CHAPTER I

THE ECONOMY: DEVELOPMENTS AND POLICIES

Two disturbing developments dominated the economy in 1983: a worsening of the balance of payments, for the third consecutive year, and the rapid acceleration of inflation. Trends were mixed during the year. In the first nine months the current account deficit and external debt continued to grow and the rate of private saving fell; the domestic product and employment, however, recovered a bit. During this period inflation ran at the high rate of the three preceding years.

The economic developments had their roots in the expansionary fiscal policy pursued since 1981, the exchange rate policy implemented in 1981–82, and the devaluation expectations engendered by these developments—all these against the background of the high level of the public's liquid asset holdings built up in previous years. Another contributory factor was the slump in world markets. The devaluation expectations induced the public to reshuffle its financial portfolio, especially a shift from sheqel assets, including bank shares, to assets linked to foreign currency. These changes influenced the developments that destabilized the capital market during 1983, in particular a marked decline in demand for bank shares, which reached a climax in October and led to the temporary closure of the Tel Aviv Stock Exchange.

In response to developments in the first three quarters of the year, the government changed its policy at the beginning of October: it devalued the sheqel by 23 percent, slashed subsidies, and decided to prune the budget. In addition, it reached an agreement with respect to bank shares, under which the supporting of their price was discontinued; this led to a sharp drop in the price and liquidity of these securities. These steps reversed the prevailing trends in the fourth quarter of the year: domestic demands weakened, the balance of payments improved somewhat, domestic economic activity contracted, and real wages fell. But at the same time inflation accelerated to a very worrisome record level—double the already high average monthly rate of the last few years.

The civilian import surplus rose faster than GNP, with the result that its weight in the economy's available resources continued upward. The increase in the import surplus reflected the further rapid growth of domestic demands against the backdrop of a cumulative decline in foreign trade prices relative to domestic prices, which has persisted for the past three years. In contrast to 1982, when GNP drifted up only marginally, a larger share of the domestic demands was this year diverted

Table I–1

MAIN ECONOMIC INDICATORS, 1977–83

(Percent annual increase unless stated otherwise)

	1977	1978	1979	1980	1981	1982	1983
Resources and uses (in constant prices)							
Total uses, excl. direct defense imports	3.3	4.6	6.6	–1.7	4.6	4.6	5.2
Gross domestic product							
Estimated from expenditure side	1.7	3.7	4.8	3.1	2.8	1.0	1.8
Estimate based on indicators of sectoral output volume	2.4	6.3	5.5	–0.9	4.1	2.4	4.6
Gross domestic business sector product[a]	0.9	3.4	5.0	3.5	3.1	–0.1	2.1
Real disposable private income[b]	11.0	4.6	2.7	–1.3	16.2	–1.7	–0.5
Private consumption							
Total	4.8	8.1	8.0	–2.9	10.9	7.2	7.0
Per capita	2.4	5.8	5.4	–5.2	8.9	5.1	5.0
Public consumption							
Total	–13.4	8.4	–8.7	9.1	6.4	–6.4	–4.2
Excl. direct defense imports	–2.0	–1.4	2.5	3.5	0.8	4.8	4.8
Thereof: Civilian consumption	2.9	5.4	2.1	–1.2	0.9	0.4	0.8
Fixed capital formation	–11.4	5.7	12.1	–9.8	4.0	4.6	9.7
Public sector income[c]/GNP (percent, in current prices)	50	48	52	50	48	54	55
Subsidies and transfers to the public/GNP (percent, in current prices)	32	28	28	27	33	32	31
Balance of payments and international reserves (in $ billion)							
Imports	8.1	10.0	12.0	13.9	15.1	15.3	15.3
Exports	5.7	6.8	8.3	10.1	10.8	10.4	10.3
Import surplus	2.4	3.2	3.7	3.8	4.4	4.8	5.0
Foreign currency debt[d]	8.8	9.5	10.7	11.6	13.4	15.5	17.7
Foreign exchange reserves[e]	0.2	1.1	0.4	0.3	0.1	0.3	–0.1
Population, employment, and wages							
Average population	2.3	2.2	2.5	2.4	1.8	2.0	1.9
Number of Israeli employed	2.9	4.6	2.3	1.1	2.0	1.4	3.2
Unemployment rate (as a percent of civilian labor force), absolute level	3.9	3.6	2.9	4.8	5.1	5.0	4.5
Monthly wage per employee post (in current prices)	48	54	90	126	139	119	155

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

Table I–1 (cont.)

