

Chapter 1

The Economy: Developments and Policies

During 1999, there was a turnaround in economic activity, but the rate of GDP growth remained lower than that of the population, so that *per capita* GDP edged down by 0.2 percent, having declined at a similar rate in 1998. After falling in the first quarter of the year, GDP grew sharply for the rest of 1999. Accelerated activity was led by a recovery in domestic demand and export, and was accompanied by an increase in the current-account deficit. The acceleration was also reflected by a significant rise in overall employment, also in the business sector. Despite the increase in employment, unemployment rose during most of the year, as the labor force expanded even faster. It is too early to assess, however, the extent to which accelerated activity will continue, because, among other things, the rapid growth from the second quarter compensated in part for the reduction at the beginning of the year, and was affected by transient factors. The disinflation process continued in 1999, and the rate of price increases was below the inflation target. The annual rate reflected the price reductions in the first quarter—which corrected the exceptional hikes at the end of 1998 in the wake of the rapid depreciation of the NIS in the last quarter of 1998—and the convergence of the inflation rate thereafter to the 1999 target rate of 4 percent.

The background to the turnaround in activity in 1999 was provided by long-term factors acting to return the economy to the path of sustainable growth, as well as short-term factors which boosted activity during the year. The main factors which supported recovery in 1999 included macroeconomic stability, the renewal of the peace process, the boom in world capital markets and hence in domestic share prices, the acceleration in world growth and trade, as well as calm on the security front, and the approach of the new millennium which had a beneficial effect on tourism. The recovery in exports was also helped by real depreciation, which mainly reflected the rapid nominal depreciation at the end of 1998. All the above contributed to the significant acceleration of exports and private consumption in 1999. Investment rose, too, mainly due to two special transactions (the purchase of equipment for an Intel plant, and the import of airplanes).

At the beginning of 1999, the tight monetary policy, reflected by the rise in short-term real interest, was intended to prevent the price increases at the end of 1998 from being translated into accelerated inflation. Thereafter, the policy was aimed at anchoring inflation at a level consistent with the target for 1999, and at creating the conditions necessary for the achievement of the annual target (3–4 percent) set for 2000 and 2001. In following this policy, yield differentials between Israel and abroad had to be taken into consideration. Net capital flows rose faster than the rise in the current-account deficit. Prominent among these flows were nonresidents direct investment, which rose slightly above its 1998 level, and nonresidents' investment in equity portfolio, which went up again after declining steeply in 1998, with renewed buoyancy in world financial markets.

Fiscal discipline was maintained in 1999, continuing the restraint exercised in 1997–98. The budget deficit deviated only marginally from the target determined in the Budget Deficit Reduction Law, due to the fact that activity was below that assumed in the budget. The public debt, however, is still far higher than that considered acceptable in the industrialized countries. The composition of the budget and public expenditure did not change in 1999 as it should in order to support long-term growth: neither the tax burden nor its structure altered, and expenditure on infrastructure investment declined, while the shares of transfer payments and current public consumption remained unchanged. Nor was progress made in implementing structural reforms to encourage competition, which would help raise productivity and thereby support faster expansion of activity.

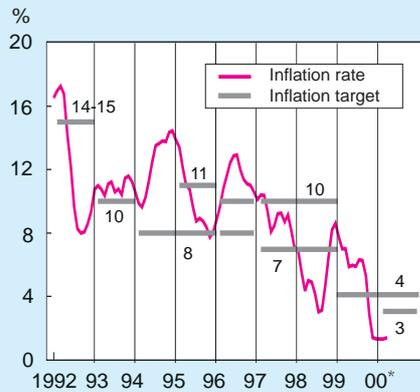
1. MAIN DEVELOPMENTS

Accelerated activity was led by a recovery in domestic demand and exports, and was accompanied by an increase in the current-account deficit.

Economic activity changed direction in 1999, but the rate of GDP growth remained lower than that of the population, so that *per capita* GDP edged down by 0.2 percent, having declined at a similar rate in 1998. After falling in the first quarter of 1999, GDP rose rapidly in the rest of the year. Domestic demand and exports led the recovery in economic activity, which was accompanied by a rise in the current-account deficit. Accelerated activity was also reflected in significantly higher employment, also in the business sector. Despite the rise in employment, the rate of unemployment went on rising during most of the year, due to the faster increase in the labor force. It is still too soon, however, to assess the extent to which heightened activity will continue, because *inter alia* the rapid growth from the second quarter of the year in part reflected a correction to the decline in activity at the beginning of the year, and was affected by temporary factors. There was further progress in the disinflation process in 1999, and prices rose by less than the inflation target. The annual rate reflected the price reductions in the first quarter, which corrected the sharp rises at the end of 1998 following the

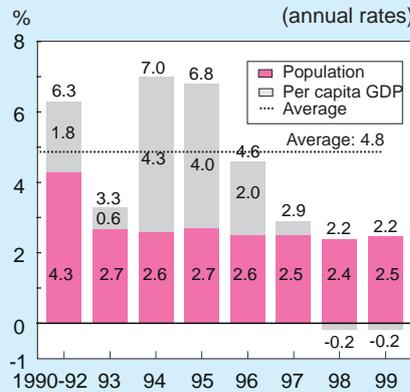
Figure 1.1: Key Economic Indicators

Inflation Rate^a and Target, 1992–99

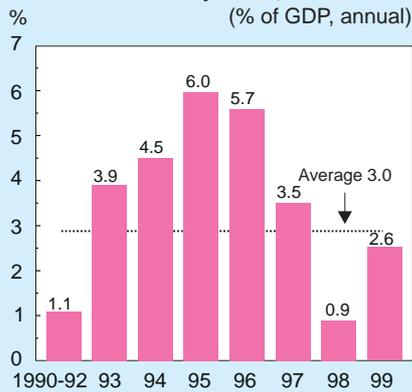


^a Inflation rate calculated as change during last 12 months.
 Target for 2001: 3–4 percent.
 * Latest figure, February 2000.

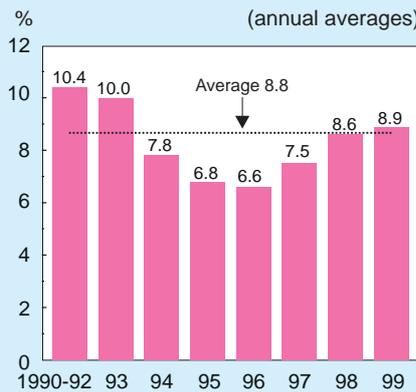
Growth Rate of GDP, 1990–99



Current Account of Balance of Payments, 1990–99

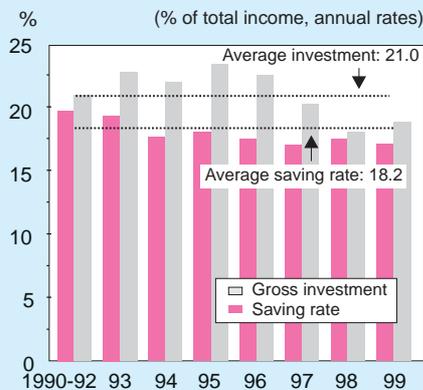


Unemployment Rate, 1992–99

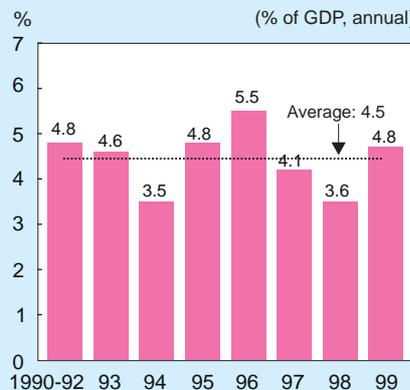


^a The Central Bureau of Statistics definition and sample were changed in 1995. See Table 4.1.

Gross Saving Rate and Investment, 1990–99



Overall Public-Sector Deficit, 1990–99



SOURCE: Based on CBS data.

Table 1.1A
Israel: Basic Economic Data,^a 1986–99

	1986– 1989	1990– 1992	1993– 1996	1997– 1999	1997	1998	1999
Mean population ('000s)	4,407	4,911	5,473	5,974	5,829	5,971	6,121
Population growth rate (percent)	1.7	4.3	2.6	2.5	2.5	2.4	2.5
Israeli persons employed ('000s)	1,421	1,575	1,900	2,083	2,041	2,072	2,137
GDP (NIS billion, 1999 prices)	246.6	290.0	351.0	400.5	391.8	400.4	409.2
GDP (percent)	3.6	6.3	5.4	2.4	2.9	2.2	2.2
Per capita GDP (\$'000s, current prices)	8.7	12.0	14.7	16.6	17.1	16.6	16.1
Unemployment rate (percent)	7.1	10.5	7.8	8.4	7.5	8.6	8.9
Inflation rate (during year, percent)	18.2	15.0	11.1	5.6	7.0	8.6	1.3
Current-account deficit (percent of GDP)	0.2	1.1	5.0	2.3	3.5	0.9	2.6
Foreign-exchange reserves (\$ billion)	5.5	6.5	8.8	22.2	20.8	23.3	22.4
Net foreign debt (percent of GDP)	46.5	29.1	22.8	12.6	14.6	12.4	10.9

^a Annual averages.

SOURCE: Based on CBS data.

rapid depreciation of the NIS in the last quarter, and the convergence thereafter of the inflation rate to the 1999 target environment of 4 percent.

The recovery in economic activity evident since the second quarter of the year followed a three-year recession which started in the middle of 1996, and reached its trough at the end of 1998 and the beginning of 1999, reflecting the down stage of the business cycle which commenced at the start of the decade in the wake of the influx of immigrants and of the peace process. Immigrant absorption, which necessitated a huge increase in investment in productive capital stock and residential housing and brought about a rapid increase in consumption, was reflected in fast growth, accompanied since 1994 by fiscal expansion and a steep rise in the deficit on the balance-of-payment current account. The slowdown in activity which followed reflected the adjustment of the rate of change of capital stock (including the stock of residential housing) to that derived from the long-term rate of GDP growth and the tight macroeconomic policy. The policy was intended to restore balance-of-payments stability and to enable progress to be made towards the long-term targets in the fiscal and prices spheres. The slowdown in activity was aggravated by external conditions—the slowdown in world growth and trade which resulted from the financial crises which affected several emerging economies and from security-related tension which had an adverse effect on tourism.

