Chapter 1
The Economy: Developments and Policies

In 1994, the economic growth which had started in 1990 with the influx of immigrants continued. GDP expanded rapidly, and the surge in investment in the principal industries persisted, with a rapid increase in capital stock. The most notable achievement of 1994 was the sharp fall in unemployment, and the approach to almost full utilization of the labor force. Nonetheless, alongside the impressive achievements some problems evolved, chief among them the acceleration of inflation and the rise in the civilian import surplus, reflected in a higher current-account balance of payments deficit.

The rapid expansion of economic activity was due first and foremost to increased in demand, caused by expansionary government policy combined with the Bank of Israel's expansionary monetary policy at the beginning of the period, against the background of the peace process.

With regard to factors of production, economic trends for the years ahead continue to be positive and able to sustain further expansion. This potential will not be fully realized, however, unless the problems which arose in 1994 are solved, in particular inflation and the current-account balance of payments deficit.

In 1994 there was an upsurge in demand, and economic activity expanded rapidly. Among the factors encouraging demand, those due to economic policy were prominent. The combination of the government's expansionary policy in the short term and the Bank of Israel's expansionary monetary policy at the beginning of the period, against the background of the peace process, stimulated demand while saving declined. Demand rose faster than supply, even though the latter increased considerably; hence economic activity expanded, creating inflationary pressures and a higher import surplus.

There was significant progress in several key areas during 1994. GDP expanded rapidly, as did per capita GDP; there was a sharp drop in the rate of unemployment, reaching almost full utilization of the labor force; the surge in investment in the principal industries persisted, resulting in the rapid expansion of capital stock to the beginning of 1995. Alongside these impressive achievements several problems developed, however (Table 1.1 and Figure 1.1): inflation accelerated; the civilian import surplus/GDP ratio grew, reflected in a higher current-account balance of payments deficit; the tax/GDP ratio continued to increase; total business-sector productivity did not rise; and several indicators attested to a deterioration in profitability.

Economic developments in 1994 were influenced mainly by the monetary and fiscal policy mix and the peace process. The budget deficit remained low, below the level required by law, and the public debt/GDP ratio continued to fall. Thus the creation of conditions required for long-term economic stability continued. However, an examination of the components of policy in 1994—particularly on the nominal side—show that it had an expansionary effect on demand, causing increased economic activity and faster price increases. Domestic public consumption rose more rapidly than in recent years, and there was a considerable (3 percent) increase in civilian per capita consumption. This development is inconsistent with the utilization of economies of scale evident since the start of the influx of immigrants. On the nominal side, the government awarded exceptional wage increases of some 24 percent, a significant deviation from the 8 percent inflation target. The increase in expenditure did not result in a larger deficit, since the expansion of economic activity generated a concomitant rise in tax receipts.

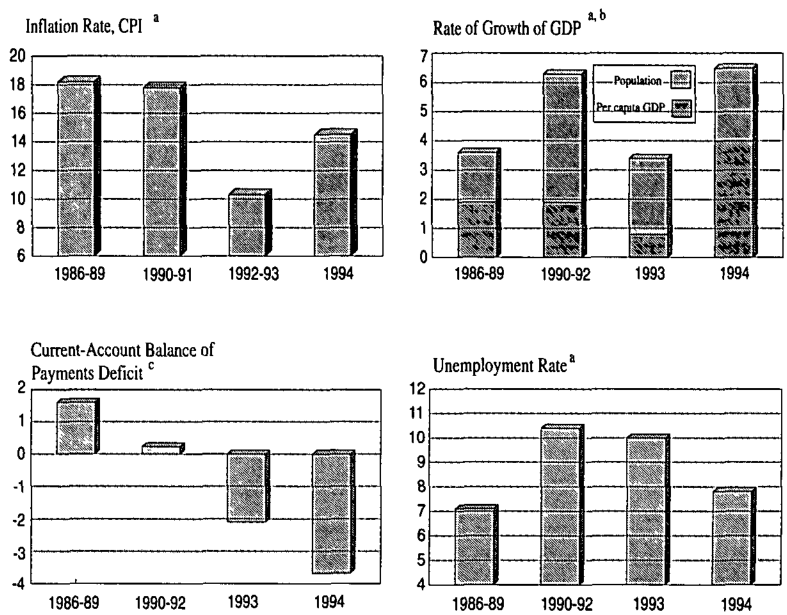
Table 1.1
Main Economic Indicators, 1986-94

	1986–89[a]	1990–92[a]	1993	1994
Growth rate (GDP, percent)	3.6	6.3	3.4	6.5
Per capita growth rate (GDP, percent)	1.9	1.9	0.8	4.0
Inflation during year[b]	18.2	14.9	11.2	14.5
Unemployment rate (percent)	7.0	10.4	10.0	7.8
Immigration (percent)[c]	0.3	3.2	1.5	1.5
Balance of payments on current account ($ billion)	0.6	0.1	−1.4	−2.8
General government deficit (–) (percent of GDP)	−1.0	−3.8	−2.8	−1.0
Total productivity (percent change)[d]	2.3	3.0	−1.2	−0.3

[a] Annual average.
[b] Percent change in CPI.
[c] Relative to population.
[d] In business-sector product.