	1977	1978	1979	1980	1981	1982	1983
Monetary (in current prices)							
Money supply	39	45	31	98	78	111	132
Total liquid assets of the public	58	70	86	150	109	128	217
Bank credit to the public[f]							
December levels	74	80	101	110	82	139	133
Average level	68	84	80	103	103	102	129
Prices							
Consumer price index (December levels)	43	48	111	133	101	131	191
Price deflator for gross domestic product, at market prices (average level)	43	55	81	127	126	121	149
Productivity and labor cost, business sector (in constant prices)							
Total productivity[g]	0.0	2.3	1.3	−1.9	1.5	1.3	1.7
Real unit labor cost[h]	3.0	5.9	2.8	−6.5	1.9	5.5	5.5

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

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

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

to the home market, and the domestic product advanced 3 percent[1] (all of it in the first three quarters of the year). Fixed investment expanded strongly (10 percent in real terms); the gain was concentrated in nondwelling investment (19 percent), and this will enlarge the economy's growth potential in the years ahead.

Total public consumption was down 4 percent because of a smaller direct defense import. It should be noted, however, that the government's domestic spending has risen rapidly since mid-1982 in the wake of the war in Lebanon. In each of the last two years the domestic defense bill rose 7 percent, while public civilian consumption edged up less than 1 percent. Given the rate of unemployment prevailing in 1983 (an average of 4.3 percent in the first three quarters of the year), one could have expected the growth of demands to be reflected by a relatively larger growth of employment and product. However, along with the much heavier defense spending, in September 1983 the government adopted a new strategy aimed at slowing inflation by targeting the increase in basic product and service prices and the exchange rate at 5 percent a month. But this did not succeed in reducing inflation, and the drop in relative foreign trade prices became more

[1] According to national accounts data of the Central Bureau of Statistics, the domestic product rose 1.8 percent and the business sector product by 2.1 percent; a measurement by sectoral origin shows increases of 3.6 and 4.6 percent respectively.

pronounced. The 5 percent monthly target was set after two years of real appreciation of the sheqel against a basket of foreign currencies, and in particular in relation to European currencies following their weakening against the dollar in the last few years. In 1981–83 the price of imports in relation to domestic uses fell 15 percent, and export prices by 10 percent. Since this policy was implemented against the background of a cumulative real appreciation of the sheqel, the swelling of the import surplus and external debt, and the failure to tone down inflation, the public's expectation of a large one-time devaluation, and apparently the stiffening of import taxes as well, grew stronger.

The drop in relative import prices and the devaluation expectations stimulated household demand for consumer durables (and foreign travel) and business demand for imported capital goods. This trend was strengthened by the sharply rising weight of financial assets in the public's wealth in the three preceding years, the high level of share prices, and the fear that financial saving might be impaired, which arose when the public began to increasingly feel that a change in economic policy was unavoidable and the government was finding it hard to decide on a budget cut. In other words, in 1982–83 individuals and firms adjusted the composition of their wealth owing to the change in expected relative yields (net) and to the risk associated with holding various assets. The enormous growth of liquid assets (including bank shares) in 1981–82 and the comparatively small drop in their price upon realization facilitated the shift to tangible assets. Besides the much heavier demand for consumer durables (up 16 percent) and investment goods (25 percent), most of which have no close domestic substitutes, the relative price decline induced a preference for other imported products, for which there are local substitutes. All told, civilian imports exclusive of capital services rose at a 10 percent real annual rate in 1982–83, compared with a 4 percent average increase in 1976–81. This deviated sharply from the long-run stable trend in the import component of resource use.

As stated, the decline in relative foreign trade prices and the expectation that the trend would be reversed was a very weighty factor in the growth of the civilian import surplus. But it should be stressed that the relative price changes were not uniform: the drop was more mild in the case of exports than of imports, since a large percentage of the exports benefit from exchange rate insurance and directed credit. Exports are also greatly influenced by world trade developments. In 1980 the world market slid into a recession, which deepened noticeably in 1982. This also hit developing countries, which take a large percentage of Israel's exports, and some of them even experienced a financial crisis. In 1983 the world market regained the ground lost the year before (a rapid recovery in the U.S. and a slow one in Europe). These developments led to a 2 percent increase in Israel's exports (excluding capital services) in 1983, after they had retreated in 1982 (by 4 percent), for the first time after a long period of rapid growth. Commodity export data by market destination point up the importance of world trade and relative prices to Israel's overseas sales: exports to the U.S., which in 1983 experienced a strong rebounding of demands and became a more profitable market compared with other countries, fared much better this year, while sales to Europe, whose currencies continued to weaken in relation to the dollar and which enjoyed only a very mild recovery, rose sluggishly; exports to other countries, which consist mostly of defense items, slumped appreciably.

