persons in the tradable goods sector. The investment of resources allocated to increasing professional retraining of the labor force and developing the infrastructure would make a more efficient contribution to a sustainable rise in employment.

The additional increase in the minimum wage in 1998 could impede the return to work of unemployed persons with few years of education.

The increase in unemployment affected workers at all levels of education, although those with low educational levels were affected most severely. The share of long-term unemployed rose in 1998, indicating a greater threat of a lingering effect of current unemployment on future employment prospects. The further increase in the minimum wage in 1998, by 5.4 percent in real terms, faster than the rise in the average business-sector wage, is likely to act as a barrier to the re-employment of unemployed persons with low levels of education. The increase in the number of foreign workers (including Palestinians) eased significantly in 1998, but their share of labor input in the business sector continued to rise (Table 1.2). This development in a period of slow demand growth, and specially in a year when construction activity—a major source of employment of foreign workers—contracted markedly, indicates the great difficulty in reversing the upward trend in their number. The inflexibility of employers in reducing their number is probably explained by the relatively low cost of their employment compared to that of Israelis with similar skills, by the high fixed costs related to their absorption and by employers' concern that if they fire foreign workers, they may not be permitted to bring others to replace them should demand recover.

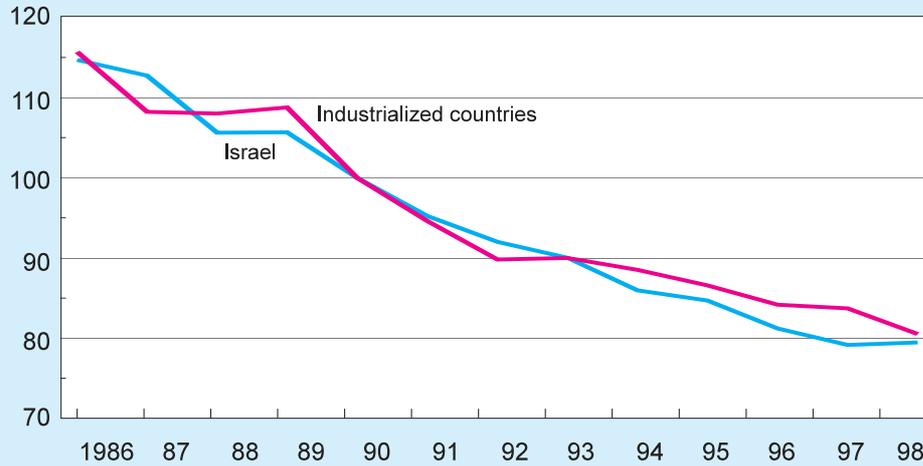
In the business sector the increase in the real hourly wage accelerated in 1998.

Real wages continued to rise in 1998, mainly in the business sector. In the public sector it rose moderately, having risen steeply in 1994–96. The real wage per employee post in the business sector rose by 3 percent in 1998, following a rise by 3.5 percent in 1997.⁶ In addition, the reduction in the number of hours worked per employee resulted in the acceleration of the rise in the real wage per hour in that sector, from 3.5 percent in 1997 to 4.3 percent in 1998. Several factors contributed to the rise in the real wage in 1998 and to its acceleration: firstly, there was a 2.2 percent rise in labor productivity (in terms of net business output per hour worked), after it had remained stable in 1997. Secondly, the average rate of inflation was lower than expected at the time the agreements were signed; this accounts for a rise of up to half a percent in the real wage. Thirdly, there was excess demand for workers in the high-tech industries. These factors, however, explain only part of the rise in the real wage. Unit labor cost went down slightly in 1998, after rising steadily in the last few years. This reduction was made possible, despite the acceleration in the rise in the hourly wage over and above the increase in labor productivity, by the rise in the ratio of the GDP deflator (price to the producer) to prices of private consumption (relevant to the employee), following the

⁶ Nevertheless, the real wage at the end of 1998 was similar to that at the end of 1997, due to the acceleration of prices towards the end of 1998. In this context, note that although the Cost of Living Allowance agreement (COLA) for the second half of 1998 did not compensate employees for price increases resulting from the depreciation, the Labour Federation (Histadrut) and the employers have agreed in principle that there will be some compensation for those increases.

Figure 1.4a

The Real Exchange Rate in Export Terms (1990 = 100)^a



^a Ratio of export prices to GDP deflator.