Starting in mid-1993, in the context of the slowdown in economic activity, moderate increases in price indices, expectations of a lower inflation rate, and the 1994 inflation target—but before the extent of the nominal wage increases in the public sector was known—the Bank of Israel reduced interest rates. Against the backdrop of the combination of fiscal policy, the peace process, and other factors described below, both demand and the rate of price-increases accelerated. Thus, monetary policy in retrospect turned out to be expansionary, reflected in a fall in real interest, and an exceptional increase in the monetary aggregates and credit. The reduction of the interest rate, served—with a delay—to increase demand, particularly in areas sensitive to interest. Greater liquidity and the availability of credit to households may also have contributed to the expansion of private consumption, After the end of 1993—as inflation accelerated, unemployment fell, and economic activity increased—the Bank of Israel implemented a policy of monetary restraint, which helped curb the acceleration of inflation. The deviation from the inflation target to which it was committed impelled the central bank to further tighten monetary policy in the latter part of 1994, and by the end of the year the measures taken had reached significant proportions. This helped to reduce inflationary expectations, but apparently also created a differential between expected foreign-currency and local-currency yields, so that extensive short-term capital imports ensued.

Figure 1.1
Main Economic Indicators, 1986-94



[a] Percent, annual rates.
[b] Growth rate of GDP is growth of per capita GDP *plus* population growth.
[c] Percent of GDP, annual rates.

The rapid economic growth of 1994 was the continuation of a process which started in 1990, when the influx of immigrants began. In general, Israel's economic performance since the beginning of the 1990s is impressive, in comparison with its past record as well as on an international basis, especially in the light of the national goal of immigrant absorption. By the end of 1994, more than 600,000 immigrants had arrived, increasing the population by about 13 percent. With regard to the main problems which economic policy has had to address since this massive influx started—employment and housing—it may be claimed that developments in 1994, particularly the decline of unemployment, represent the successful completion of the first stage of immigrant absorption. Although excess demand persisted in the housing market, exerting pressure on its relative price and on the Consumer Price Index (CPI), this reflected the public's desire to increase the real estate component of its portfolio, rather than a physical shortage of apartments for immigrants.

Although the 8 percent increase in capital stock to the beginning of 1995 and the rise in the labor force due to further immigration provide a firm basis for continued growth, the problems which arose in 1994 may prevent the potential from being utilized to the full in the next few years. In order to achieve the inflation and GDP growth targets, with a further gradual reduction in unemployment and improved utilization of the immigrants' human capital—as yet far from realization—without harming the balance of payments, there must be close coordination between fiscal and monetary policy instruments. A key component of the required policy is the reduction of the tax burden, while maintaining a low budget deficit; hence, any tax reduction necessitates a parallel cutback in government expenditure. It is particularly important to tackle the problems of public-services employment and wages, in the light of the wage pressures which are likely to arise in the business sector. In this framework, monetary policy can balance the use of its instruments.

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In view of the effect of economic policy on developments in 1994, and bearing the objectives in mind, the question arises of the appropriate policy and its monetary/fiscal mix. Under the current exchange-rate regime in Israel's small open economy, which is highly exposed to foreign markets, the slope and position of the exchange-rate band determine the exchange-rate trend, and therefore constitute a central element of nominal developments—provided the regime's credibility is preserved. Hence, setting the slope and position of the band—principal nominal policy decisions—must be consistent with the inflation target. The components of the government's nominal policy—budget prices, prices of controlled and supervised goods, and wage agreements—must conform with the inflation target, because they affect both the credibility and the effectiveness of exchange-rate and monetary policies. In a balanced situation, there should not be a large gap in the long term between the rate of inflation, the rate of depreciation, domestic interest rates,[1] the trend in nominal wages, and the expansion of the monetary aggregates.

The openness of the economy and liberalization of capital movements, given Israel's exchange-rate regime, limit the ability of monetary policy to influence the rate of interest,

[1] The gap between inflation and the exchange-rate trend, assuming no change in the real exchange rate, mainly reflects world inflation. The gap between the interest and inflation rates reflects real interest, and that between interest and the exchange-rate trend primarily reflects interest abroad. These gaps are also affected by risk premiums and expectations.

and the longer the time horizon, the lower this ability. In the short run, monetary policy may be implemented with greater flexibility than fiscal policy, especially in the case of fiscal restraint entailing a cutback in government expenditure. Hence, the objectives of short-term interest-rate policy—via the divergence of domestic interest rates from the trends determined by the exchange-rate band and foreign interest rates—correct short-term deviations in prices and/or the level of economic activity, in accordance with the severity of the problem and the order of priorities. Fiscal policy may also have a stabilizing effect, if automatic stabilizers are built into the structure of government expenditure and the tax system.[2] In general, however, these stabilizers have a limited effect on economic activity and prices, so that it is more appropriate to formulate fiscal policy to enable it to cope with the counter-cyclical needs of the medium and long term, at the same time utilizing features which bolster the government's credibility (e.g., the Budget Deficit Reduction Law). The combination of monetary and fiscal policies is reflected in the ability to implement monetary policy which may even be rigorous, as a preliminary and temporary step before fiscal policy takes effect.