Long-term factors, acting to redirect the economy onto a path of sustainable growth, as well as temporary factors which boosted activity in 1999, formed the background to the turnaround in activity during the year. The former included the improvement in the basic conditions underlying macroeconomic stability, and optimistic expectations

Table 1.1B
Basic Economic Data: An International Comparison, 1990–99

	1990			1999			1990-99 average		
	Israel	G7 ^a	OECD ^b	Israel	G7 ^a	OECD ^b	Israel	G7 ^a	OECD ^b
Population growth rate (percent)	3.1	0.7	0.5	2.5	0.3	0.6	3.1	0.5	0.6
GDP growth rate (percent)	6.2	2.6	3.1	2.2	1.8	2.9	4.8	2.0	2.7
Per capita GDP growth (percent)	3.1	1.9	2.6	-0.2	1.5	2.4	1.7	1.5	2.1
Per capita GDP (\$'000s, current prices)	11.3	21.6	16.9	16.1	29.5	21.6	14.5	26.2	20.0
Unemployment rate (percent)	9.6	5.6	5.9	8.9	6.2	6.7	8.8	6.6	7.1
Inflation rate (average, percent)	17.2	5.0	10.2	5.2	1.1	4.9	11.2	2.6	7.8
Inflation rate (during year, percent)	17.6	5.2	9.9	1.3	1.5	5.6	10.6	2.5	7.4
Current-account deficit (percent of GDP)	0.3	-0.5	-0.6	-2.6	-1.0	-0.8	-3.0	-0.2	-0.2
Public debt (percent of GDP)	144.7	60.0	57.0	106.6	78.7	64.5			

^a G7 countries: US, UK, Germany, Italy, Japan, France, Canada.

^b Organization for Economic Cooperation and Development.

SOURCE: OECD Economic Outlook, 1999; World Economic Outlook, 1999, and Bank of Israel annual reports.

regarding the renewal of the peace process. The stability or even buoyancy in world capital markets, and thence also in domestic share prices, accelerated world growth and trade and expectations of further acceleration, calm on the security front, and the approach of the new millennium which caused a renewed rise in tourism, all supported recovery in 1999. The recovery of exports was also helped by real depreciation, which mainly reflected the rapid nominal depreciation at the end of 1998 (although the depreciation was largely dissipated towards the end of 1999 and at the beginning of 2000). All these factors contributed to the significant acceleration in the rise of exports and private consumption during 1999. Investment also rose, although this was largely due to two nonrecurring transactions (the purchase of equipment for an Intel plant, and the import of airplanes). Most of the principal industries experienced accelerated activity, chief among them being manufacturing industry, and commercial and services industries; on the other hand, the decline in construction activity persisted.

Despite the turnaround in activity, the rate of unemployment continued to rise during most of the year, reaching a peak in the third quarter, and falling slightly in the fourth. The continued rise in unemployment is the result of the combination of an increase in the labor supply, partly due to an increase in the rate of participation in the labor force, and a more moderate rise in employment. Employment continued to rise quickly in the public services, and accelerated in the business sector. From the second quarter, the

The continued rise in unemployment is the result of the combination of an increase in the labor supply and a more moderate rise in employment.

number of weekly hours per employee in the business sector also rose markedly, which is a characteristic feature of the stage of recovery from a recession. At such a stage, when there is uncertainty regarding the extent to which accelerated activity will persist, employers tend to increase the hours worked per employee before they take on extra workers, so that employment and unemployment react with a lag to a turnaround in the level of activity. The continued rise in unit labor cost in the business sector was one of the obstacles in the path of increasing employment in that sector. As in the last few years, the rise in unemployment affected mainly those with low levels of education.

Monetary policy at the beginning of 1999 focused on preventing the price increases evident at the end of 1998 from being translated into accelerated inflation, and later in the year aimed at consolidating inflation at a level consistent with the 1999 target.

Prices did not follow a uniform pattern in 1999. The 1.3 percent rise in consumer prices during the year, below the 4 percent target figure set for 1999, reflects a reduction in the first quarter of the year—which corrected for the exceptional rises at the end of 1998 following the series of sharp depreciations and the Bank of Israel's response to them—and a more moderate rise thereafter, at a rate close to the target for 1999 and to the target of 3–4 percent per year for 2000 and 2001, and close to the rate prior to exceptional increases at the end of 1998. The policy of monetary restraint adopted in 1999, as reflected in the rise in the short-term real interest rate,¹ focused at the beginning of the year—as it had at the end of 1998—on preventing the price increases evident at the end of 1998 from becoming ongoing inflationary acceleration. Later in the year policy aimed at consolidating inflation at a level consistent with the 1999 target and at creating the conditions for attaining the target for the next two years, while taking into consideration the yield differentials vis-à-vis abroad in order to avoid shocks on the foreign-currency market. The NIS appreciated at the beginning of 1999—continuing the trend that began at the end of 1998, after the steep interest-rate hike—depreciated gradually from April to October, and appreciated again from November until the end of the year and at the beginning of 2000. This path influenced the development of prices during the year. Net capital flows rose beyond the increase in the current-account deficit; foreign direct investment was prominent in this respect, rising slightly more than in 1998, and foreign investment in shares increased, after plummeting in 1998, against the backdrop of the resurgence of the international financial markets.

No progress was made in 1999 in changing the composition of the budget and public expenditure to make it supportive of long-term growth; the tax burden and its structure remained unchanged, and infrastructure investment declined.

Fiscal discipline was maintained in 1999, continuing the restraint that has characterized fiscal policy in the last two years. The budget deficit was 2.2 percent of GDP, a deviation of 0.2 percent of GDP from the target set in the Budget Deficit Reduction Law, due mainly to a lower level of economic activity than had been assumed in the budget. The deviation that emerged during the year was higher, but narrowed towards the end due to a surge in tax receipts as economic activity rallied and imports soared. No progress was made this year in changing the composition of the budget and public expenditure to make it supportive of long-term growth; the tax burden and structure remained unchanged, and infrastructure investment declined, while the share of both transfer payments and current public expenditure did not alter. Neither was

¹ For a definition of short-term real interest see note c to Table 1.9.

there any improvement in implementing structural reforms intended to enhance competition and which could have contributed to increased productivity, and hence to accelerated economic activity.

The background: the economy in the 1990s

The economic recovery that became apparent during 1999 provides a good starting point for the year 2000, concluding a decade in which GDP grew by an annual average of 4.8 percent and business-sector product by 5.5 percent. At the beginning of the decade there was a rapid recovery from the recession at the end of the 1980s, followed by accelerated growth generated by two factors—the influx of immigrants from the former USSR, and the peace process. However, alongside the rapid growth of that period there was a continuous rise in public expenditure, expressed at a later stage in growing deficits in the budget and in the current account of the balance of payments. The deficits reached a peak at the middle of the decade, in 1995 and 1996, and led to a sharp shift in fiscal policy together with the tightening of monetary discipline in order to make progress in the disinflation process. The end of the decade was marked by a protracted recession and notable rise in unemployment, alongside the reduction of the deficits in the budget and the balance of payments, and progress in disinflation. As the economy returns to a growth path the business cycle evident in the last decade will be completed.

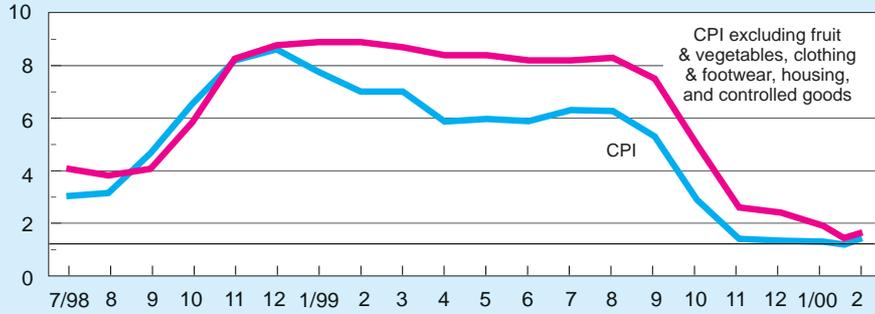
At the start of the decade, after two years of recession, there was a turnaround in economic activity: the business sector responded to soaring domestic demand in the wake of the huge influx of immigrants, so that business-sector product expanded in the first half of the decade by an annual average of 7 percent, alongside a rise in the import surplus. Initially, as stated, the influx of immigrants led to a rapid rise in domestic aggregate demand, especially consumption and investment, including housing. But a rise in the labor supply followed soon after, and, together with the rapid increase in capital stock due to increased investment, and a rise in productivity (of about 1 percent, annual average), enabled GDP to rise rapidly. Output was also diverted to exports, which surged and penetrated new markets, due *inter alia* to the peace process and globalization. As the first stage of the absorption of immigrants ended, and the capital/GDP ratio reverted to its pre-immigration level, investment, including that in housing, declined sharply from 1996, and private consumption moderated markedly. These developments reflected the tapering off of the expansionary effect of the influx of immigrants, and were expressed in the marked slowing of economic activity from 1996. This was also reflected in the significant drop in total factor productivity (TFP) (by a cumulative 5 percent since 1996), *inter alia* due to the decline in capital utilization that is characteristic of an economic slowdown. The fall in labor productivity (net business-sector product per hour worked) was smaller—a cumulative 0.5 percent.