^b The industrialized countries are weighted by their share in Israel's foreign trade.

* A rise in the real exchange rate reflects depreciation.

Figure 1.4b

The Real Exchange Rate in CPI Terms^a (1990 = 100)



^a The NIS exchange rate against the weighted average of the currencies of Israel's trading partners, adjusted for inflation differentials in CPI terms.

^b The figure for the first quarter of 1999 is an estimate.

* A rise in the real exchange rate reflects depreciation.

reduction in import prices. Note, however, that despite the persistent rise in unemployment, the potential contribution of the fall of import prices to the profitability of production was offset by the rise in the real wage.

Real appreciation in 1998 was far more moderate than the trend in Israel and the advanced economies in the last few decades.

Movement of the real exchange rate in 1998 reflected a far more moderate appreciation than the long-term trend which has characterized it in Israel and in the industrialized countries over the last few decades, and which was reflected in a decline in the ratio of prices of traded goods to the GDP deflator. This trend apparently reflects a difference between the path followed by total factor productivity and by demand in the tradable goods sector on the one hand, and that in the nontradables sector on the other. The real exchange rate, if measured as the ratio of export prices (excluding diamonds) to the GDP deflator, actually depreciated in 1998, closing almost the whole gap which had developed in this ratio between Israel and the industrialized countries since 1994 (Figure 1.4a), a gap which was affected by the mix of macroeconomic (fiscal and monetary) policies in Israel. The long-term development of the real exchange rate, if measured as the nominal exchange rate *minus* the difference in inflation between Israel and its trading partners (Figure 1.4b), followed a similar path. Continued slow growth of domestic demand and nominal depreciation contributed to real depreciation in 1998; nominal depreciation was affected by the contraction of short-term capital flows resulting from the yield differentials between Israel and abroad. The narrowing of the differentials with the lowering of the interest rate until October and with the rise in exchange-rate risk enabled nominal depreciation of the NIS. Against the background of moderate activity, and the credibility of the commitment to the achievement of the inflation target, the depreciation resulted in only a partial rise in prices. On the other hand, the persistent rise in the real wage served to halt real depreciation. In 1998, an important factor in real appreciation—measured as the ratio of import prices to the GDP deflator—derived from the reduction of prices of imported factor inputs (Table 1.5), especially of raw materials, most of which have no domestic substitutes. This component of the real appreciation does not reflect an adverse effect on profitability. Real depreciation is important as a basis for structural reform—the reallocation of resources to the tradables sector—which will enable sustainable growth and a reduction in unemployment.

3. FISCAL POLICY

This year fiscal policy had to contend with the dilemma of continuing to advance towards attaining the government's long-term budget and inflation targets, on the one hand, and refraining from exacerbating the economic slowdown in the short run, on the other. The dilemma was caused to a great extent by the expansionary fiscal policy which was adopted in the 1994 supplementary budget and persisted until the end of 1996. This policy was expressed in the increase in expenditure on consumption and transfer payments when a rise in revenues was expected, and in the failure to cut these items when it transpired that actual revenues had fallen short of expectations. At that

time there was extensive investment in Israel, as part of the strategy of rapidly providing the influx of immigrants with employment and housing—backed by guarantees from the US government—which helped to finance the resulting current account deficit. The decline in the public saving rate (not offset by an equivalent rise in the private saving rate)—by over two percent of national income—at just the same time, served to raise the current account deficit to an unsustainable level (6.9 percent of GDP in 1996).⁷ Consequently, it was necessary to adjust the fiscal path just when the pace of investment in Israel was declining. Furthermore, the composition of the rise in expenditure in 1994–96, which led to a permanent increase in the share of domestic civilian consumption and transfer payments in GDP and a fall in investment, makes it difficult to use the budget in order to restore the economy to a path of sustainable growth. Fiscal policy in 1998 should be examined in light of its contribution to the utilization of the real depreciation to return more rapidly to a sustainable growth path. Such a contribution requires progress in three dimensions: (1) permanently reducing both the public-sector deficit and the size of the public sector, enabling a future cut in tax rates; (2) slashing the share of public-sector employment, which constitutes a rigid component of public-sector expenditure and hampers diversion of the labor force to the tradables sector; (3) increasing the share of infrastructure investment in public-sector expenditure, thereby enhancing productivity.