In the summer of 1993, during the discussions on the budget but before the extent of public-sector wage increases and their time-spread were known, a target rise in the CPI of 8 percent during 1994 was announced. This represented a continuation of the process which had reduced the inflation rate in 1992 to the level at which it remained in 1993. The 1994 target was influenced by the slowdown in economic activity, and by the assessment that inflation had already fallen below the 10–12 percent level, so that the target could be attained without resorting to drastic measures.[3] The slope of the exchange-rate band was therefore reduced to 6 percent, and its position raised by 2 percent (and the exchange-rate insurance premium was abolished); interest on the monetary (discount window) loan was adjusted downwards by 3 percentage points, and the subsequent nominal adjustment of government expenditure for the preparation of the budget was carried out in accordance with the inflation target. (Wages, however, were revised by a higher factor, as part of the government's policy of raising the relative wages of public-services employees, especially in education.) In retrospect, it seems that the slowdown in price increases in the summer of 1993, which went beyond what could be explained by the usual seasonal factors (which generally moderate price rises in the summer months), did not reflect a real reduction of inflation. Inflationary expectations do not appear to have fallen significantly either. This is supported by indirect measures of expectations, which did not decline below an annual rate of 10 percent; some of these rose following the adjustment of the nominal variables at the end of the summer of 1993, against the background of the exceptional wage agreements in the public sector.

[2] Demand pressures which stimulate economic activity, reducing unemployment and government expenditure on transfer payments, also increase tax receipts. These automatic effects reduce the fiscal deficit and dampen demand pressures. The reverse case produces the opposite result.

[3] Anti-inflationary measures are generally required, and entail a real cost in the short term.

The results of the adjustment of nominal instruments were evident in several areas: the reduction of interest was translated into a fall in real interest, with an exceptional increase in liquidity, contributing to the rise in demand and the adjustment of the public's portfolio; the lower slope of the exchange-rate band was accompanied by a slower rate of depreciation, while pressure for real appreciation due to the increase in domestic demand was reinforced. For the first time since 1990, the government submitted a supplementary budget, mainly because of the exceptional wage increases, thereby contradicting the message it wished to convey regarding its determination to achieve the inflation target.

Table 1.2
Indicators of Business-Sector Production, 1986–94

	1986–89	1990–92	1993	1994
Business-sector product[a]	4.6	7.7	3.5	7.6
of which Tradables[a,b]	2.9	6.3	3.1	4.9
Nontradables[a,b]	6.0	8.7	3.9	9.5
Domestic labor inputs[a]	2.0	5.3	4.7	8.6
Gross capital stock[a]	2.7	3.0	5.1	6.4
Total productivity[a]	2.3	3.0	–1.2	–0.3
Real unit labor costs[a,c]	2.6	–2.9	1.8	1.9
Net domestic product per man-hour[a]	2.6	2.9	–1.4	–0.9
Yield on gross capital[d]	9.7	13.1	13.5	12.7
Gross tax rate on nonwage income	31.2	24.3	27.0	31.2

[a] Annual change, percent.
[b] Business-sector product resulting from production of tradable goods, defined as imports, exports, and their domestic substitutes; nontradables consist of other output.
[c] Based on net product at factor prices.
[d] Before tax.

Business-sector product rose rapidly—by 7.6 percent—in 1994, after temporarily slowing to 3.5 percent in 1993 (Table 1.2). This expansion apparently outstripped the growth potential (estimated at 5–6 percent), and therefore could not be maintained. The upsurge in economic activity came in response to the increase in demand, and particularly to the greater effect of fiscal and monetary policies combined than of each separately. Government policy stimulated demand, both directly, through the increase in public domestic consumption, and indirectly, through wage increases (including future increments), which raised private consumption. The reduction in interest rates increased demand, and may also have affected its composition, the demand for asset-type goods (those whose consumption is spread over several years, such as machinery and equipment, consumer durables, and real estate) rising faster than that for other goods.

The result of the policy mix was the expansion of domestic demand which, in contrast to 1993, was on the whole met by supply (Table 1.3). In effect, the fundamental shift in economic activity was reflected by significant expansion in the second half of 1993; this continued up to the first quarter of 1994, but eased in the rest of 1994. For the purpose of analyzing developments, the factors can be classified as affecting mainly demand or supply.

Table 1.3
GDP and Aggregate Demand[a], 1986–94

(annual averages)

	Real annual change, percent				Percent of GDP
	1986–89	1990–92	1993	1994	1994
GDP	3.6	6.3	3.4	6.5	100
Per capita private consumption	5.3	2.6	5.0	6.2	
Private consumption	7.0	7.0	7.7	8.8	64
Public consumption	1.4	2.9	1.3	3.9	25
Gross domestic fixed investment					
Nonresidential	1.7	19.6	16.7	16.9	17
Residential	3.0	26.7	–27.1	2.0	6
Domestic use of resources[b]	4.7	9.1	5.2	8.0	113
Exports	4.7	4.8	10.6	10.8	33
Imports[b]	6.6	12.0	12.8	12.7	46
Business-sector use of resources					
Nontradables[c]	5.3	11.8	0.0	7.7	29
Domestic use of tradables[c]	6.2	10.6	9.5	9.6	54
Total use of tradables[c]	5.1	9.2	10.5	9.3	81

[a] National Accounts figures.
[b] Excluding direct defense imports.
[c] See definition in note to Table 1.2.