In 1983 attempts were made to partly rectify the undesirable decline in relative foreign trade prices through exchange rate substitutes: exchange rate insurance coverage was extended to additional branches, and the protection of import substitutes was stepped up by means of taxes and administrative restrictions against dumping. It should be noted that broadening the system of exchange rate substitutes militates against efficient resource allocation: it creates differential effective exchange rates for various balance of payments transactions, in particular a lower rate for most services, unilateral transfers, and capital movements. Moreover, the deterioration in the balance of payments and the devaluation expectations led to a shift in individuals' financial portfolios away from all sheqel assets to assets linked to foreign currency—a change which grew progressively stronger and also influenced the anticipated size and timing of the devaluation. It can therefore be concluded that had the October devaluation been accompanied by a reduction of exchange rate substitutes (taxes and foreign trade incentives), the speculative pressures in the capital market could have been contained without such a steep jump in prices, thereby leading *inter alia* to a more efficient resource allocation.

The cumulative growth of the current account deficit in 1981–83 greatly increased Israel's net external debt, both absolutely and in relation to GNP. In 1983 the net debt rose 14 percent, bringing the total increase during the last three years up to 52 percent—faster than the growth of the economy. The uptrend in the debt-GNP ratio has persisted for many years—a development typical of economies in the process of building up their infrastructure, but which obviously cannot be sustained for very long. In the debt burden too, which is reflected, for instance, in the ratio between net interest paid to foreigners and the economy's income, there has been a long-run rising trend, which in 1983 tapered off at the previous year's level.

In the short run, the composition of Israel's external debt is fairly convenient. First of all, the country's foreign currency assets exceed the short-term debt (including long-term liabilities falling due within the coming year), although there was a turn for the worse this year, when the surplus of assets over current liabilities shrank appreciably. Secondly, a large part of the debt is owed to foreign governments and to world Jewry. Despite the favorable composition of Israel's indebtedness, the government must quickly steer the economy back to a course that will slow the piling up of debt.

As in 1981–82, the current account deficit was larger than total investment, despite the healthy growth of the latter. In other words, the rate of national saving was negative, implying that total consumption (private and public) exceeded total income available to the economy. The net national saving rate dipped sharply in the two preceding years, but bottomed out in 1983. The downturn in the saving rate in 1981 was due to a swelling government fiscal deficit. In 1982–83 the domestic deficit was reduced but remained fairly large (about 8 percent of GNP); the rate of private saving, however, fell precipitately.

The reduction of the fiscal deficit since 1982 can be attributed to the government's decision to impose new taxes in order to blunt the potential expansionary effect of a heavier defense spending, as well as to a much larger import of highly taxed products. Because of the war in Lebanon indirect taxes were stiffened in 1982 and a compulsory loan was levied for a limited period; this year too import and purchase taxes were raised. The policy of subsidizing controlled goods and services underwent frequent shifts in 1983, with a big increase in subsidies in the first nine months of the year followed by a sharp cut in the fourth quarter. As a result of the tax policy pursued in the last two years, net tax revenue swelled 44 percent in real terms in 1982 and by 17 percent in 1983. Despite the heavier tax burden imposed on the public in recent years, it should be noted that the dampening effect of taxes on private consumption is outweighed by the stimulative effect of an increased public consumption. In addition, the hiking of taxes, which the public regards as a transitory phenomenon, has only a marginal impact on private consumption, and is felt mainly in saving. The government's net tax receipts have been quite volatile in recent years, mainly because of the frequent shifts in subsidy and indirect tax policy. This has been one of the reasons for the poorer saving performance. In 1982–83 the rate of gross private saving turned sharply downward, from a 32 percent average in 1979–81 to 23 percent in 1983—a development explained by the special factors mentioned above with respect to private consumption. It should be borne in mind that during the past decade economic growth was very sluggish, and the prospects for reversing the trend without a rise in the external debt-GNP ratio largely depend on the releasing of resources for investment, i.e. an increase in national saving—private and public alike.