An analysis of the development of the public-sector deficit adjusted for the effect of the business cycle (see Chapter 5) indicates that the fiscal restraint that began in 1997 persisted. The public-sector deficit grew moderately, to 2.6 percent of GDP, and this can be explained by the slowdown in economic activity. The domestic deficit rose to 4.4 percent of GDP, compared with 3.7 percent in 1997, after reaching 5.2 percent in 1996. The central government's budget framework for 1998 was consistent with the path set by the Budget Deficit Reduction Law, and in effect the government even met the target, using the method of calculation set down in the law (Table 1.5). However, when the Bank of Israel's 'Real realized profits'⁸—which amounted to 1.1 percent of GDP (compared with a forecast of 0.4 percent)—are deducted, the overall public-sector deficit in 1998 was similar to that of 1997, 3.5 percent of GDP, compared with a planned deficit of 2.8 percent. About half of this deviation of the budget deficit from its planned level is explained by the lower than predicted GDP growth rate, although

An analysis of the development of the public-sector deficit, adjusted for the effect of the business cycle, indicates the persistence of the fiscal restraint that had begun in 1997.

⁷ From the 1960s to 1990 changes in the private and public saving rates offset one another almost completely, expressed by a correlation of -0.85 between them. This effect weakened considerably in the 1990s (when it was -0.14), although this does not necessarily constitute an indication of the future offset coefficient.

⁸ This item (i.e., inflation-adjusted realized profit) is stripped out when fiscal policy is analyzed as it does not reflect fiscal developments. Most of the Bank of Israel's income is recorded in the budget, but only a small part of its expenses: income from interest on the Bank of Israel's foreign exchange reserves is included, but not its interest payments to banks on their deposits, which reflect the cost of sterilizing the injection due to the purchase of foreign currency from the public. For example, if the Bank of Israel had sold foreign currency when there was accelerated depreciation and used the receipts to reduce the banks' deposits with it, according to the current accounting method this would have increased the budget deficit.

Table 1.5
Main Indicators of Fiscal Policy, 1990–98

(percent of GDP, annual rates)

	1990–92	1993	1994	1995	1996	1997	1998	Budget 1999
Overall public sector deficit	4.0	2.2	1.1	2.7	4.1	2.3	2.6	—
Public sector domestic deficit	7.2	4.0	2.3	3.9	5.2	3.7	4.4	—
Net overall public sector debt	111.9	101.3	93.6	90.5	90.3	89.3	89.6	—
Total public sector expenditure ^a	58.7	56.0	54.4	56.3	56.1	54.9	55.3	—
Total taxes (including property tax) ^a	39.3	40.0	41.2	41.8	40.7	41.9	41.4	—
Ceiling on domestic budget deficit ^b	6.2*	3.2	3.0	2.8	2.5	2.3	2.2	2.6
Actual domestic budget deficit	4.9*	2.4	2.0	3.2	4.7	3.1	3.3	—
Ceiling on overall budget deficit ^c	8.5*	4.4	3.5	3.8	3.6	2.8	2.4	2.0
Ceiling on overall budget deficit <i>less</i> Bank of Israel profit	8.5*	4.7	3.8	3.9	3.7	3.0	2.8	3.1
Actual overall budget deficit	5.3*	3.9	2.1	4.1	4.1	2.8	2.4	—
Actual overall budget deficit <i>less</i> Bank of Israel profit	5.5*	4.0	2.1	4.5	4.6	3.5	3.5	—

* For 1992 only.

^a As of 1995 taxes and expenditure include national health insurance tax and government transfers to the health funds in accordance with the National Health Insurance Law.

^b Until 1996 the deficit ceiling as prescribed by law; from 1997 the planned deficit (excluding credit extended). The gap between the planned and actual deficit includes about 0.15 percent of GDP reflecting income listed as domestic at the time the budget was planned but recorded as income abroad in the implementation figures.

^c Until 1996 the planned deficit; from 1997 the deficit ceiling as prescribed by law.

another significant part stems from the failure to enhance tax collection as expected. The public-sector debt/GDP ratio rose by about 0.3 percentage points, and this checked the decline that has characterized the ratio in the last ten years.