The following factors mainly affected demand:

- The general optimism which followed the signing of the agreement with the Palestinians, and the expectations of significant progress in the peace process. These were reflected by the continued growth of investment in the principal industries, and may also have generated expectations regarding an increase in households' income, and thereby also in private consumption.
- The exceptional public-sector wage agreements of the second half of 1993 and at the beginning of 1994. The agreements, which cover several years and which spread unexpectedly within this sector, increased the estimated expected income of almost one third of all employees. The change in permanent income resulted in significant upward adjustment of private consumption and a sharp fall in the private saving rate.
- The continued real growth of public-sector demand—by 4.6 percent.
- The fall in unemployment among immigrants, from 22 percent in 1993 to 14 percent in 1994, following the 11 percentage point decline in 1993; as a result, tens of

thousands of households ceased to be dependent on small and uncertain transfer payments (some temporary), receiving a steadier income from labor. This change appeared to increase their consumption, and thus total private consumption.

- In the second half of 1993, the Bank of Israel reduced the cost of the financial sources available to the business sector, and this appears to have been reflected by the reduction of real interest.
- By the second half of 1993, the contractionary effect of the sharp reduction in government-initiated construction had run its course—a factor that was the major cause of that year's economic slowdown. Towards the end of 1993, when building contractors became convinced that the government was limiting its intervention while demand for housing and its relative price were rising, private-sector activity increased. The government also continued to initiate construction—albeit to a far smaller extent than in 1990–92—so that the industry's total contribution to economic activity in 1994 was positive.
- The expansion of world trade and the peace process boosted demand for Israel's exports.

In contrast to these factors, which encouraged demand, the income effect caused by the deterioration in the terms of trade[4] is estimated as some 1 percent of GDP. This adverse effect, resulting partly from the composition of imports and exports, appears to have been short-lived, so that its contractionary effect on demand was slight.

The following factors mainly affected supply:

- Investment in the principal industries during recent years led to a rapid rise in capital stock to the beginning of 1994. Although not all the investment can reasonably be expected to have reached maturity (especially that in the infrastructure), the rise in demand occurred in the context of capacity that enabled considerable expansion of output.
- The labor market became more flexible when the influx of immigrants began, as they entered the labor force and unemployment rose. In 1994, in contrast to the years before this immigration—when employment rose together with wages—higher business-sector employment did not result in a significant rise in wages.

The closure of the administered areas in March 1994, following an upsurge in terrorism, acted in opposition to these factors, which increased supply. As in previous years, the closure temporarily disrupted normal economic activity, particularly in construction and agriculture. The continued sporadic appearance for work by employees from the areas seems to have impelled many employers in these industries to reduce their dependence on this source of labor. The government's issue of entry permits for 50,000 foreign workers supported this process. The replacement of workers does not appear to have harmed GDP growth, but in the short term it hampered an increase in labor and total

[4] The rise in world prices of Israel's imports was greater than the fall in the prices of its exports to the same markets.

productivity. A deterioration in the terms of trade also reduces supply, as in most industries imports are a large component of inputs.[5] Finally, the reduction of the slope of the crawling exchange-rate band caused a similar decline in the rate of depreciation and in expectations of its rise, and these were not accompanied by an equivalent slowdown in the rate at which nominal wages rose; hence, with productivity unchanged, the profitability of exports was impaired, and their rate of growth moderated.

Thus, in the short term the effect of demand pressures, which raised private consumption and domestic resource use by 9 and 8 percent respectively, appears to have outweighed that of the factors acting on supply. The expansion of demand created inflationary pressures, causing prices of nontradables to rise faster than those of tradables.

Table 1.4
Prices, 1987–94

(annual average change, percent)

	1987–89	1990–91	1992–94	1993	1994
Consumer prices (CPI)					
All items	18.8	18.1	11.7	10.9	12.3
Excl. housing	18.1	14.5	10.0	8.5	9.4
Excl. housing and controlled commodities	17.7	12.9	9.2	7.6	9.0
of which Tradables[a]	13.0	12.4	8.7	7.3	7.8
Nontradables[a]	23.6	13.3	10.1	7.8	10.8
Business sector					
Gross product prices	18.6	15.6	10.0	9.9	9.0
Nominal unit labor cost	21.6	10.2	11.4	12.5	10.8
Export prices[b]	15.9	12.0	7.6	9.7	5.9
Import prices[c]	14.2	10.2	8.0	9.8	7.3
Exchange rate (against currency basket)	10.1	11.5	10.1	12.1	7.8

[a] See definition in note to Table 1.2.
[b] Excluding diamonds.
[c] Excluding direct defense imports and diamonds.

In 1994 price increases accelerated alarmingly (Table 1.4), due to the rise in domestic demand. The CPI rose by 14.5 percent during the year, after increasing by 9.4 and 11.2 percent during 1992 and 1993 respectively, even though the target figure for the year was set at 8 percent. Simply determining an inflation target without adopting an appropriate policy cannot help achieve it, and if it is not attained, the credibility of those responsible for setting the targets is undermined.

[5] A deterioration in the terms of trade also affects the composition of consumption, increasing demand for domestic rather than imported goods. This effect seems to have been very slight, as stronger forces operated in the opposite direction.