As stated, in 1983 exports made only slight headway and domestic demands, in particular for imported goods, continued to grow strongly, for the third consecutive year. But in contast to 1982, this year part of the incremental demand was evidently diverted to the domestic market, expanding the domestic product by 3 percent. This reflected a bigger gain in the business sector product and zero growth in the product of the public sector and nonprofit institutions (all the increase was posted in the first three quarters of the year). The modest GNP advance came after the previous year's stagnation, and was similar to the low growth rate of the past decade. The upturn of GNP stemmed primarily from a big increase in local purchases by the defense establishment and the recovery of exports. Private consumption also contributed to the GNP gain; this occurred despite the declining relative price of imports, and is explained by the protection of domestic production (in order to prevent unemployment) through various exchange rate substitutes—

such as an import levy and an import deposit requirement—as well as administrative import curbs under the antidumping law.

The growth of employment and capital stock also testified to the recovery of economic activity this year. However, there were still idle factors of production in the economy which could have permitted GNP to expand more than it actually did. The number of Israeli employed persons rose 3.2 percent, but most of the increment consisted of part-time workers, so that the number of hours worked per employed declined and the labor input went up only 2.6 percent. Nearly all the growth in employment (about 95 percent) was in the business sector, but a large proportion of the additional employed persons were absorbed in trade and services and the financial sector, which expand rapidly in an inflationary period. The increase in employment outstripped the growth of the civilian labor force, depressing the unemployment rate from last year's 5 percent level to 4 percent in the first three quarters of 1983. The recovery of the labor market was also reflected by a fairly rapid rise in real wages per employed person—about 10 percent in the first three quarters of the year compared with the average for 1982. This year too real wages per employed person went up faster than labor productivity. This trend, evident since the mid-1970s, reduces the possibility of a real devaluation and the changing of relative prices in the economy. Despite a much heavier investment in 1982–83, the nondwelling capital stock rose only 3 percent each year, for a large part of the investment was for replacing obsolescent assets. The increase in capital stock slightly exceeded the sluggish economic growth rate in recent years.

The business sector product expanded only a little faster than the capital and labor input, with the result that productivity remained at the low level prevailing since 1973—a mere 1 percent rise, after a protracted average annual 4 percent advance. Among the main causes of the slack productivity are the rapid inflation, high level of taxation (gross), and frequent shifts in government policy. It is reasonable to assume that the jump in the inflation rate at the end of 1983 will further impair the efficiency of the economy and the possibilities of growth.

In the fourth quarter of 1983 economic activity sagged following the change in basic policy. The drastic shrinkage of the public's financial wealth, a real credit squeeze, and the cutting of subsidies quickly dampened domestic demands; at the same time exports recovered some ground. These developments were reflected in the domestic product and labor market, pushing the unemployment rate back up to 5 percent and depressing real wages 14 percent below their level in the first three quarters of the year.

A very worrisome feature of 1983 was the marked aggravation of inflation, which hit 190 percent after averaging 120 percent in 1979–82. The turn for the worse occurred in the fourth quarter of the year, whereas in the first nine months prices moved up at roughly the same pace as in previous years. They continued to climb steeply in the first four months of 1984; in other words, during the past seven months the monthly inflation rate did not fall below 10 percent, and between

October 1983 and March 1984 it averaged 14 percent. Inflation has thus reached new heights, with the monthly rate double that in 1981–September 1983.