There was no change in the composition of public-sector expenditure in 1998 that could support a renewal of growth and a sustained contraction of the public sector. Furthermore, the increase in the actual domestic budget deficit (especially beyond the forecast level) made possible by including the Bank of Israel's 'Real realized profits' was not utilized to change the composition in that way; public-sector employment rose by 5.7 percent in 1998, outstripping the increase in the labor force and further intensifying the trend evident since 1995. In addition, the cessation of the decline in defense expenditure and interest payments as a share of GDP (after their reduction made the fall in public expenditure possible since the mid-1980s), indicates the need to be wary of increasing the other expenditure items. The share of public-sector investment, which fell sharply in 1997, rose somewhat in 1998; this is explained primarily by the greater investment by local authorities, however, and its continuation is doubtful in view of the shaky financial position of many of them. A persistent increase in investment would require the diversion of additional resources to this sphere, particularly to the transport infrastructure, in which there is an ongoing backlog. A step in this direction was represented by the increase in the infrastructure investment allocation in the 1999

The composition of public-sector expenditure in 1998 did not indicate a change in 1998 that would serve to revive growth.

budget. Nevertheless, the 1999 budget framework does not include any adjustment of the deviation from the domestic budget deficit path made possible by including the Bank of Israel's 'profits' in the budget, and the deficit planned for 1999 *less* the Bank of Israel's real realized profits is larger than that planned for 1998 (Table 1.5). Consequently, the increase in investment is not accompanied by a process of fiscal consolidation that would serve to sustain it.

4. MONETARY POLICY, MONETARY DEVELOPMENTS, AND PRICES

Monetary and price developments from the beginning of the year to August were very different from those later in the year. At the beginning of the year inflation was relatively low—about 4 percent (in annual terms), below the inflation target of 7–10 percent—while in September, following rapid local-currency depreciation, there was a significant acceleration in the rate of price increases. This ended in December, after a steep interest-rate hike by the Bank of Israel (Table 1.6, Figure 1.2). In the first part of 1998 tight monetary policy served to buttress the lower inflation environment attained towards the end of 1997, assisted by the fall in import prices and moderation of demand, as the expansionary effect of the mass immigration tapered off. The lower inflation environment until August made it possible for the Bank of Israel to gradually reduce the interest rate, allowing the interest-rate spread between Israel and abroad to narrow slowly. The nominal interest rate had to be reduced very gradually in order to prevent international financial crises from spilling over into Israel, particularly in view of Israel's increasing openness to capital flows. Since inflation expectations declined more quickly, however, the real Bank of Israel interest rate gradually rose to an average of 7.3 percent in the first half of 1998, compared with an average of 5 percent in 1997 (Table 1.7). At the same time, the real long-term interest rate rose, and the yield curve declined as residual maturity lengthened. During this period all the indicators pointed to a marked moderation of the inflation environment, bringing the economy faster than planned to the long-term goal set by the government—the price stability customary in developed economies—and this appeared to have been internalized by both the public and policymakers. An expression of this can be found in the adjustment of the inflation reserve in the national budget to a lower inflation prediction, and the fact that the Cost of Living Allowance agreement (COLA) signed in August between the Employers' Association and the Histadrut was based on the assumption that Israel had attained an inflation rate of 4 percent.

Against this backdrop, in August an annual inflation target of 4 percent was set for 1999, the lower slope of the exchange-rate band was reduced by 2 percentage points, and the Bank of Israel subsequently reduced its interest rate by 1.5 percentage points. After some depreciation of the NIS, which appeared at the time to constitute an overreaction, the exchange rate eventually stabilized on a lower plateau. However, the financial crisis in Russia, which was accompanied by its announcement of a moratorium on its external debts, and the resulting shocks in western financial markets, led to a fall

In the first part of 1998 tight monetary policy acted to buttress the decline in the inflation environment, aided by the fall in import prices and the moderation of domestic demand.

The very gradual reduction of the nominal interest rate was necessary in order to prevent contagion of the Israeli economy by world financial crises.