Except for 1990 and 1991, when TFP rose due to streamlining processes set in motion during the recession at the end of the 1980s, the decade was marked by stagnation in both TFP and labor productivity. This is because of the considerable backlog in infrastructure investment and lack of progress in a) implementing structural reforms,

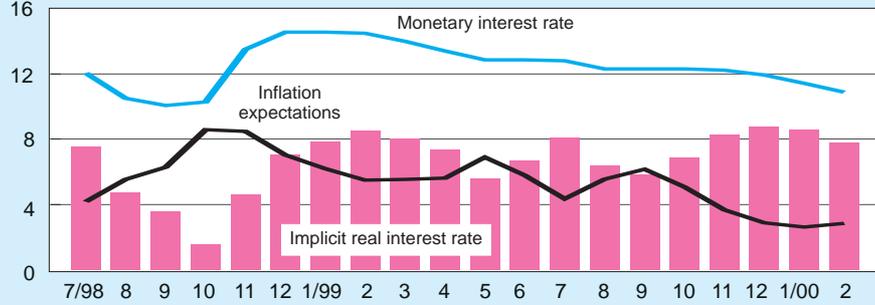
Output was also diverted to exports, which surged and penetrated new markets, due *inter alia* to the peace process and globalization.

Figure 1.2

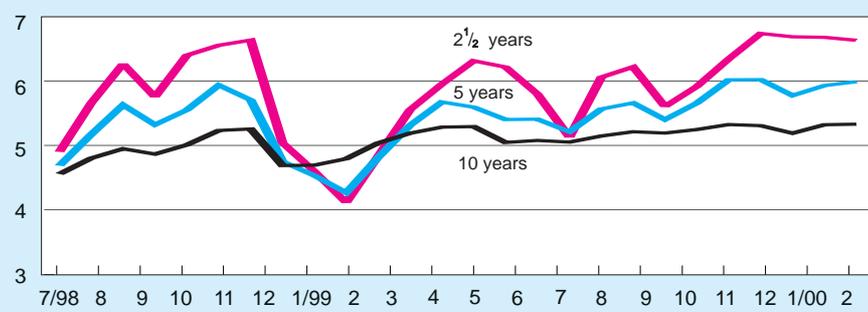
A. Rates of Change of Selected Price Indices in the Previous 12 Months



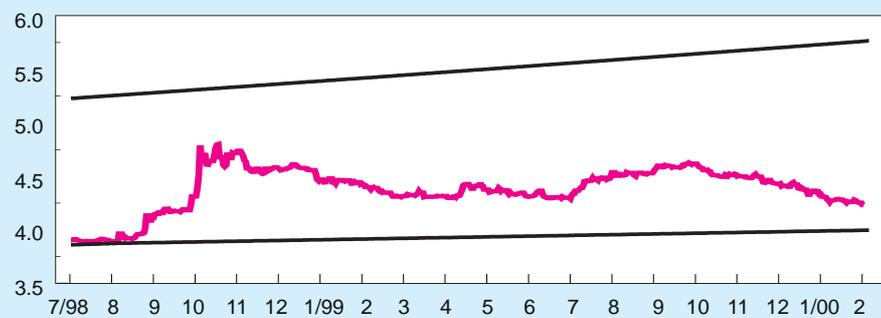
B. The Bank of Israel Interest Rate, Inflation Expectations, and Implicit Real Interest



C. Real Indexed Interest Rates



D. NIS/Currency-Basket Exchange Rate



SOURCE: Bank of Israel.

b) the rationalization of the tax system, and c) the easing of the tax burden. At the beginning of the period the stagnation in productivity also reflected the difficulties in absorbing immigrants in employment, while at the end of it attested to the underutilization of factors of production that, as stated, characterizes an economic slump.

The changes in the structure of the economy in the last decade were affected primarily by shifts in the structure of domestic demand as a result of the influx of immigrants, changes in the composition of manpower—due to long-term trends in the established population as well as to its composition among the new immigrants—trends in global demand, changes in relative costs of factors of production, and the continuous process of trade liberalization (Table 1.2). These were expressed in the first half of the decade in the increased share of construction while the shares of the other traditional industries, including those supplying construction inputs, and of high-tech industries remained constant. The direction of structural change has shifted since 1996, when it reverted to the trend that characterized it before the influx of immigrants; the share of the high-tech industries in manufacturing output rose steeply, due mainly to the sharp increase in exports in response to soaring global demand. The increase in the share of construction was checked in 1997, following the expansion that stemmed from the mass immigration, and its share of GDP fell in the two subsequent years. Alongside these changes, due as stated to the influx of immigrants, long-term trends of reducing the shares of manufacturing and agriculture were evident throughout the decade together with the increased share of transportation and communications, as well as of commerce and services—trends that are typical of economies with levels of *per capita* income similar to Israel's.

The direction of structural change since 1996 reverted to the trend that characterized it before the influx of immigrants; the share of the high-tech industries in manufacturing output rose steeply, in response to soaring global demand.

Table 1.2
Composition of Business Sector,^a 1970–99

	1970	1980	1990	1994	1995	1999
Total manufacturing	31.5	32.2	30.0	29.1	28.7	28.3
<i>of which</i> (percent of manufacturing)						
Traditional	67.1	56.6	51.7	50.5	50.1 ^b	44.8 ^c
Advanced	25.6	34.6	40.3	40.5	41.9 ^b	47.1 ^c
Agriculture	3.3	3.8	4.5	3.6	3.7	3.6
Transport and communications	10.5	11.3	11.6	11.9	12.5	14.3
Construction	17.4	13.0	9.8	11.2	11.3	8.9
Commerce and business services	42.7	44.7	49.1	49.7	49.3	56.1
Electricity and water	2.8	2.9	2.9	2.8	2.7	2.8
Total business sector	100.0	100.0	100.0	100.0	100.0	100.0

^a Share of industry in business sector, at constant 1995 prices.

^b The CBS sample was changed in 1995.

^c The 1999 data were calculated on the basis of the 1995 survey, linked to the annual rate of change of the industrial production index of each industry.

SOURCE: Based on CBS data.

The country's business cycle in the last decade, and the major shift in the labor supply arising from the influx of immigrants, were both sharply expressed in the unemployment rate. At the beginning of the decade the unemployment rate was high as a result of the economic recession at the end of the 1980s. Unemployment continued to climb, reaching a peak of 11.2 percent in 1992, as a result of the great increase in the labor supply due to the immigration, then fell rapidly, to an annual rate of 6.7 percent in 1995 and 1996, alongside rapid economic growth, reflected in the steep rise in employment, particularly in the business sector.² Note that the strategy of direct absorption of immigrants adopted in the 1990s, in contrast to earlier policies, relied to a great extent on their employment in the business sector. The rapid expansion of employment, alongside the integration of immigrants in employment, was also made possible by the flexibility of the labor market, expressed in the absence of change in the average real business-sector wage, in the context of the vast increase in the labor supply, and the slight decline in unit labor cost. Since mid-1996, as demand and economic activity slowed, the unemployment rate has risen again, reaching 8.9 percent at the end of the decade, together with an upward trend in labor costs.

The strategy of direct absorption of immigrants adopted in the 1990s, in contrast to earlier policies, relied to a great extent on their employment in the business sector.

During the 1990s, labor force developments, employment, and unemployment were not uniform for groups with different levels of education (see Box 4.1). The share of skilled workers in both employment and the labor force rose steadily, while the unemployment rate among unskilled workers was particularly high, and has increased in the last few years. Parallel with this, unskilled workers have dropped out of the labor market in large numbers, reflected in the continuous decline in their participation rate. These trends express long-term structural changes—the increased share of skilled and educated workers in employment in all industries and the greater proportion of skill-intensive industries. This process was accelerated *inter alia* by the higher wage paid to unskilled workers due to the significant rise in the minimum wage, making it difficult for industries that depend on unskilled labor to compete in an era of globalization and trade liberalization. The greater availability of foreign workers since 1993, whose employment cost is relatively low and who compete with unskilled workers, has also served to increase the unemployment rate of the latter.

The long-term structural changes were reflected by the increased share of skilled and educated workers in employment in all industries and the greater proportion of skill-intensive industries in the economy.

The changes in the structure of the demand for labor, expressed in the increased yield on education, the rise in the number of unskilled workers dropping out of the labor force, and the higher unemployment rate in recent years, are expressed in the greater economic inequality that has emerged during the decade. Progressive taxation and transfers had a slightly moderating effect on increased inequality of net incomes. At the same time, the proportion of families below the poverty line rose.³ A comparison of the level of net income inequality in Israel with that in industrialized countries (according to the Gini index) shows that it is similar to the median level in those

The changes in the structure of labor demand were expressed in greater economic inequality that has emerged during the decade.

² In 1990–95 the share of business-sector employment in total employment rose from 70.5 to 72 percent; during the recession, towards the end of the decade, the trend reversed, and its share dropped to 70 percent.

countries, but the proportion of poor people is greater in Israel than in most of them. The rising trend of inequality in the last decade is similar to that in other countries.

The influx of immigrants led to a rapid rise in public expenditure intended to facilitate their absorption. The realization that although the initial stages of integration require an increase of this kind, it is important to ensure that the accompanying growth of the budget deficit is not permanent, led to the introduction of the Budget Deficit Reduction Law, which defined a declining domestic budget deficit path. In the early 1990s the government met the deficit targets set in the Law without difficulty, due to the surge in economic activity expressed in a rapid rise in tax receipts, and in 1993 and 1994 also due to the ending of the special expenditure arising from the absorption of the immigrants (e.g., absorption grant and government-initiated construction). The increase in revenues enabled the government to extend its expenditure substantially, and also to sign expansionary wage agreements in the public sector for 1993–96 and to submit a supplementary budget in 1994 without deviating immediately from the deficit targets. However, an overly optimistic forecast of tax receipts in 1995, the slowdown in activity in 1996—expressed in a sharp fall in tax revenues—and the permanent rise in expenditure due *inter alia* to the wage agreements created fiscal expansion, which was expressed in 1995, and particularly in 1996, in a steep increase in the budget deficit and marked departure of the domestic deficit from its statutory target. The surge in domestic demand, including the public sector's contribution, was expressed in a rapid rise in the current-account deficit, which reached a record 5.5 percent of GDP in 1995 and 1996.⁴ This increase in the deficit led the government to alter the path of fiscal policy: in 1997 it was decided to cut government expenditure and raise tax rates, so that the government attained the statutory deficit target. In the following years, too, fiscal discipline was maintained in principle (albeit due in part to the Bank of Israel's 'real realized profit'), apart from a relatively slight deviation of 0.2 percent of GDP in 1999. In general, fiscal policy since 1997 can be described as being relatively tight, although the extent to which it remained so declined in the last two years. The composition of the fiscal consolidation did not support growth, however: the statutory tax rates and the tax burden rose, while the share of investment in government expenditure fell; the share of public consumption was unchanged, and transfer payments continued to rise (until this trend was checked in 1999).