Real and monetary developments this year were largely an outcome of the price policy followed by the government since September 1982. Policymakers concluded that inflation in Israel does not fulfil the traditional role of financing the budget deficit, and that it stems predominantly from spiraling costs, which influence the public's expectations. Since the government deficit also shrank in 1982 (especially the second half) because of higher taxes, several measures were taken with the object of synchronizing price increases at a 5 percent monthly rate. This target was applied to the exchange rate and basic commodities and services only. In addition, the cost-of-living allowance arrangement was modified in order to more quickly adjust wages for rising prices, but this had only a marginal effect on the inflation rate. This policy was pursued until July 1983. It exacerbated the balance of payments problem but did not succeed in slowing inflation: the average monthly price advance during the period when the policy was in effect reached 7 percent, with the prices of noncontrolled items moving up slightly faster. The failure of the policy to achieve its prime objective can be attributed to several factors: (a) It was not accompanied by the dampening of government demand, and defense spending even rose; in addition, the rate of private saving fell sharply. (b) The policy was implemented under unfavorable circumstances, namely a cumulative, grave deterioration in the country's current account. (c) Although the policy was intended to synchronize all price increases, it did not embrace all factors in the economy by way of a price-wage agreement, the lack of which was felt in particular with respect to wages. (d) The attempt to cool inflation solely by slowing the depreciation of the sheqel conflicted with the goal of preserving the country's international reserves, which are extremely important to the economy. In addition, the resort to exchange rate substitutes in order to moderate the drop in relative foreign trade prices contradicted the slower devaluation policy. (e) In the face of all these factors, especially the serious deterioration in the balance of payments, the government's strategy did not win the public's confidence. Also contributing to this was the fact that a similar policy implemented in 1981 only temporarily curbed the rise of prices; the public's inflationary expectations therefore stayed at their high level.

The failure of the price policy gradually increased the real appreciation of the sheqel and the current account deficit. In consequence, the government began to retreat from this policy already in June, with the imposition of an import deposit requirement, and in August it devalued the sheqel by 7.5 percent in order to check the speculative pressures in both the commodities and financial market. Since the devaluation was not accompanied by complementary measures, the public's expectations were not dampened and purchases of foreign currency in all its various forms even increased. In switching to foreign currency the public disposed of bank shares, which were greatly overpriced, and the mounting wave of selling pressure eventually brought on a crisis in the stock market. These developments caused the government to completely abandon its 5 percent target at the beginning of October: the sheqel was devalued by 23 percent, the prices of subsidized items were raised appreciably, and the government decided to reduce its spending. These changes reflected a shift in emphasis in the policy targets: whereas the price policy introduced in the previous year had as its prime objective the slowing of inflation, even at the risk of aggravating the current account deficit in the short run, in view of the sizable growth of the current account deficit and external debt, the improvement of the balance of payments now became the central target, even if this resulted in the acceleration of inflation.

This change in emphasis prompted the government to try to preserve the large real early-October devaluation through the current depreciation of the sheqel in line with the rate of domestic inflation. It also continued to gradually cut subsidies on controlled items. As a result of these measures, the fourth quarter of 1983 saw an appreciable real contraction of both individuals' financial asset holdings (following the agreement to discontinue the supporting of bank shares) and the volume of credit. In addition, the government reduced its outlays and real wages eroded. These changes dampened domestic demands and improved the balance of payments somewhat.

The structure of Israel's financial market, in which the bulk of the public's holdings are linked to the consumer price index or the exchange rate, and the accumulation of financial assets (including accrued interest) made it possible in the past to pass on nearly all cost increases without greatly harming real activity. But the weakening of demand in the fourth quarter of 1983 permitted only part of the cost pressure to find expression in prices during this period, with the consequence that there was a real depreciation of the currency and a drop in employment. Nevertheless the average monthly inflation rate in this quarter reached 16 percent, and the average monthly depreciation of the sheqel and the average rise in controlled prices came to 19 and 20 percent respectively. The attempt to preserve the end-1983 real devaluation and to trim subsidies continued in the first quarter of 1984, and the consumer price index went up 12.5 percent on a monthly average.

The high rate of inflation prevailing in the last few years impedes economic activity and productivity. It has also generated a much heavier demand for financial services as a hedge against inflationary losses. Consequently, their share in employment has risen at a remarkable pace in recent years, i.e. the economy has diverted more resources to financial intermediation without increasing its welfare level. The system of direct taxation has also been warped by inflation, and the attempt to rectify this in 1983 only aggravated the situation because of the shortcomings of the law for taxation under inflationary conditions. It should be noted that an inflation-related contraction of tax receipts is also typical of other economies experiencing high inflation, where it has led to a self-generating inflationary spiral. In Israel this problem is likely to find its main expression in a widening current account deficit. In income distribution too it has resulted in unplanned changes, both because of variations in gross income distribution and because of the asymmetrical effect of direct taxes on wages compared with other incomes. The acceleration of inflation at the end of 1983 made this problem more acute.