Table 1.6
Indicators of Price Developments, 1990-98

	(percent)						
	In annual terms				1998	1998 (during period)	
	1990-91	1992-95	1996	1997		Jan-Aug	Sep-Dec
<i>Year-end</i>							
CPI	17.8	10.8	10.6	7.0	8.6	2.6	5.9
CPI excl. housing	14.8	9.2	9.8	6.8	8.6	2.6	5.9
CPI excl. housing, fruit & vegetables, clothing & footwear, and controlled goods	14.1	8.9	10.2	7.8	8.8	2.7	6.3
Wholesale price index	13.6	9.0	7.0	5.9	8.2	0.2	8.0
Exchange rate (against currency basket) ^a	11.4	8.5	3.0	3.7	20.6	4.1	15.9
<i>Average</i>							
CPI	18.1	11.3	11.3	9.0	5.4		
CPI excl. housing	14.5	9.7	9.9	8.4	5.3		
CPI excl. housing, fruit & vegetables, clothing & footwear, and controlled goods	14.3	9.3	10.5	8.6	6.0		
Wholesale price index	13.8	9.2	8.6	6.3	4.2		
Exchange rate (against currency basket)	11.4	8.6	3.5	4.3	9.6		
Exchange rate against dollar	9.0	7.3	5.9	8.2	10.2		
Real exchange rate in export terms ^b	-4.7	-3.0	-4.0	-2.8	0.3		
Real exchange rate in import terms ^c	-5.7	-2.6	-6.7	-5.4	-3.1		
Terms of trade ^d	1.4	-2.0	3.0	3.5	2.0		

^a Average of last month of period vis-à-vis average of last month of preceding period.

^b Ratio of export prices excluding diamonds to implicit deflator of business-sector product including residential services.

^c Ratio of import prices excluding diamonds to implicit deflator of business-sector product including residential services.

^d Dollar prices of imports and exports, excluding capital and diamonds.

in capital flows to emerging markets. These developments, which served to narrow the yield differentials between Israel and abroad, and the deterioration in the goods account evident since the middle of the year, brought about a steep decline in the capital inflow to Israel and sharp depreciation of the exchange rate from end-August to end-October. The shift in capital flows was expressed mainly in capital exports by residents and the realization of financial investment by nonresidents. In the wake of the depreciation, price indices soared in September–November, as did inflation expectations. Since the Bank of Israel interest rate remained unchanged, the expected real Bank of Israel interest rate fell sharply. At the same time, real long-term interest rates declined, and the yield curve flattened.

Table 1.7
Monetary Indicators, 1990–98

	(percent, annual rates)						
	1990–92	1993	1994	1995	1996	1997	1998
M1 ^a	25.6	23.7	20.6	8.4	14.9	14.3	12.1
Nondirected credit ^a	32.8	44.9	28.1	26.2	22.0	18.2	15.9
Nominal Bank of Israel interest rate	14.2	11.3	13.4	15.5	16.1	14.3	12.0
SROs (CDs)	12.1	9.7	11.6	13.3	13.8	12.2	10.2
Nondirected credit in NIS ^b	24.2	16.5	17.4	20.2	20.7	18.7	16.2
Expected inflation ^b	14.6	9.0	12.9	10.8	11.8	9.3	6.3
Average currency-basket interest rate	7.5	4.5	4.6	5.3	4.6	4.9	4.9
Real interest rate on 5-year bonds	1.9	2.8	2.9	4.1	4.4	3.9	5.0

^a Rise in annual average. M1 = cash in the hands of the public *plus* demand deposits.

^b 12-month inflation expectations estimated from the capital market, assuming full tax exemption.

In view of these developments, and in order to prevent the price increases from being translated into accelerated inflation, the Bank of Israel raised the interest rate by a cumulative four percentage points (two increases of two percentage points); this was done while adopting a strategy of nonintervention in the foreign-currency market within the exchange-rate band. As a result, inflation expectations moderated significantly, real short-term interest rates rose (to about 7.5 percent in December), long-term interest rates increased too, and in December there was real local-currency appreciation, which persisted into the beginning of 1999. In the wake of all this, from December 1998 to February 1999 the CPI declined by a cumulative 1.2 percent. The passthrough from the exchange rate to prices between August and the end of the year was faster than before, but it is still too early to assess the change in its overall intensity, as in the past the effect of depreciation on prices extended over two quarters. The intensity and speed of the passthrough were affected on the one hand by the extent of depreciation, and on the other by the vigorous policy response, which signalled that monetary policy would not accommodate the price rise and that it would continue to aim at attaining the inflation target set for 1999; the economic recession also had an effect, as demand rose more slowly. The development of prices and expectations since December reinforce the assessment that the price increases that followed the sharp depreciation were temporary. Nonetheless, the COLA agreement that was in effect in the second half of the year afforded only very partial compensation for price increases at that time, and the associations representing employers and employees are currently discussing the compensation that will be given. The larger this is, the greater its likely contribution to the continued translation of price rises into higher inflation.