The 1994 inflation figure represents some acceleration above the 10–12 percent level of recent years. The exchange rate, together with world prices and taxation on trade, determine the development of prices of tradables, whereas domestic demand pressures determine the rate of increase of prices of nontradables over and above those of tradables. From the beginning of the influx of immigrants until 1993, in the context of the high unemployment rate which moderated wage and price increases in the nontradables sector, the exchange rate was effective in maintaining the overall level of price increases. During that period, monetary policy resulted in low interest rates and considerable expansion of the monetary aggregates and credit. In the light of the exchange-rate regime and the interest rate set by the Bank of Israel, these aggregates were determined mainly by the public's demand, and they grew markedly. At the same time, the rate of inflation fell from an average of about 18 percent until 1991 to a 10–12 percent level in 1992–93. The acceleration in price increases in 1994 was influenced, as stated, by the sharp rise in domestic demand relative to supply. With the steep decline in unemployment and upward pressure on prices of nontradables, the exchange rate—which affects mainly prices of tradables—could not prevent the rapid increase in prices of nontradables and hence the overall price index rose.

Pressures for the adjustment of the public's portfolio resulted from the increase in demand in 1994. Relative yields at the beginning of the period operated to increase the share of nonfinancial components, particularly real estate. This led to the continued steep rise in housing prices, contributing to the acceleration of the CPI. Severe short-term shortages of fruit and vegetables led to exceptional price increases, which also pushed the CPI up temporarily. Other price indices, such as those of wholesale prices or business-sector product, indicate a more moderate acceleration of the inflation rate. During 1994 the rate of price increases eased, stabilizing at the end of the year, albeit at a level higher than the 1995 target of 8–11 percent.

The salient achievement of 1994 was the reduction of unemployment, which had been rising since the late 1980s (Table 1.5). The turning-point came in 1993, although the average unemployment rate remained high. Only in 1994 did it fall steeply, reaching almost full utilization of the labor force.

The changing causes of rising unemployment should be examined in a long-run perspective. In 1988–89 unemployment soared, reaching 9 percent at the end of 1989, just before mass immigration began. To a great extent this reflected a lagged response by the business sector to the new economic situation created when inflation was checked, as well as to the basic change in the government's employment policy. Before the 1985 economic stabilization program (ESP) the government absorbed the surplus labor force and did not allow unemployment to rise. This policy contributed to the inflexibility of the labor market. Under the ESP the government changed its policy; it restricted the rate at which public-services employment rose and reduced its involvement in alleviating economic problems requiring a reduction in employment. At that time the business sector was undergoing extensive readjustment, streamlining production processes, closing unprofitable production lines, and improving its response to market forces. The outstanding examples of this are the restructuring of Koor and of the Israel Aircraft Industry after the Lavi project was ended. In both cases employment shrank without a fall in output, i.e., labor productivity soared. In 1990–93 unemployment reached an unprecedented level, because the increment in the civilian labor force due to immigration exceeded the rise in employment. The relatively high unemployment rate of these years served to increase the flexibility of the labor market. Real business-sector wages declined by a cumulative 4.5 percent, after a large rise following the ESP, while the rate of increase of nominal wages slowed, helping to curb inflation.

Table 1.5
The Labor Market, 1986–94

(annual change, percent)

	1986–89	1990–92	1993	1994
Mean population	1.6	4.3	2.6	2.6
Participation rate[a]	51.0	51.6	52.9	53.6
Israeli employed persons				
Business sector	2.2	4.2	7.2	7.7
Public services	1.6	4.0	3.5	4.8
Unemployment rate[a]	7.0	10.4	10.0	7.8
Real average wage[b]				
Per employee post	5.0	–0.5	0.5	2.6
of which Business sector	4.9	–1.1	0.3	–0.5

[a] Actual rate, not the rate of change.
[b] Deflated by the CPI.

Unemployment dropped steeply in 1994 in the context of the appreciable expansion of business-sector activity, the increase in public-services employment, and the continued replacement of workers from the administered areas. The expansion of the employment of Israelis—6.9 percent—significantly outstripped that of the labor force—3.7 percent—and the unemployment rate plummeted. This checked the decline in real business-sector wages, rather than causing them to rise. Unit labor costs rose by some 1.5 percent, contributing to the decline in profitability, principally in the tradables sector.

There was no rise in labor productivity alongside the considerable expansion of employment evident since the influx of immigrants began, even though the former is one of the chief characteristics of growth. Several factors may be responsible for this. First, the professional qualifications of many immigrants—who account for most of the incremental labor force—do not match the requirements of the labor market in Israel. Evidence for this is provided by the discrepancy between their original occupations and their actual employment in Israel. There also appears to be a gap between their formal education, which is higher than the average in Israel, and the appropriateness of their qualifications to Israel's requirements, and hence the need for a relatively long retraining period before their potential can be utilized. Second, there was an increase in the proportion of new entrants—whose productivity tends to be lower—in the labor force. Part of this rise reflects the replacement of workers from the administered areas. Third, labor intensity increased. In the context of the decline in real wages, the process of immigrant absorption caused the capital/labor ratio to decline. This development, which also characterized the initial stages of earlier influxes of immigrants, gave rise to only a temporary change in work methods, indicating the faster growth rate of capital stock than the expected increase in the labor force. Fourth, growth was unbalanced. In recent years the growth rates of different industries have been unequal. When the influx of immigrants began, construction expanded appreciably and there was little export activity, while since 1993 the situation has reversed—construction has fallen and exports have expanded rapidly. The change in the composition of economic activity appears to have had a negative effect on productivity.