Monetary policy was relatively expansionary at the beginning of the decade: M1 rose rapidly, and the Bank of Israel's real interest rate was very low (and even negative for some of the period); during this period the inflation rate was about 20 percent. At the end of 1992, in line with a similar trend in other small open economies, an inflation target was announced for the first time, but did not serve as an operative target for

An overly optimistic forecast of tax receipts in 1995, the slowdown in activity in 1996—reflected in a sharp fall in tax revenues—and the permanent rise in expenditure were expressed in 1995, and particularly in 1996, in a marked departure of the domestic budget deficit from its target.

³ The poverty line is defined as half of the median disposable income, adjusted for the number of family members. It indicates relative poverty, rather than absolute poverty in the sense of the ability to consume a basic basket of goods.

⁴ The financing of the deficit in this period was facilitated by the US government guarantees of \$ 10 billion.

Monetary policy was relatively expansionary at the beginning of the decade: during this period the inflation rate was about 20 percent.

Since the end of 1994 policy has focused on attaining the inflation targets, and the Bank of Israel's real interest rate has risen steadily, reaching an average of 7.5 percent in 1999.

monetary policy until the end of 1994, when inflation accelerated to 14.5 percent, compared with the 8 percent target announced for that year. Only from the end of 1994 did monetary policy focus on attaining the inflation target, as was done in the growing number of industrialized countries with inflation targets. At the beginning of the period the exchange rate served as a nominal anchor; later on the exchange-rate regime was gradually made more flexible by widening the band, and at the end of the decade its width was almost 40 percent.⁵ Initially the Bank of Israel intervened in foreign-currency trading within the limits of the band in order to influence the real exchange rate, but since February 1996 the Bank has adopted a strategy of non-intervention within the band's limits except in order to defend them. The combination of the width of the band at the end of 1999, the Bank of Israel's non-intervention strategy, and the fact that the exchange rate is far from the limits of the band means that in effect the regime is one of a floating exchange-rate. Nonetheless, because of the trend of local-currency appreciation evident in recent months, in March 2000 the exchange rate reverted to only 3.5 percent from the lower limit of the band.

As is customary in countries which have adopted an inflation target, the Bank of Israel has acted since 1994 to attain it by means of the interest rate. Since the end of 1994 policy has focused on attaining the inflation targets, and the Bank of Israel's real interest rate has risen steadily (except for a few brief episodes), reaching an average of 7.5 percent in 1999. Until 1997 the intensity of the monetary restraint required was also influenced by fiscal expansion at the time. The rise in the Bank of Israel's key interest rate, together with other factors that increased capital flows to emerging markets in general, were expressed in the marked expansion of capital inflow to Israel. These flows, together with the lack of consistency between the inflation target and the exchange-rate band, brought the exchange rate for part of the period, especially from 1995 to 1997, to the bottom of the band, obliging the Bank of Israel to intervene in trading by buying foreign currency. As a result, the foreign-exchange reserves rose steeply, and stood at \$ 22 billion at the end of 1999. At the same time, the Bank of Israel absorbed the additional liquidity, at first by reducing the extent of the monetary loan to banks, and then by continually increasing banks' (interest-bearing) deposits in the Bank of Israel. The need to meet the government's inflation target while at the same time defending the limits of the exchange-rate band led to a change in the stock of the Bank of Israel's assets and liabilities, as a result of which expenditure exceeded the income arising from these activities.

In the process of disinflation of the last decade it is possible to discern periods on the basis of plateaux in the development of inflation: 18–20 percent from the Economic Stabilization Program of 1985 to 1991; 10–12 percent from 1992 to 1997; and convergence to a 3–4 percent environment since 1998, with the exception of the episode

⁵ In June 1997 the slope of the lower limit of the band was set at 4 percent, and that of the upper limit remained at 6 percent, and in August 1998 the lower slope was altered to 2 percent, so that the band has been gradually widening.

of rapid depreciation, sharp price rises and subsequent declines in the fourth quarter of 1998 and the first quarter of 1999. Remaining at a given inflation plateau for several years indicates the support of monetary policy—together with fiscal policy, wage policy, exchange-rate policy, indexation mechanisms, and other institutional characteristics—in fixing inflation expectations each time at the prevailing inflation environment. Thus, swings in the inflation environment occurred against the backdrop of significant changes in these factors. Note that progress in the disinflation process in the last decade is not unique to Israel, characterizing advanced economies as well as most of the emerging ones (Table 1.1B).

In the last few years monetary policy has focused on achieving the inflation targets by means of the Bank of Israel's key interest rate, taking into consideration the differentials in yields between Israel and abroad, and exercising the caution required to prevent shocks in the foreign-currency market. Towards the end of the year the inflation environment reached a level consistent with the target rate of 3–4 percent a year set by the government for the years 2000–01. This occurred with the real rate of interest still relatively high, typical of a disinflation process, and with GDP below its potential. The downward trend of prices abroad also facilitated the process.

Since the Economic Stabilization Program, Israel's capital market has undergone a gradual process of reform which reduced both the government's role in it and its degree of centralization. This process was reflected by *inter alia* a reduction in the share of directed credit until it ceased completely, a decline in the share of earmarked bonds in the public's total financial assets, and increased competition in the banking industry—expressed in the form of, among other things, reduced interest-rate margins, privatization of banks, and permitting the entry of nonresidents into banking activity in Israel, including the opening of offices of foreign banks. Furthermore, banking corporations' holdings in nonbanking corporations were reduced. These processes took place at the same time as the liberalization process in the foreign-exchange market, reflected by the cancellation of most of the restriction on foreign-currency transactions and on individuals' and companies' investment abroad. Pension funds and life insurance funds are still prevented from investing abroad, and restrictions still apply to investments of the provident funds. One aspect of the liberalization process is the increasing reliance on raising capital abroad and on nonresidents' investment in Israel, including a huge rise in the extent of issues by Israeli companies in stock exchanges abroad.

The changes in monetary and fiscal policy took place against the background of the liberalization processes in the foreign-currency and capital markets, the continued process of trade liberalization and globalization, which broadened and deepened Israel's integration into the global economy. Side by side with the advantages afforded by these processes, there are also clear limitations which they impose on the macroeconomic policy makers. The more open and connected the economy is to the global economy, the more exposed and vulnerable it is to external shocks; this vulnerability necessitates greater emphasis on stability, including advancing the fiscal consolidation process, maintaining the reduction in the balance-of-payments current-account deficit, and

In the last few years monetary policy has focused on achieving the inflation targets by means of the Bank of Israel's key interest rate, taking into consideration the differentials in yields between Israel and abroad.

The more open and connected the economy is to the global economy, the more exposed and vulnerable it is to external shocks.

converging to the inflation level considered the norm in industrialized countries. Table 1.1B highlights Israel's progress towards the norms of the industrialized countries in these areas in the last decade, but also shows that it is still lagging behind them.

Fiscal and monetary expansion at the beginning of the 1990s and the tight policies since 1997 aggravated the economy's underlying business cycle which during the last decade was centered around the influx of immigrants. Fiscal expansion, which was due at least in part to the needs of immigrant absorption, occurred at exactly the same time as individuals' demand was at peak level, also as a result of the immigration. Fiscal restraint was inevitable, because of the extent of the effect on the balance of payments and the risk of running into financing difficulties apt eventually to cause a crisis and an even deeper recession. The question arises whether the adoption of a pro-cyclical macroeconomic policy was inevitable. It may be assumed that if fiscal expansion at the beginning of the period and the ensuing rise in the balance-of-payments current-account deficit had been more moderate, then the restraint needed, and its contractionary effect, would also have been less intense. Regarding monetary policy, if a tighter policy would have been applied sooner (and if not for fiscal expansion which made even more severe monetary contraction necessary), a less tight monetary policy would have been needed in the period of the economic slowdown, and it would have had a less contractionary effect. In short, a mix of a tighter fiscal policy and a less tight monetary policy in the mid-1990s would have achieved progress in the field of the balance of payments and inflation by means of a less contractionary macroeconomic (fiscal and monetary) policy towards the end of the decade, which would have alleviated the recession arising from the underlying business cycle.

Macroeconomic policy of fiscal and monetary discipline pursued during the last few years, against the background of progress in Israel's integration into the global economy, served to prepare the ground for a return to a path of sustainable growth, while advancing towards the long-term targets of price stability and strengthening the economy's resistance to global financial crises. Nevertheless, despite fiscal consolidation in the last few years, the public debt is still too large (Table 1.7), as is the size of the public sector. Most of the consolidation was carried out by increasing taxation, while the components of expenditure supportive of growth were not increased, and the whole tax system, and in particular tax rates, still needs revision. Monetary policy is still contractionary, as the disinflation process is still under way, and the inflation environment, despite its decline, is not yet firmly established at the levels considered normal in the industrialized countries. The above factors, combined with the ongoing rise in labor costs, the decline in productivity, and the erosion of real depreciation at the end of 1999 and beginning of 2000, express the continued reduction in business-sector profitability, and are likely to hinder the economy's return to a path of sustainable growth.

Despite fiscal consolidation in the last few years, the public debt is still too large, as is the size of the public sector.

2. REAL ECONOMIC DEVELOPMENTS

After some three years of moderate economic activity, well below the potential, in the second quarter of 1999 there was a turnaround in economic activity, although it is still too early to assess its intensity and persistence. The turnaround, which was led by demand, both domestic and for exports, was expressed on the sources side by an increase in GDP and the marked expansion of imports. However, unemployment continued to grow in the first three quarters, and leveled off only in the fourth.