In the wake of events since October, the question of the Bank of Israel's direct intervention in the foreign-currency market has been raised. Those who favor intervention claim that it could have moderated local-currency depreciation and the subsequent price rises, and eased the burden on interest-rate policy. Despite these considerations, the Bank of Israel chose a strategy of nonintervention, assessing that the risk that intervention would intensify both demand for foreign currency and capital

The Bank of Israel chose a strategy of nonintervention in the foreign-currency market because the risk that intervention would intensify both demand for foreign currency and capital outflow was perceived as too high.

outflow was too great. The experience of other central banks shows that consistent intervention to defend the currency can exacerbate a crisis, leading to the rapid loss of the foreign-exchange reserves, and in the final event obliging the authorities to alter the exchange-rate regime alongside rapid devaluation. The existence of the exchange-rate band, and the Bank of Israel's commitment to defending its limits, given a limited stock of foreign-exchange reserves, was one of the reasons why the Bank chose a strategy of nonintervention. Moreover, direct intervention by the Bank in the foreign-currency market could have adversely affected the process of developing the foreign-currency market and the internalization by economic agents of the risks inherent in it. The rise in the purchase of instruments for hedging against depreciation accompanying the renewed growth of credit (albeit at a moderate rate) and the increase in deposits denominated in or indexed to foreign currency indicates that exchange-rate risk was internalized to some extent, and this could help to make the deployment of monetary policy instruments more effective. Evidence regarding the volume of trading in those days in October when there was rapid local-currency depreciation does not support the claim that it was irregular or negligible—in which case direct intervention in trading by the Bank of Israel would have been justified. The average daily volume of trading excluding swaps, which ranged from \$ 350 million to \$ 450 million until August, rose to about \$ 570 million in August and September, and peaked at some \$ 675 million in October, before declining again to \$ 450 million in the last months of the year.

The volume of trading during the period of rapid depreciation does not support the claim that activity was irregular or that its extent was negligible.

In recent years the nominal exchange rate has constituted one of the main channels through which monetary policy, together with other basic factors, affects the inflation environment. Although until August local-currency depreciation outstripped inflation in Israel (and even more so the gap between inflation in Israel and its principal trading partners), this did not prevent the inflation rate from slowing or expectations from declining at that time. From August, with the change in the trend of capital flows, the NIS depreciated quite sharply against both the currency basket and the dollar, so that the path of the nominal exchange rate did not support the lowering of the inflation rate. However, the real interest rate, which was higher than before, continued to affect inflation (until August and from November), by both dampening domestic demand and directly affecting inflation expectations, serving as an indicator of the central bank's determination to attain the inflation target.

Continuing the process of gradually liberalizing the foreign-currency market, restrictions on households were lifted in May (those on the business sector had been removed earlier), while some restrictions on institutional investors and nonresidents' futures transactions remained in force. The restrictions that were removed in May related primarily to direct investment abroad by residents, unilateral transfers, and opening foreign-currency accounts by individuals in Israel and abroad. Discrimination in taxation between investment in Israel and abroad limits the effect of the measures introduced on capital exports by residents at this stage, however.

5. POLICY OBJECTIVES FOR THE NEXT FEW YEARS

The main policy objective for the next few years is to bring the economy to a sustainable growth path, enabling the unemployment rate to decline while maintaining economic stability and buttressing the improvement in the balance of payments. Since mid-1996 economic activity has expanded slowly, and the unemployment rate has risen. Consequently, the main challenge confronting economic policy is to advance towards growth rates that are consistent with Israel's potential, without reverting to an unsustainable path; returning to a growth path should be accompanied by bolstering the improvement achieved in the balance of payments and proceeding towards price stability. Hence, a policy based on expanding demand in the short term in a way that might impair stability should be avoided. This is especially the case in view of the findings indicating that a rise in the public expenditure/GDP ratio during a slowdown is not reversed once there is a recovery, but tends to lead to a permanent enlargement of the public sector. Progress towards full utilization of Israel's growth potential will be made possible by improving the productivity and profitability of the business sector—especially its tradables sector—and this requires a policy that enables the buttressing of real depreciation and focuses on the supply side. This should operate in both the fiscal sphere, by adjusting the composition of expenditure, i.e., increasing the share of those items that serve to foster growth, as well as by reducing the tax burden while reforming its structure and extending and intensifying the structural reforms that will contribute to competitiveness and economic efficiency (see below). The continued reduction of the inflation rate will also help to increase productivity (see box 2.3).