Table 1.6
Balance of Payments, 1986–94

($ billion)

	1986–89	1990–92	1993	1994
Import surplus	4.7	6.4	8.1	9.7
Unilateral transfers	5.1	6.5	6.7	7.0
Current account	0.6	0.1	–1.4	–2.8
Civilian import surplus	2.9	4.7	6.0	8.2
Civilian imports	17.8	24.6	28.9	33.2
Exports	14.9	19.8	22.9	25.0
Industrial exports (excl. diamonds)	5.9	8.3	10.2	11.4
Implied private capital imports	–0.4	–0.7	1.1	1.7
Foreign reserves[a]	5.2	6.1	6.7	7.1
Net external debt	17.4	15.2	15.7	16.5

[a] Held by central monetary institutions at end of period.

The civilian import surplus continued to grow in 1994, and reached $ 8.2 billion (Table 1.6), its share in GDP rising by about 1.8 percentage points to some 9.1 percent. This was reflected by an increase in the deficit on current account—to about $ 2.8 billion—and a rise in the external debt. There was no change in the foreign reserves, though considering the country's economic needs—and in the context of the liberalization of capital movements in particular—they are low.

Two factors accounted for the deterioration in the balance of payments. The decline in the private saving rate outstripped the rise in the public saving rate, so that the total saving rate fell. Investment remained stable, that in machinery, equipment and nonresidential buildings rising to the same extent as residential and inventory investment declined (Table 1.7). As stated, the saving and investment rates were affected by the public's portfolio adjustment.

Table 1.7
The Rate of Saving, Investment, and the Balance of Payments on Current Account, 1986–94

(percent of income)[a]

	1986–89	1990–92	1993	1994
Gross national saving	**17.5**	**20.1**	**19.5**	**18.1**
General government	1.5	–0.2	1.1	1.8
Private	16.0	20.3	18.4	16.3
Gross investment	**16.4**	**20.5**	**21.3**	**21.7**
of which Nonresidential	11.4	12.3	14.6	15.4
Transfers on capital account	0.4	0.5	0.3	0.3
Net balance of payments on current account	1.5	0.1	–1.4	–3.3

[a] Income is defined here as GNP *plus* unilateral transfers

The exceptional rise in private consumption was the main cause of the deterioration in the current account. The increase was due principally to the government's wage policy—reflected by a one-off adjustment of permanent income—and to optimism arising from the peace process, in the context of monetary policy which has since become contractionary. It is therefore reasonable to assume that the exceptional rise included a nonrecurring element. In addition, part of the increase in private consumption derives from the growth in immigrants' income as the process of their absorption progresses. The immigrants' future contribution to GDP is expected to outweigh their current pressure on demand, but this will take time. The gap between current pressure on resources and future GDP growth is bridged by increasing the external debt through the US government loan-guarantees. Provided the correct price of capital is maintained for users, these debts do not constitute a threat. In view of the high rate of investment and low budget deficit, it will be possible to meet the extra debt-servicing burden, as long as the negative trends evident in 1994 are corrected.

While the effect of demand on the balance of payments included transient elements, the adverse effect of supply may persist in the future, causing a deterioration in business-sector profitability, especially of tradables, slowing the growth of their output, and harming exports. In addition, wage increases in the public services may be extended to the business sector, further damaging profitability. The policy recommendations made here take these processes into account, especially the need to cope with supply problems in the tradables sector.

There were no financing problems in 1994 as the government continued to use the loans guaranteed by the US government and GDP grew markedly, hence the debt/GDP ratio did not rise. Moreover, in the context of the improvement in Israel's main economic indicators in recent years as well as the peace process, which has changed the geopolitical situation in the region and was further reinforced in 1994 by the peace treaty with Jordan, Israel has benefited from an improved international image, better access to international capital markets and, it appears, a lower risk premium for Israeli borrowers. All these are reflected by the $500 million increase in long- and medium-term direct capital imports by the nonfinancial private sector. This capital inflow, which may reflect considerations other than those of interest, contributed to the increase in both demand and the import surplus.

Alongside the rise in the import surplus, there was an increase in trade. The volume of exports (excluding diamonds and capital services) grew by 8 percent, with continued penetration of new markets, albeit to a limited extent in view of the expansion of world trade. The volume of civilian imports (excluding diamonds and capital services) rose by 12.9 percent. The expansion of imports also reflects the continued liberalization of trade, which helped to increase exports, too. The cost of imports and receipts from exports were affected by sharp changes in world exchange rates, and especially the unexpectedly intense weakening of the dollar. Due to the deterioration in Israel's terms of trade, the deficit on current account rose beyond what was implied by the increase in average prices and the volume of trade.

Table 1.8
General Government Deficit, 1986–94

(annual rate, percent of GDP)

	1986–89	1990–92	1993	1994
Total deficit (–)	–1.0	–3.8	–2.8	–1.0
Domestic deficit (–)	–3.3	–6.9	–4.4	–1.9
Domestic revenues	49.2	45.4	46.6	47.5
Domestic expenditure	52.5	52.3	51.0	49.4
of which Direct domestic demand	29.2	29.3	29.1	29.3
Total public debt	130.0	107.0	99.0	92.0
of which External public debt	28.0	19.0	21.0	20.0

In terms of long-term economic stability, appropriate fiscal policy continued (Table 1.8). The total public-sector deficit was a mere 1 percent of GDP, reflecting the budgetary discipline which the government has imposed on itself through the Budget Deficit Reduction Law, and the domestic deficit was even lower than required by law. Thus, the public debt/GDP ratio fell by another 7 percentage points, reaching 92 percent, and the share of debt-servicing in government expenditure declined.