GDP grew by 2.2 percent in 1999, with a 0.2 percent decline in per capita GDP, and business-sector product increased by 1.8 percent—significantly below the potential derived from the growth rates of capital stock and the labor force. However, a review of developments during the course of the year indicates that GDP and business-sector product declined in the first quarter and rose at average rates of 6.3 and 7.7 percent respectively (annual rates) in the subsequent three quarters,⁶ partly correcting for the decline at the beginning of the year (Table 1.3). The economic turnaround is also evident from indicators of the activity of the various industries, foremost among them the index of industrial production and the index of revenue in commerce and the services (at constant prices), as well as on the basis of the results of the Bank of Israel's survey of companies. Note, however, that according to some of the indicators of economic activity there was a slowdown in the fourth quarter of 1999, and it is still too early to tell whether they signal a swing or the weakening of the recovery.

Already at the end of 1998 the turnaround in demand was signaled by a shift in fixed investment, especially in machinery and equipment. After declining since 1996, investment rallied at the end of 1998; it increased rapidly at the beginning of 1999 but stopped rising at the end of the year. Most of the growth in investment reflected large, nonrecurring transactions—investments by Intel, imports of airplanes, and investment in software arising from fears of Y2K-associated problems—and was concentrated entirely in imported equipment. Inventory also soared, largely reflecting the expansion of activity of start-up companies and the renewal of diamond stocks. Alongside the growth in nonresidential investment, the decline in nonresidential construction investment persisted and even intensified. Residential construction continued to decline in 1999, although according to preliminary indicators (e.g., the survey of companies) this appeared to be checked towards the end of the year. The increase in investment in 1999 was expressed in the substantial rise in capital stock at the beginning of the year 2000, when it rose by 6.6 percent, after a similar increase in capital stock at the beginning of 1999. The rising trend of the long-term real interest rate that has characterized it in recent years persisted, bringing it closer to long-term interest rates abroad, as a consequence of the capital liberalization process and rise in short-term real interest rates.

GDP fell in the first quarter of 1999 and rose at an average rate of 6.3 percent in the three subsequent quarters—as a partial correction of the decline at the beginning of the year.

Most of the increase in investment reflected large one-off transactions—investment by Intel, imports of planes, and investment in Y2K-associated software.

⁶ Note that the quarterly data of the National Accounts are not particularly reliable, and may change significantly when updated.

Table 1.3
Developments During the Year,^a 1998 and 1999

	1998				1999			
	I	II	III	IV	I	II	III	IV
Sources and uses								
GDP	3.8	2.9	2.4	0.8	-3.7	8.0	5.1	5.8
Business-sector product	5.9	2.4	1.8	0.0	-6.5	9.5	7.1	6.5
Private consumption	3.6	14.0	-3.7	-2.4	6.0	1.7	12.1	1.3
Excl. durables	4.6	6.0	1.9	0.9	4.6	2.4	6.4	4.1
Public consumption	5.5	-1.8	-0.4	-1.1	-2.0	20.5	7.0	5.2
Fixed investment	-1.4	-1.9	-17.4	6.5	8.0	6.1	-1.2	-18.0
Nonresidential	-2.8	0.9	-14.4	6.0	18.9	12.1	6.1	-22.6
Residential	-6.5	-10.9	-15.7	0.9	-12.4	-11.9	-14.3	-9.6
Exports	6.2	40.5	-14.2	-1.1	7.4	17.1	24.1	17.3
Excl. diamonds	11.4	42.0	-13.7	-0.2	2.6	16.1	26.5	16.3
Goods exports	9.9	15.7	-4.7	-8.6	5.6	19.9	19.6	15.9
Uses	2.9	4.9	0.8	-0.1	5.4	11.4	11.1	7.3
Imports	-0.8	11.9	-4.6	0.6	18.5	30.5	21.2	13.7
Excl. defense imports, and ships, planes and diamonds	4.9	16.9	-3.1	-3.5	12.7	12.7	19.3	24.5
Domestic uses	1.3	-4.1	9.3	-3.0	9.4	6.2	5.5	2.0
Unemployment rate ^b	8.6	9.2	8.2	8.2	8.7	8.9	9.1	8.9
Business-sector employment ^c	-0.4	-0.8	1.0	-0.1	1.6	0.4	0.7	2.2
Average hours worked ^d	-4.3	-1.2	-7.2	1.4	0.4	4.7	4.9	0.1

^a Seasonally-adjusted data; rates of change over preceding quarter, in annual terms.

^b Percentage of labor force.

^c Rate of change of number of business-sector employees.

^d Average of hours worked per Israeli employee in business sector.

SOURCE: Tables 2.2, 4.1.

The turnaround in the export trend this year was affected by the real depreciation, the swing in world trade, and the surge in tourism.

Exports, which had been affected by the slowdown in world trade since mid-1998, as expressed in their sharp decline in the third quarter of that year and subsequent stagnation, began to recover and rose rapidly from the second quarter of 1999, although the annual average growth rate remained stable. The real depreciation of 1999 contributed to the turnaround in the trend of exports, after the trend of real appreciation that has characterized Israel in the last few years was checked in 1998. The swing in world trade, including that in imports from Asia, which had previously had to contend with economic crises, and the surge in tourism, against the backdrop of the improved security situation, the renewal of the peace process, and the end of the millennium, also contributed to the turnaround.

Private consumption, which had declined in the second half of 1998, began to rise at the beginning of 1999, and its growth rate has accelerated markedly since the second quarter, encompassing both current and durables consumption. As an annual average, the rise in private consumption was similar to that in 1998—3.3 percent. The recovery of private consumption was based on an increase in both the real wage and wealth, due to soaring share prices, and was also supported by expectations of renewed growth due to the background conditions of economic stability and progress in the peace talks.

The marked acceleration of demand and the more moderate growth of GDP during the year were expressed by the significant increase in the import surplus and the expansion of the current-account deficit from 0.9 to 2.6 percent of GDP. Even after this expansion, however, the deficit was substantially lower than the level of capital transfers and investments by nonresidents, making its financing possible while continuing to reduce the external debt and its share in GDP (Table 1.4).

From the investment savings balance it can be seen that the expansion of the current-account deficit as a share of total income drew on both the increase in the share of

Table 1.4
Balance of Payments, 1990–99

	(\$ billion, annual rates)				
	1990–92	1993–96	1997	1998	1999
Import surplus	6.2	9.9	9.7	7.0	9.0
Current-account deficit	-0.7	-4.1	-3.5	-0.8	-2.6
Implied capital imports ^a	0.3	6.2	14.1	2.1	2.9
Capital transfers	1.1	1.8	2.2	1.8	1.6
Investment in Israel by nonresidents ^b	0.3	1.7	3.6	2.4	3.7
Rise (-) in foreign-exchange reserves ^c	0.4	-1.5	-9.3	-1.9	-1.3
Foreign-exchange reserves ^d	6.5	8.8	20.8	23.3	22.4
Net external debt	17.2	18.3	14.5	11.6	10.9

^a Including errors and omissions.

^b Direct and portfolio investment.

^c Excluding revaluation gains.

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

SOURCE: Tables 6.1, 6.2, 6.13.

investment, and the decline in the saving rate. However, at least part of the increase in the import surplus can be ascribed to a nonrecurring rise in imported investment goods (for Intel), diamonds (to renew stocks), and planes, for which there is no domestic substitute. Thus, it cannot be concluded that there was a permanent increase in the level of investment or an enduring expansion of the import surplus. Investment accounts for a larger share of total income than it did before the influx of immigrants, as is expressed in the relatively rapid rise—by some 6.5 percent a year—in capital stock, as well as in the capital stock/GDP ratio. However, these developments do not necessarily imply that the investment rate will decline in the future, as its rise may express the

The increase in the import surplus can be ascribed, at least in part, to a nonrecurring rise in imported investment goods which have no domestic substitute.

structural and technological changes that are occurring in the economy, and which may persist. Hence, a further improvement in the current account will apparently necessitate an increase in the saving rate. The saving rate declined by about one percent in 1999, to some 16.4 percent of national income, reflecting only a partial offsetting of the fall in public saving by a slight rise in private saving (Table 1.5). An increase in public saving which is regarded as permanent, in the framework of fiscal consolidation, could contribute to a rise in the saving rate and bring about a lasting decline in the current-account deficit. This will come about provided it is not fully offset by a drop in private saving. Note that the extent to which changes in public saving are offset by changes in private saving has been somewhat smaller in the 1990s.⁷

Table 1.5
Saving, Investment, and the Current Account, 1990–99

	(percent of income, ^a annual rates)				
	1990–92	1993–96	1997	1998	1999
Gross saving rate	19.7	18.1	16.9	17.4	16.4
Public	–0.6	–0.3	–1.1	–1.0	–2.3
Private	20.3	18.4	18.0	18.4	18.7
Gross investment	20.9	22.6	20.2	18.1	18.8
of which Business sector	12.5	15.1	13.7	12.9	13.6
Current account of					
balance of payments	–1.1	–4.6	–3.3	–0.7	–2.4

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

SOURCE: Table 2.A.16.

The rise in the unemployment rate reflected the slowdown in economic activity, but in 1999 it was affected by a significant increase in the labor supply, also reflecting a higher labor-force participation rate.

The unemployment rate continued to rise in 1999, and reached 9.1 percent in the third quarter, after rising constantly since 1996, when it was 6.6 percent. In the fourth quarter it stopped rising, and even dipped slightly. The rise in the unemployment rate reflected the economic slowdown, but in 1999, in contrast to the two preceding years, it was supplemented by a significant increase in the labor supply, reflecting an increase in the participation rate over and beyond the incremental working-age population. The civilian labor force (the labor supply) rose by 3.5 percent in 1999, while the working-age population increased by 2.7 percent, and the rate of Israelis employed went up by 3.1 percent (Table 1.6). The rise in Israelis employed was significantly steeper than in the preceding two years, when it grew by an average annual rate of about 1.5 percent, increasing at similar rates in the business sector and the public services. This reflected

⁷ From the 1960s to the 1990s changes in private saving have been almost fully offset by those in public saving, as is expressed in a –0.82 correlation between them. The offsetting was weakened to –0.36 in the 1990s, though this is not enough to indicate a future trend. The decline in private saving in the early 1990s, alongside the fall in public saving, may have reflected the low saving rate of the immigrants in their first years in Israel, when their income was less than expected. This result is consistent with the permanent income theory, according to which the immigrants' saving rate will rise once they have been longer in Israel.