Consolidating the improvement and continuing to progress towards reducing the balance-of-payments deficit are particularly important in view of the changes in the external environment and Israel's increasing integration in the global economy. The latter, which took another step forward with the further liberalization of capital flows in May 1998, requires the adoption of policies that are responsible and cautious. Alongside the inherent advantages of exposing the economy to trade and to capital flows—both inward and outward—this also intensifies the reaction of these flows to policy that is perceived to be unreliable, making the economy more vulnerable to external economic crises. This vulnerability is expressed in the risk that the shocks will deteriorate into a financial crisis. A significant component in turning economic shocks into a financial crisis is the extent to which the public—and the banking system in particular—is exposed to exchange-rate risks, so that it is important to act cautiously to reduce this exposure. The need for cautious policy is accentuated by the extent of short-term, unindexed, local-currency assets held by the public; these have risen since mid-1993, as the inflation rate declined and public confidence in the stability of the NIS grew, continuing as the real interest rate rose from early 1994. Consequently, policy must act to maintain the growing public confidence in the NIS and its long-term stability.

The main policy objective of the next few years is to bring the economy to a path of sustainable growth enabling the reduction of the unemployment rate while maintaining economic stability.

Policy that is based on increasing demand in the short run in such a way as to undermine stability should be avoided.

Vulnerability to exogenous shocks depends to a great extent on the policy adopted. Adherence to fiscal discipline while improving the allocation of public expenditure and reducing its share in GDP, and a monetary policy that is committed to attaining the inflation target while relating to the yield spread vis-à-vis abroad, together with effective supervision of the financial system, will help to reduce vulnerability to internal and external crises, while eventually enabling the narrowing of the yield spread. Furthermore, the problems encountered in many emerging markets in 1998 caused capital flows to these countries, including Israel, to drop and the cost of borrowing to rise. As total capital flows to these countries fall, they may also become more selective. This development, together with the conclusion of the US government's loan guarantees, increases the need to continue improving the balance of payments and pursue a reliable policy in order to gain a larger share of the shrinking sources of finance. Moreover, the continued process of liberalizing the foreign-currency market could lead to a rise in capital outflow and investment abroad by residents—developments that will also increase Israel's financing requirements.

Continued improvement of the balance of payments is a particularly difficult task at present, in view of the marked slowing of the expansion of world trade. The implications of this slowdown are that Israel's exports will have to face stiffer competition in order to continue to grow at the pace they have displayed in the past and substantially increase their share of decelerating world trade (which is expected to rise by less than 5 percent in 1999). The competitiveness of Israel's exports depends on the ability to buttress the real depreciation that emerged in the second half of 1998, and especially at the end of the year, and on improving total factor productivity. Real depreciation depends on dampening the rise in production costs, and first and foremost wages. It is important in this context that the public-sector wage agreements that are up for review should be consistent with economic policy in general and fiscal policy in particular. This is in view of the effect of the wage component on the budget and savings, and their possible spillover into the business sector. An increase in TFP, which has fallen by 4.5 percent since 1993, would be enhanced by a rise in infrastructure investment, a reduction of the tax burden and rationalizing the tax system—in particular reducing the difference in taxation rates between income from capital and from wages while emphasizing the reduction of marginal tax rates on labor in the middle income brackets. The business environment will also be improved by continuing the structural reforms intended to enhance competitiveness, especially with regard to the infrastructure and the financial sphere.

Fiscal policy is seminal in attaining these objectives. The 1999 budget and its attendant legislation incorporates several measures that will enable progress to be made towards sustainable growth by increasing the share of infrastructure investment and removing obstacles to a series of structural reforms. However, they do not embody steps to ease the tax burden, rationalize the tax system, and reduce the share in the economy of the public sector. The fact that there are no wage agreements in effect and fears of excessive wage settlements in the public sector contribute to the uncertainty regarding fiscal policy. The danger in conducting fiscal policy that is influenced mainly

by short-term considerations does not lie solely in deviation from the desired deficit path in the present but also in the burden that might be placed on the budget in the long run, primarily because of the growth in components with a long-term effect, such as employment and wages, and the rise in the public debt, which increases future interest payments. Beyond the issue of the deficit, a policy of this kind is heavily biased towards current expenditure at the expense of infrastructure investment, the return on which is received in the longer term but which is crucial for the growth process. Note that a 22 percent real increase (over the original 1998 budget) in infrastructure investment is planned in the 1999 budget, but care must be taken to ensure that the investments implemented are those bearing the highest economic return.