The share in GDP of infrastructure expenditure by the government remained high, and continued to help solve transportation problems that had built up for two decades, although there has not yet been a reduction in congestion. Since serious problems still exist in the major urban centers, a high rate of infrastructure expenditure should be maintained in the future and the development of mass transportation systems encouraged.

Government civilian consumption rose by a steep 5.5 percent in 1994. The tax/GDP ratio increased—continuing the trend of 1992–93—although part of this was temporary. This was due to the expansion of direct tax revenues, the progressive nature of direct taxes, exceptional wage increases in the public services, and increased corporation taxes arising in part from past income. The share in GDP of direct taxes rose, while that of indirect taxes fell.

These developments in 1994 indicate that fiscal policy contributed to the increase in demand, economic activity, and prices. The budget deficit was small, but the rise in tax revenues facilitated increased expenditure. Furthermore, since the implementation of the wage agreements is spread over several years, the increase in expenditure is more permanent in nature than is that in tax revenues. The latter is the result of expanded economic activity in 1994 and in previous years, so that its contractionary effect was limited.

Monetary policy was not uniform in 1994 (Table 1.9). In the last four months of 1993 it was expansionary, as stated, but at the end of 1993, in view of the acceleration of inflation and the stepping up of economic activity, the Bank of Israel began a series of interest-rate increases on the sources it makes available to the business sector. Until the autumn of 1994 interest went up in line with prices and inflationary expectations, and consequently there was no significant rise in real interest. Monetary policy was tightened in the last quarter of 1994, because of fears that inflation would accelerate further. The Bank of Israel raised interest further, and consequently the expansion of the monetary aggregates, and of M1 in particular, was reduced. During the year there was substitution between the monetary assets, intensifying towards the end of the year and involving the transition from M1 and foreign-currency-indexed deposits to interest-bearing local-currency deposits. At the end of the year there was also a clear downward trend in inflationary expectations, as estimated from the capital market.

Monetary policy in 1994 represents a departure from that of the past. From 1990 to the end of 1993 the main object of monetary policy was to advance the process of immigrant absorption. In view of the high rate of unemployment, interest was kept as low as possible in order to stimulate growth and increase investment in the principal industries. The instruments of monetary policy were exercised from time to time, primarily to defend the exchange-rate regime. This, in conjunction with the government's policy, had the desired result, helping to reduce unemployment without impairing the reduction of inflation or harming the balance of payments. Economic conditions in 1992 and 1993 made it possible to attain the inflation target without having to resort to rigorous monetary policy. The gradual rise in the effective interest on the Bank of Israel's monetary loan, from 9.5 percent in November 1993 to 18.5 percent at the end of 1994, reflects the central bank's commitment to attaining the inflation target, in view of the departure from it during the year. As the unemployment rate declined, monetary policy was given a more active role in combating inflation, and greater attention was paid to the expansion of the money supply. The policy switch appears to have made a positive contribution to preventing the further acceleration of inflation in 1994, as it was instrumental in stopping a monetary adjustment to price-increases, as had occurred in the past. It also appears to have helped to dampen inflationary expectations at the end of the year. This trend has persisted in 1995.

Table 1.9
Monetary Indicators, 1987–94

(annual change, percent)

	1987–89	1990–92	1993	1994
Monetary aggregates (average change)				
M1[a]	40	26	24	21
M2[b]	37	29	38	33
M3[c]	24	29	25	26
Short-term bank credit	28	24	34	24
Public-sector injection[d]	–0.9	3.3	1	2
Bank of Israel[d,e]	1.3	–0.2	2	–2
Private-sector foreign-currency sales[d]	–0.0	–2.6	–3	1
Nominal interest				
SROs (CDs)[f]	14.2	12.1	10	12
Nondirected credit[g]	41.8	24.2	16	17
Average currency-basket interest rate	7.5	7.5	5	5
NIS/currency-basket rate (during period)	10.2	11	12	8
Real interest on 5-year bonds	3.4	1.9	3	3
Nominal average share yield	38.0	52.5	50	–10
Nominal GDP (average rate of change)	24.4	23	15	20
CPI (average rate of change)	18.8	16.0	11	12

[a] M1 = currency in circulation and demand deposits.
[b] M2 = M1 + interest-bearing, local-currency deposits and Treasury bills.
[c] M3 = M2 + foreign-currency-denominated deposits.
[d] As percent of GDP.
[e] Contribution to monetary expansion.
[f] Self renewing overnight (on-call deposits).
[g] In local currency.

In an open economy, gaps between foreign and domestic yields can give rise to capital flows. Until 1991, in the context of the horizontal exchange-rate band and low local-currency interest, expectations of discrete local-currency devaluation developed from time to time. These gave rise to speculative foreign-currency purchases, resulting in a short-term increase in the interest rate. These purchases diminished markedly after the introduction of the crawling exchange-rate band, which reduced uncertainty regarding the future path of the exchange rate. The increase in interest in 1994 made it necessary to tackle the reverse problem—a capital inflow. The liberalization of recent years enabled Israel to find its place in international capital markets, making capital flows more sensitive in the short term to foreign/domestic interest-rate differences. This increased sensitivity was evident after local-currency interest was raised at the end of 1994. In the context of the crawling exchange-rate band, which was set at an annual 6 percent, conditions were created that made the expected yield on local-currency deposits higher than that on foreign-currency deposits, both in Israel and abroad, reducing the cost of foreign-currency credit in particular. This development caused short-term capital imports of over $2 billion between November 1994 and February 1995. The inflow of capital exerted pressure on the exchange rate, taking it below the midpoint rate. The exchange-rate pressures impelled the Bank of Israel to intervene, and it moderated the decline in the exchange rate, purchasing foreign currency from the public. The large-scale capital imports and the yield gaps which developed at the end of 1994 cannot persist in the long run, and the reduction of interest in March 1995 acted to mitigate this.