Table 1.6
Conditions of Business-Sector Activity, 1990–99

	(annual change, percent)					
	1990–92	1993–96	1997–99	1997	1998	1999
Business-sector output	7.6	6.5	2.3	2.9	2.2	1.8
Domestic labor inputs	5.5	7.2	1.4	1.4	–0.6	3.3
Civilian labor force	5.0	3.8	2.9	2.5	2.6	3.5
Labor supply ^a	5.9	5.5	3.1	3.0	3.2	3.1
Proportion of nonresidents in business sector	9.0	9.3	12.6	12.3	12.8	12.8
Gross physical capital stock	3.1	7.3	7.7	8.8	7.7	6.5
Total factor productivity (TFP)	2.8	–0.8	–1.1	–0.9	0.1	–2.4
Yield on gross capital ^b	13.7	13.1	10.3	10.7	10.6	9.7
Average business-sector wage	–1.6	0.5	3.3	3.5	3.0	3.4
Unit labor costs (business sector)	–3.3	2.2	1.4	1.9	0.1	2.1
Real minimum wage	–1.8	1.2	4.6	6.1	5.4	2.2

^a Civilian labor force *plus* foreign and Palestinian workers.

^b Before tax.

SOURCE: Tables 2.1, 2.4, 4.1.

an acceleration of business-sector employment and a slowdown in public-sector employment. The increase in the share of Palestinian and foreign workers in business-sector employment, which persisted from 1993 until 1997, was checked in 1998, remaining at the same (high) level in 1999—about 13 percent of business-sector employment, higher than in almost any OECD country (except Switzerland).⁸ In 1999 there appears to have been a trend shift in the demand for labor, expressed in the rise in the number of hours worked per employee in the business sector since the second quarter, a development that characterizes the initial stages of emergence from a slump—when employers are still skeptical as to its persistence—as well as in the steep rise in employment in the fourth quarter.

The average real wage continued to rise in 1999, reflecting its persistent increase in the business sector and slight decline in the public services. The real wage per employee post rose by some 3.4 percent in the business sector, continuing the 3.3 percent average increase in the preceding two years. These increases, the decline in labor productivity, fall in the number of hours worked per employee (annual average), and rise in the GDP

During the year there was a trend shift in the demand for labor—the number of hours worked per employee rose in the business sector from the second quarter and employment soared in the fourth.

⁸ This figure reflects the updating of data used in the past; the CBS went over to using Palestinian Authority data in estimating Palestinian workers, and the figure is far higher than the previous estimate. At the same time, the estimate of the number of unreported foreign workers was adjusted downwards. According to the data, the number of Palestinian workers rose by some 10,000 in 1999, and the number of foreign workers fell slightly (by 2,000) for the first time since 1993. This decline is relatively moderate, and took place despite the contraction in construction activity since 1997; some foreign workers who left construction appear to have moved as illegal workers to other industries where the incentive to employ them is great because of their relatively low cost.

During the recession the cost of labor in the business sector rose by 6.5 percent, hampering the expansion of employment even during a surge in activity.

deflator relative to the price of private consumption, are reflected by a 2 percent rise in unit labor cost, after this had remained stable in 1998 and gone up by an annual rate of 2 percent in the two previous years.⁹ Since 1996 labor cost in the business sector has risen (during the economic slowdown) by about 6.5 percent—making it difficult to expand employment even at a time of accelerated growth. The rise in the cost of labor during the slowdown is explained in part by the rapid—and to some extent also unexpected—decline in inflation in that period, and apparently also by the change in the composition of employment: during a slump firms tend to dismiss newer workers, whose wage is relatively low.

The drop in the real wage in the public services in 1999, further to its stability in the two preceding years, reflects the conclusion of the expansionary wage agreements that applied to the period from 1993 to 1996, the lack of valid wage agreements in the following period, and the one-off payment of a 4.8 percent wage supplement towards the end of 1999 due to wage agreements for the end of 1997 and 1998. Negotiations for wage agreements in the public sector for 1999 and subsequently are still in their initial stages, and can be expected to be accompanied by industrial unrest.

3. FISCAL POLICY

The share of the public debt remained high—88 percent of GDP (net) and 106 percent (gross), compared with 60 percent according to the criteria of the Maastricht treaty and an average of 80 percent in the G7 countries.

Discipline was maintained in the conduct of fiscal policy in 1999, and it can be described as restrained, continuing the line adopted since 1997, although according to the fiscal impulse index it was less stringent in the last two years than in 1997. The public-sector deficit as a ratio of GDP, the share of public expenditure in GDP, and the tax burden have remained almost unchanged since the fiscal consolidation of 1997. Thus, while there was no retreat from the government's long-term goals, despite the moderation in economic activity, neither was there any real progress towards attaining them. In particular, the share of the public debt has not altered, and it is still at the high level of 88 percent of GDP (net) and 106 percent (gross), far higher than the international norm reflected in the criteria laid down in the Maastricht treaty (60 percent) and above the average of the G7 countries (around 80 percent).

The budget deficit, which was about 2.2 percent of GDP in 1999, deviated slightly from its target of 2 percent of GDP under the Budget Deficit Reduction Law. This is due *inter alia* to lower than planned tax revenues in the wake of lower growth than forecast in the budget. During the year it seemed that the deviation from the target set by law would be even wider, but a substantial increase in tax receipts due to accelerated economic activity towards the end of the year offset most of it.

⁹ A similar trend of rising unit labor cost has also been evident in the US since the mid-1990s, as well as in other countries, and could reflect *inter alia* the relative expansion of skilled labor-intensive industries in which wages constitute a relatively large proportion of product. Nevertheless, the index of unit labor cost in manufacturing in Israel relative to that in developed countries (weighted index of 20 countries) indicates an increase of 25 percent between 1994 and 1997, and stabilization subsequently (IMF figures, Bank of Israel Research Department internal memorandum, Nitza Kasir, *Unit Labor Cost* (Hebrew)).

Adherence to fiscal discipline since 1997, despite the economic slowdown and tendency in the past to conduct a counter-cyclical policy by raising expenditure, which could have contributed to economic activity in the short term, is commendable. The fact that fiscal discipline was maintained even during the economic slowdown reflects its growing importance at a time of globalization, when markets, and foreign investment in particular, can respond rapidly to policy that is perceived as being destabilizing.

The maintenance of fiscal restraint in recent years was not accompanied by changes in the composition of the budget in a way that stimulates the economy's return to a growth path; in particular public-sector investment fell from 3.5 to 3.1 percent of GDP after rising in previous years. Investment in roads and railways plummeted (by 14 and 38 percent respectively). In the last few years government investment in transportation has focused on roads, while investment in mass transportation projects—which could contribute significantly to reducing road congestion in an environmentally-friendly way—did not rise despite indications of a severe backlog in infrastructure investment in Israel. The tax burden, which declined in 1996, rose again in 1997, and has remained at that level since then. Increased infrastructure investment and a reduction of the tax burden could contribute to greater utilization of factors of production and improved productivity in the business sector, thereby serving to increase profitability

Investment in mass transportation systems, which could make a significant contribution to reducing road congestion in an 'environmentally-friendly' way, did not increase.

Table 1.7
Main Indicators of Fiscal Policy, 1990–99

	(percent of GDP, annual rates)							
	1990–92	1993	1994	1995	1996	1997	1998	1999
Overall public-sector deficit	4.8	4.6	3.5	4.8	5.5	4.1	3.6	4.8
Public-sector domestic deficit	7.9	6.3	4.6	5.9	6.6	5.4	5.0	5.5
Net overall public-sector debt	111.8	101.3	92.5	89.9	89.7	88.3	88.3	87.8
Gross overall public-sector debt	133.3	126.0	118.1	111.8	109.5	107.1	111.2	106.0
Total public-sector expenditure ^a	58.0	57.2	55.0	56.2	55.2	54.0	54.3	54.4
Total taxes (including property tax) ^a	38.6	39.5	40.4	40.8	39.4	40.4	40.1	40.3
Ceiling on domestic budget deficit ^b	6.2 ^d	3.2	3.0	2.8	2.5	2.3	2.2	2.6
Actual domestic budget deficit	4.9 ^d	2.3	1.9	3.2	4.5	3.1	2.9	3.0
Ceiling on overall budget deficit ^c	8.5 ^d	4.4	3.5	3.8	3.6	2.8	2.4	2.0
Ceiling on overall budget deficit less Bank of Israel profit	8.5 ^d	4.7	3.8	3.9	3.7	3.0	2.8	3.1
Actual overall budget deficit	3.9 ^d	2.5	2.3	4.1	3.8	2.7	2.4	2.2
Actual overall budget deficit less Bank of Israel profit	4.0 ^d	2.5	2.3	4.5	4.3	3.4	3.4	3.2

^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.

^d For 1992 only.

SOURCE: Table 5.1.

and stimulate activity. The existence of the underlying forces for a continuous increase in current public expenditure (at least as regards population growth) hampers adherence to fiscal restraint, and especially to a declining deficit path, during a recession, explaining the tendency to make a fiscal consolidation by reducing investment and increasing the tax burden.

The composition of the budget displays certain positive developments, such as the fact that the increase in the share of transfer payments has been checked for the first time this year, after a long-term rising trend. Nonetheless, no progress has been made regarding the composition of these payments, especially in view of the negative incentives to work which some of them embody.¹⁰ In the sphere of public-service employment, the counter-cyclical policy continued in 1999, and employment in this sector rose by 3.1 percent, further to the 5.1 percent increase in 1998.¹¹ In this way the government has returned to its policy of offsetting some of the unemployment arising from the slowing of business-sector activity and which it adopted in previous recessions. The expansion of general government employment during an economic slump tends not to be reversed during a boom, and therefore hampers the contraction of general government in the long run.