With regard to prices, the challenge to policy is the re-establishment on a firm basis of the 4 percent inflation environment that prevailed until August—and that was consistent with the inflation target for 1999 set by the government—within the framework of approaching the long-term goal of price stability. The attainment of the target is supported in the short run by the moderate level of domestic demand and continued decline in the price of imported intermediates, which are the result of the world economic slowdown. The uncertainty regarding the path of wages in both the business and public sectors, and budgetary policy that is governed by short-term considerations, could hamper its attainment, however. In the longer term all the elements within the economy will have to act in concert to progress towards the long-term goal of price stability, especially once the exogenous forces supporting disinflation fade away. Concerted action will be possible only within a framework that firmly commits macroeconomic policy to the targets that have been set. Such commitment can be established by setting long-term objectives that determine a clear path along which inflation converges to the target level, and annul the need to respond to random fluctuations in price levels resulting from exogenous factors. A quantitative long-term target, together with extensive and reliable commitment to attaining it, incorporating fiscal policy that is consistent with it, will reduce the burden on monetary policy in responding to the deviation of the inflation rate from the target. The developments of 1998, especially the speed and intensity with which prices responded to depreciation, indicates the necessity of adhering to monetary discipline; this is particularly the case because of the effect of Israel's past inflation experience on the expectations and behavior of the public. At all events, the continuation of the process of disinflation requires continuing to focus monetary policy on the inflation targets, taking into account the effect of economic developments on the inflation environment.

Another area in which policy measures have a considerable effect on progress towards sustainable growth is structural reforms and the privatization process. The reforms of the last few years in communications (e.g., in cellular and international telephony) are an example of how greater competition contributes to a significant reduction of prices alongside a marked increase in economic activity. The accelerated progress in this process, especially in infrastructure industries (transport, electricity, petroleum, and the domestic telephone network), will serve to increase competition, reduce costs, and accelerate activity without generating inflation. The reduction of exemptions from the

With respect to prices, the challenge facing policy is the re-establishment of the 4 percent inflation environment that prevailed until August.

The economic developments of 1998, in particular the rapid and intensive reaction of prices to depreciation, indicate the need to persevere with monetary discipline.

anti-trust regulations given to major industries will foster progress in this direction.

The solution to the problem of unemployment lies in restoring the economy to a sustainable growth path. The arrangements for providing workers with vocational training must be improved, so that it can contribute to the better and quicker adaptation of workers' skills to the opportunities created by economic changes. This is particularly the case in view of the currently relatively low placement of graduates of such courses. The rise in the number of institutions of higher education in the last few years is an important step in that direction, making higher education more accessible to weaker sections of the population and residents of the periphery. Against the backdrop of the continued rise in the proportion of foreign workers in the labor force in employment, despite the increase in unemployment, it is necessary to settle the employment of these workers in such a way as to ensure fair competition with local workers, on the one hand, and the rights of legally employed foreign workers, on the other.

Many restrictions still exist in the capital market, obliging the business sector to compete for long-term capital with the government's earmarked bonds, which bear a high interest rate and are allocated to the pension funds. Arrangements that limit the share of these bonds in the asset portfolio of institutional investors and direct these investors to long-term investment in the principal industries, as is customary in advanced countries, will contribute greatly to developing the capital market. Bringing institutional investors into the capital market has assumed greater importance in the wake of the agreement reached regarding the transfer of new public-sector employees from a pay-as-you-go pension system to a pay-as-you-earn one, and the greater share of salary covered by pension insurance. This arrangement will lead to a significant and continued rise in the amounts saved in the pension funds. Capital market reform should also aim at reducing the tax differentials between investment in Israel and abroad, in order to make the allocation of resources more efficient by increasing the diversification of the public's asset portfolio. These improvements should serve to increase the private saving rate, which is significantly lower than that prevailing in advanced economies. Mention should be made in this context of the need to regulate the relations between institutional entities in the capital market and the banks in order to protect the rights of savers.

Bringing institutional investors into the capital market assumes greater importance in the wake of the pensions agreement, which will lead to a constant rise in the amounts saved in the pensions funds.