Share prices fell in February 1994. This seems to have been the result of their adjustment after rising sharply for several years. The decline continued throughout the year, and was also affected by monetary policy, fears of conflicts of interest—and even suspicions of illegal activity—among market participants, and uncertainty regarding the decision (later reversed) to impose a tax on capital gains from shares. At the same time, the volume of trading activity shrank steadily, with sales dropping to very low levels. The upsurge in stock-exchange flotations which had persisted to the end of 1993 weakened, and during 1994 the stock market's role as a financial intermediary declined. This also affected the privatization process, so that while sales were expected to reach NIS 4.6 billion, as reflected by the 1994 budget, only some NIS 0.6 billion was actually raised. Developments on the bonds market were similar, and no capital was raised through this instrument by the business sector. Thus, in 1994 the capital market and financial mediation processes were shaken, in the context of the decline in the private saving rate, which may itself have been influenced by the capital market. The share of financial mediation through the banking system rose, and this may have contributed to the considerable increase in the volume of credit. Credit from abroad also rose, influenced by cost differentials. On the asset side, the demand for less risky instruments, such as savings schemes, grew, and the public continued to try to increase the real-estate component in its portfolio, exerting appreciable upward pressure on its relative price.

* * *

Economic trends for the next few years continue to augur well as regards the growth of factors of production, enabling further economic expansion. It will be impossible to utilize this growth potential to the full, however, unless the problems created in 1994 are solved. The high inflation rate, the civilian import surplus, and the current-account deficit are not consistent with sustainable growth. Appropriate economic policy must be adopted in order to return to a steady growth path. The measures introduced by the government in March 1995 (budget cuts, lower taxes, and the reduction of public-services employment) are a step in the right direction.

The basis for continued sustainable growth is better utilization of the human capital of the immigrants already in Israel and the continued absorption of new immigrants at the rates evident in the last few years (70,000–80,000 a year). Achieving the former is expected to take several years and will involve adapting the immigrants' skills to Israel's needs and improving their professional qualifications. It is reasonable to assume that this process will increase both labor and total productivity.

Economic activity in the industrialized countries, which constitute Israel's principal export markets, is expected to continue to rally in 1995. Geopolitical changes in the region have also created a greater potential for the penetration of new markets by Israel's exports. Nonetheless, processes are at work which could impede investment; these include a decline in profitability, especially of tradables, the replacement of optimism regarding the peace process by uncertainty—exacerbated by acts of terror—the stock-market decline, and the monetary restraint required to contend with inflation, if the latter persists.

The decline in the unemployment rate and increase in the civilian import surplus pose a serious challenge for economic policy as far as inflation and the balance of payments are concerned. While it must be stressed that there is no economic crisis in this respect, keeping inflation low and the current-account balance of payments balanced was easier when there was downward pressure on business-sector wages. The exceptional wage-increases in the public services and fears that business-sector wage adjustments will ensue necessitate tighter monetary and fiscal policy than in the past. In fiscal terms, however, while the deficit/GDP ratio does not threaten economic stability, the extent of government expenditure and its relatively high proportion of GDP require a heavy tax burden in order to prevent the deficit rising. This is particularly the case in view of the fact that certain economic problems which represent a constant threat to the budget, e.g., the defense industries, the kibbutz debt arrangement, and the pension funds crisis, have not yet been solved. Hence, in view of the rise in the import surplus, declining profitability, and inflationary pressures, the reduction of government expenditure—and especially of public-services employment—is a necessary condition for the principal policy measure required, i.e., a significant easing of the tax burden. This is essential for improving profitability and the allocation of resources, as well as for freeing resources for the business sector—all of which are needed for sustainable growth. In March 1995 the government acted in this direction, and this course must be maintained, while adhering to the appropriate long-term path.

This policy will also make it possible to persevere with the process of bringing inflation down to a low, one-digit level without harming the balance of payments. Within the proposed policy framework, monetary policy should support the same aims, continually adjusting interest rates to the new economic conditions. As almost full employment is attained and world interest rates rise, a higher level of real interest is required than prevailed at the beginning of the 1990s. The combination of relatively high real interest, lower government expenditure, and a lighter tax burden will make it possible to adhere to a credible exchange-rate path, while adjusting the slope of the exchange-rate band in accordance with the inflation target without impairing profitability, and that of exports in particular. Maintaining the conditions which help to foster exports, while better utilizing the opportunities created by the peace process, is an important objective of economic policy, since sustainable growth cannot be based on domestic markets alone.

Finally, economic policy must serve to advance the economic reforms recommended in previous Annual Reports. Progress in this direction was insufficient in 1994. The unequivocal reduction of economic intervention by the government will help to create an atmosphere of stability and certainty while encouraging the further expansion of the business sector, which constitutes the engine of future economic growth.