The counter-cyclical trend of policy regarding public-services employment persisted in 1999, and employment in this sector rose by some 3.1 percent, continuing the steep increase in 1998.

4. MONETARY POLICY AND DEVELOPMENTS, AND PRICES

The development of prices was not uniform in 1999. The Consumer Price Index (CPI) rose by 1.3 percent during the year—below the 4 percent target set for the year—reflecting the fall of prices in the first quarter as an adjustment to their exceptional rise at the end of 1998, and their moderate increase subsequently, at an annual rate of 4 percent, in line with the 1999 target and the upper limit of the target range for the next two years. This trend of prices was evident in most of the components of the CPI, and reflected a similar trend—albeit more intense—in the exchange rate of the NIS against the dollar and the currency basket. As an annual average, prices were up by 5.2 percent in 1999 over 1998 (Table 1.8).

In August the government set an inflation target of 3–4 percent for 2000 and 2001.

In August the government set an inflation target of 3–4 percent for the years 2000 and 2001. This reflects the view that gradual progress should be made towards the long-term target of price stability, after the tendency in the past appears to have been to set inflation targets in accordance with the inflation environment of the time. Announcing the target for two years constitutes progress, but as the target still refers to each year separately, policy must still respond swiftly and sharply to temporary exogenous shocks in order to avoid departing from the target during the course of the year.

¹⁰ The negative incentives include high effective tax rate, expressed in the denial of certain benefits to employees, on the one hand, and the failure to make other benefits contingent on employment for persons able to work, on the other.

¹¹ Labor force surveys providing employment data for the public services include, in addition to direct public-sector employees, employees of business-sector entities that supply services of a public nature, such as education, health, and welfare. The activity of these entities is partly or fully funded by the public sector.

Table 1.8
Indicators of Price Developments, 1990–99

	1990–91	1992–95	1996	1997	1998	1999	(percent)	
							1999	
							Jan–Mar	Apr–Dec
Year-end								
CPI	17.8	10.8	10.6	7.0	8.6	1.3	–1.4	2.8
CPI excl. housing	14.8	9.2	9.8	6.8	8.6	2.0	–0.5	2.5
CPI excl. housing, fruit & vegetables, clothing & footwear, and controlled goods	14.1	8.9	10.2	7.8	8.8	2.4	0.7	1.6
Wholesale price index	13.6	9.0	7.0	5.9	8.2	3.5	–0.8	4.4
Exchange rate against currency basket ^a	11.4	8.5	3.0	3.7	20.6	–2.5	–5.5	3.2
Average								
CPI	18.1	11.3	11.3	9.0	5.4	5.2		
CPI excl. housing	14.5	9.7	9.9	8.4	5.3	6.0		
CPI excl. housing, fruit & vegetables, clothing & footwear, and controlled goods	14.3	9.3	10.5	8.6	6.0	7.0		
Wholesale price index	13.8	9.2	8.6	6.3	4.2	7.1		
Exchange rate against currency basket	11.4	8.6	3.5	4.3	9.6	8.3		
Exchange rate against dollar	9.0	7.3	5.9	8.2	10.2	9.0		
Real exchange rate in export terms ^b	–4.9	–2.6	–3.8	–2.7	0.1	1.4		
Real exchange rate in import terms ^c	–6.4	–1.7	–6.4	–4.8	–2.3	0.8		
Terms of trade ^d	1.7	–0.9	2.8	2.3	2.5	0.6		

^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 deflator of business-sector product, including residential services.

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

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

SOURCE: Based on CBS data.

The Bank of Israel's nominal interest rate declined during the year, but the fall in inflation expectations was steeper, so that the average real interest rate *ex ante* rose to about 7.5 percent—its highest level in recent years (Table 1.9). At the beginning of the year, continuing the trend evident at the end of 1998, policy focused on preventing the price rise due to the sharp depreciation at the end of 1998 from becoming ongoing inflationary acceleration; subsequently, it acted to consolidate inflation at a rate consistent with the 1999 target, and to create the conditions for attaining the inflation target for the next two years, while preventing shocks on the foreign-currency market. For this purpose, the Bank of Israel's nominal interest rate was not changed at the

beginning of the year (after a steep increase in November 1998), and when prices and expectations began to fall it was reduced gradually each month from April to May (Figure 1.2). Local-currency depreciation from July to October, and the subsequent return of inflation expectations to around 6 percent, caused the Bank of Israel to avoid a further reduction of the interest rate after its 0.5 percentage-point reduction in August. In the fourth quarter the actual rate of price increases was lower than expected, and inflation expectations declined sharply, for the first time reaching the inflation target range for the years 2000 and 2001; as a result, the Bank of Israel again reduced the interest rate at the end of 1999 and the beginning of 2000. The gradual way the nominal interest rate was reduced, in order to prevent sharp shifts in the composition of the public's portfolio and shocks on the foreign-currency market in the wake of the narrowing yield differential vis-à-vis abroad, was expressed by the increase in the short-term real interest rate *ex ante* at the end of the year to 8.7 percent.

Monetary policy acted through various channels to slow the rate of price increases. The NIS appreciated at the beginning of the year, continuing the trend that had begun at the end of 1998, after the sharp interest-rate hike following the events of October 1998, depreciated between April and October, and appreciated again in November,

Table 1.9
Monetary Indicators, 1990–99

	(percent, annual rates)							
	1990–							
	1992	1993	1994	1995	1996	1997	1998	1999
M1 ^a	25.6	23.7	20.6	8.4	14.9	14.3	12.1	11.4
Nondirected credit ^a	32.8	44.9	28.1	27.6	23.3	18.5	15.9	17.9
Nominal Bank of Israel interest rate	14.2	11.9	13.7	15.8	16.3	14.7	12.5	12.8
SROs (CDs)	14.6	9.0	12.9	10.6	11.7	9.1	6.2	5.3
Nondirected credit in NIS ^b	12.1	9.7	11.6	13.3	13.8	12.2	10.2	10.7
Expected inflation ^b	24.2	16.5	17.4	20.2	20.7	18.7	16.2	16.4
Average currency-basket interest rate	6.1	3.4	4.8	6.2	5.6	5.9	5.7	5.5
Real interest rate on 5-year bonds	1.9	3.0	3.1	4.3	4.6	4.1	5.1	5.6
Real Bank of Israel interest rate ^c	0.3	2.7	2.2	5.3	4.8	5.2	6.2	7.5
General Share-Price Index ^d	54.8	39.7	-38.5	14.8	-1.6	36.1	2.9	65.7

^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.

^c Until 1995 daily average of effective marginal interest at monetary loan at quota; from 1996 average of effective interest at daily auction of banks' deposits in Bank of Israel *less* inflation expectations for 12 months, as derived from capital market.

^d Index of all shares and convertible securities, rate of change during the year.

SOURCE: Tables 7.1, 7.3.

continuing until the end of the year. Over the year as a whole there was local-currency appreciation of 2.5 percent against the currency basket, and the exchange rate remained almost unchanged against the dollar—a development that was also influenced by the interest-rate policy and helped to dampen the rise in prices. The more moderate demand

of the last few years, which remained at a relatively low level even after it rallied during the year, was affected *inter alia* by the high real interest rate, and also contributed to the process of disinflation. Part of the increase in demand in 1999 focused on imported goods (Intel, planes) and hence did not exert pressure on domestic sources and prices. The consistency of adherence to the disinflationary policy also helped to influence expectations in a way that supported the process.

In a wider sense, the growing importance attached to the subject of stability in macroeconomic policy in recent years, and increasing public awareness that in the global economy the focus on stability is inevitable, support the permanent reduction of inflation, and may require less monetary restraint in attaining it. All these can help in the process of convergence to the levels of inflation and interest rates prevailing in industrialized countries.

The growing importance of stability in macro-economic policy supports the permanent reduction of inflation, enabling its attainment with less monetary restraint.

5. POLICY TARGETS FOR THE NEXT FEW YEARS

The main policy target for the next few years is to bring Israel's economy to a path of sustainable growth that will enable the reduction of the unemployment rate while preserving stability, including the progress towards price stability and consolidation of the improvement in the balance of payments that are essential for Israel's integration into the global economy. This will have to be done while contending with the problems of poverty and inequality that have been exacerbated in recent years.

The conditions at the beginning of the year 2000 indicate that business-sector activity has stepped up, with a significant increase in employment and cessation of the rise in unemployment. Further progress towards achieving the growth potential requires an improvement in business-sector productivity and profitability, however. Profitability will be improved by means of a policy that contributes directly to business-sector productivity through increasing infrastructure investment, easing the tax burden and reforming the tax structure, extending and deepening the structural reforms that will contribute to enhanced competition and efficiency, and continuing the process of reducing the Bank of Israel's interest rate subject to attainment of the inflation targets.

The progress in Israel's integration into the global economy, together with the greater liberalization of capital flows, obliges policymakers to place considerable emphasis on economic stability. This is because, alongside its inherent advantages, the exposure of the economy to trade and capital flows, in both directions, intensifies the response of these flows to a policy that is perceived as unreliable, and increases vulnerability to global economic crises. The risk that shocks to the economy will turn into a financial crisis is affected by the extent to which the public and the banking system are exposed to exchange-rate risk. Monetary policy that aims at attaining the inflation target while relating to the yield differential *vis-à-vis* abroad will help to make the economy less vulnerable to exogenous and endogenous shocks, enabling these differentials to be reduced over time. The need for a cautious policy is intensified by the extent of the short-term local-currency assets in the hands of the public; their share in its asset portfolio

Progress in Israel's integration into the global economy, with the increased liberalization of capital flows, obliges policymakers to place greater emphasis on economic stability.

began to increase in mid-1993, when the rate of inflation declined and confidence in the stability of the shekel rose, and continued to do so as the real interest rate rose from early 1994. Hence, it is important that policy continue to bolster the public's confidence in the stability of the shekel.

Fiscal policy plays a pivotal role in attaining the aforementioned goals—both by maintaining fiscal discipline and making progress towards fiscal consolidation and by changing the composition of the budget and easing the tax burden. However, the ceiling for the budget deficit set for the year 2000—2.5 percent of GDP—expresses a retreat from the progress made in reducing the deficit, which was 2.2 percent of GDP in 1999, set above the deficit target required under the (original) Budget Deficit Reduction Law (1.75 percent of GDP). Note that this ceiling was set in mid-1999, when tax revenues were low and a large deviation from the deficit was predicted, but at the end of the year, as economic activity rallied, it transpired that tax receipts were higher and the deviation smaller than assumed in the budget forecast, and could even increase further, if the growth rate exceeded the rate on which the forecast was based. Consequently, it is particularly important that public expenditure in the year 2000 should not depart from the budgeted amount, so that the actual deficit will be below its 1999 level. Moreover, the section of the Budget Deficit Reduction Law referring to the link between the annual rate of reduction of the deficit (at least 0.25 percent of GDP) and the growth rate is formulated in vague terms. In order to ensure that there is no retreat in the process of fiscal consolidation it is therefore advisable to buttress the law by restricting the growth rate of current public expenditure, ensuring that high tax revenues resulting from increased activity are not utilized to enlarge expenditure permanently.

It is particularly important that public expenditure does not depart from the budgeted amount, so that the actual deficit in 2000 will be lower than in 1999.

Investment in the transport infrastructure, helping to reduce congestion in the Tel-Aviv metropolitan area and bringing the periphery closer to the center, will also serve to bring unemployment down in the periphery and reduce the dependence of outlying regions on individual plants.

Infrastructure investment declined in 1999 despite public awareness of its importance for stimulating sustainable growth and of the substantial backlog in it. The implementation of plans that have been drawn up in this sphere should be hastened, and the planning of additional projects brought forward. Investment in the transportation infrastructure, which will help to reduce congestion in the Tel Aviv metropolitan area and bring the periphery closer to the center, will also serve to reduce unemployment in the periphery and lower the dependence of more remote areas on individual plants. In many cases, such plants were established with the aid of massive subsidization at the initial stage, but as some of them are not profitable over time they close down once subsidization comes to an end.

The budget proposal for the year 2000 displays some progress in the right direction, as it includes an increase in government investment in the transportation infrastructure, including roads, trains, and public transport. It is also intended to incorporate private-sector entities in funding and operating infrastructure projects, using the BOT system.¹² The expected acceleration of work on the Cross Israel Highway, which is being

¹² Under the BOT (Build, Operate, Transfer) system, the business-sector entrepreneur finances and implements the system, charges users, and eventually transfers it to the government.

constructed by private funds but is initiated (and insured) by the government, is a step in this direction. On the other hand, in the area of taxation the budget proposal is not in line with the long-term target, as it embodies several steps that will increase the tax burden. In addition, the wage agreements for 1999 and later have not yet been signed, and the negotiations with the various sectors are proceeding amidst growing labor unrest. It is important to ensure that the accommodating background of relatively high tax receipts resulting from the surge in economic activity does not lead to expansionary wage agreements (as occurred in 1993–96), as these will have long-term repercussions. It is also important to adapt wage mechanisms to conditions of price stability, as under low inflation the nominal wage drift that was accepted in the past (e.g., due to seniority and grade) embodies a real wage increase even before wage negotiations begin.

In the area of taxation, alongside the importance of reducing the tax burden as a way of stimulating supply, it is also vital to further rationalize the tax system while expanding the tax base by revoking the tax exemptions on capital gains and reducing the distortions arising from tax regulations that discriminate between different investors and tax channels. For this purpose a committee to examine tax reforms has been set up and should submit its recommendations at the end of March 2000 for implementation in the 2001 budget. The policy formulated will have to find a balance between the various goals the tax system is intended to attain: efficiency, i.e., minimizing distortions in the allocation of resources, progressiveness, expressing social preferences in the allocation of incomes, and the fiscal target, the level of tax receipts required to finance public expenditure, also on the basis of social preferences. In a wider context which includes both the tax system and the transfer payments system it is advisable to tackle the problem of negative incentives for work embodied in the highest effective tax rate: making subsidies contingent on a means test so that they are fully offset when income from labor rises, i.e., an effective tax rate of 100 percent or more.

Policy regarding prices will continue to focus on attaining the 3–4 percent inflation target set by the government for the years 2000 and 2001, doing so in the framework of the long-term goal of price stability. The challenge for policy in the next few years will be to stabilize inflation at a level similar to that in the developed countries, while bringing the interest rate into line with theirs, and at the same time stimulating economic activity towards the level of potential GDP. The recovery of demand evident since the second quarter of 1999, the expansionary wage path in both the business and the public sectors, and the increase in global prices of merchandise could hinder attainment of the inflation targets. On the other hand, the increasing internalization by the public of the consolidation of a low inflation rate and of policymakers' determination to attain the targets in this respect, could help in the disinflationary process by influencing inflation expectations. Setting an inflation target for the next two years every mid-year will also support the process, since monetary policy affects prices with a lag. In the longer run, it will be necessary to coordinate the activity of all economic agents in order to progress towards the long-term goal of price stability. This coordination, and especially fiscal policy that is consistent with the long-term objective, will reduce the need for monetary policy to

It is important to ensure that the relatively high level of tax receipts due to the acceleration of economic activity does not lead to expansionary wage agreements, as these will have long-term repercussions.

It is advisable to tackle the problem of the negative incentives to work embodied in the extremely high effective tax rate.

The increasing internalization by the public of the consolidation of a low inflation rate and the determination of policymakers to attain the targets in this respect could help in the process of disinflation by influencing inflation expectations.

respond immediately if the inflation rate deviates from the target, will moderate the intensity of its response, and will make it possible to gradually reduce the nominal interest rate while also lowering the interest-rate differential vis-à-vis abroad without shocks.

Another area in which policy measures have a far-reaching effect on progress towards sustainable growth is structural reform in the framework of privatization accompanied by increased competition. There was virtually no progress in the implementation of structural reforms of this kind in 1999. The Economic Arrangements Law which is supplementary to the budget for the year 2000 contains several measures intended to remove obstacles to a series of reforms, but the test will lie in their implementation. Faster progress in this sphere, primarily in the infrastructure (transportation, electricity, fuel, and domestic telephony), will contribute greatly to increasing competition, reducing costs, and stimulating economic activity without accelerating inflation.

The solution to the unemployment problem lies in establishing the economy on a sustainable growth path. However, the prolonged economic slowdown, with its protracted unemployment, could push up the natural unemployment rate, due to the difficulty of finding and keeping employment after a long period of unemployment (hysteresis). The problem of unemployment is particularly acute among persons with a low level of schooling. In the short run, most of the potential for increasing their employment is in the service industry, which expands in a growing economy, and especially in tourism. Making vocational training better and more efficient and improving the educational system, particularly in outlying areas, could ease this process. A step in this direction is the increase in the number of institutions of higher education in recent years, alongside their greater accessibility to weaker segments of the population and residents of remote areas, but the effect of this will be felt only in the longer run. In view of the continued employment of large numbers of foreign workers, despite the rise in the unemployment rate, it is necessary to regulate this in such a way as to avoid unfair competition with Israeli labor, on the one hand, and guarantee the rights of legally-employed foreign workers, on the other.

Within the framework of the government's social policy, the appropriate instrument for addressing the problems of poverty and inequality is the system of transfer payments and taxation. The tax reform currently being prepared will give expression to social preferences in dealing with income gaps and inequalities, while expanding the tax base by reducing both exemptions and the tax on labor (human capital). In the longer term, the solution to the problem of poverty and the widening income gap rests with the education system. This must continue to aim at raising the level of education among the children of the less well-educated segment of the population, thereby reducing differences in levels of human capital. The improvement of the education system will provide the tools to enable children from low-income families to be successfully absorbed in the labor market in the future, and hence to narrow gaps. Any attempt to cope with the problem of income inequality by raising the minimum wage will serve to accelerate the process whereby industries that rely on unskilled workers will decline, as their global competitiveness is already borderline, and they have shed relatively

The problem of unemployment is especially acute among unskilled workers. In the short run most of the potential for increasing employment among them is in the service industry, which grows in an expanding economy, and in tourism in particular.

The improvement of the education system will provide the tools for the future successful integration in the labor market of children from low-income families, thereby helping to reduce gaps.

large numbers of their workers in the last few years. Furthermore, an attempt of this kind will constitute an incentive to employ foreign workers regarding whom there is little adherence to the Minimum Wage Law. Thus, the result of raising the minimum wage will be to increase the unemployment rate significantly, especially for unskilled workers (with 0–8 years of schooling), among whom it reached 14 percent in 1999.

There are still many restrictions in the capital market obliging the business sector to compete for long-term capital with government earmarked bonds which bear a high interest rate and are allocated to pension funds. Arrangements that will enable the cessation of issues of these bonds will lead to the reduction of their share in the portfolio of institutional investors, will direct these investors to long-term, as is customary in the developed countries, and will also contribute significantly to the development of the capital market. In this connection it is important to make it easier for Israeli firms going public abroad to register on the Tel Aviv Stock Exchange. The importance of integrating institutional investors in the capital market has increased in view of the arrangement whereby new employees in the public sector are transferred from a non-contributory pension to a contributory one and a greater part of their wage is covered by pension insurance. This arrangement will lead to a significant and continuous increase in the amounts saved in pension funds. The implementation of the recommendation to reduce the banks' holdings in provident funds could make the capital market more competitive and efficient. The capital market also needs to be reformed in order to reduce taxation differentials between domestic and foreign investment, making the allocation of investment more efficient by diversifying the public's asset portfolio. Alongside the completion of the reform of the foreign-currency market by extending it to institutional investors, the restrictions on the share of specific assets in institutional investors' portfolios should be removed. These improvements will serve to increase private saving, the level of which is significantly lower than in developed countries.

Ceasing to issue earmarked bonds will lead to the reduction of their share in the asset portfolio of institutional investors, diverting these investors to long-term investments and contributing to the development of the capital market.