The real appreciation of the sheqel and the ensuing devaluation expectations were another major factor in monetary developments in the year reviewed. During the first nine months the exogenous injection, which for the most part was engendered by the public sector deficit, amounted to about 10 percent of GNP, similar to last year's figure but far below the high 1981 level. The devaluation expectations, which intensified in the course of the year, had a significant twofold moderating effect on the monetary aggregates. First of all, private sector purchases of foreign currency swelled because of the growing current account deficit. This trend, however, was neutralized by the commercial banking system, which imported considerable capital in order to support the price of its shares, and on balance the total amount absorbed through the balance of payments was similar to last year's figure. It follows that the incremental domestic injection less the balance of payments absorption, measured in relation to GNP, was also about the same as in 1982. Secondly, besides their influence on the monetary base, the devaluation expectations indirectly affected the supply of credit. They spurred the public to reshuffle its financial portfolio in favor of assets linked to foreign currency, especially Patam (sheqel deposits denominated in foreign exchange) over sheqel deposits, indexed deposits, and shares. Patam constitutes a source of foreign currency-linked credit, but there is a ceiling on such finance. The move from sheqel to Patam deposits therefore squeezed the sources of bank credit, which was only partly offset by the liquidity deficiencies incurred by the banks.

In 1983 the Bank of Israel conducted a tight credit policy. The policy measures had been changed at the end of 1982: in place of administrative credit ceilings, the Bank began to use a combination of tools to influence the sheqel base in the monetary system—liquidity ratios, discount-window loans, the rate of interest on required liquid cover, and penalties for liquidity shortfalls. It continued to impose ceilings on foreign currency credit, but reduced them below their previous level. The Bank's policy was intended to enable the contractionary monetary forces engendered by the reshuffling of the assets portfolio to find expression in the restraining of credit. As a result, during the first three quarters of 1983 its nominal growth slowed from last year's 7.5 percent average monthly rate to 5.7 percent, its real balance declined 1 percent a month, and the real interest rate rose. All told, bank credit shrank 11 percent in real terms during this period.

The smaller real addition to the asset base and the reduction of credit were reflected by a much smaller purchase of domestic assets by the public. Since a large part of total financial assets is linked to the exchange rate or the price index, they continued to swell in nominal terms but fell 7 percent in real value during the first nine months. Liquid assets (including bank shares) expanded faster than total financial assets—8.3 vs. 6.4 percent on a monthly average. In real terms the balance of liquid assets changed only fractionally, following three years of rapid growth. This development, as already mentioned, was accompanied by a marked shift in the public's asset holdings—a significant increase in assets linked to foreign currency, notably Patam, and the reduction of indexed assets, sheqel deposits, and shares.

The reshuffling of the public's assets portfolio, especially the sale of bank and other shares, began in early 1983. The basic reason for the falling demand for bank shares was that they were greatly overvalued. This was an outcome of the policy followed by the majority of the leading banking groups of supporting their price through affiliated companies; for quite a long spell this had ensured shareholders a high return, thereby increasing confidence in the continuation of this trend. The more confidence in these shares grew, the more demand for them rose, and this enabled the banks to continue this practice for years and to float new issues, although it was clear that this could not go on indefinitely. In the past, whenever the market weakened the banking groups supported their own shares and later succeeded in selling them. The weight of bank shares in the public's asset holdings moved up steadily, and the gap between their price and real value widened; discontinuation of this practice therefore caused the price to drop sharply. With the heightening of devaluation expectations during 1983, bank shares came under growing selling pressure, and their continued support made it necessary to pour in increasing sums. The supporting of these shares was fraught with risks, but in view of the dimensions of the problem, which had built up over a fairly long period, termination of such intervention also posed a serious threat to the capital market and the financial system (in both Israeli and foreign currency). Reducing the risks involved in discontinuing this practice necessitated decisions in other areas, especially the exchange rate. Against this background the Tel Aviv Stock Exchange was closed in early October for two weeks; during this period the government worked out an arrangement with the banks involved whereby the supporting of their shares ceased and the government indirectly guaranteed the dollar value of the shares, which will be redeemed after several years.[2] Together with the closure of the Stock Exchange in October, a large devaluation was implemented and a new economic policy adopted, as already described.

These developments led to a real liquidity squeeze: the value of bank shares, which formerly had been perceived as a highly liquid asset by the public, shrank appreciably, and unlinked sheqel assets eroded because of mounting inflation. The government's purchase of bank shares from the public, to the tune of IS54 billion, prevented a steeper drop in their value. The public's financial asset holdings fell 16 percent in real terms in the fourth quarter, and the aggregate consisting of liquid assets and bank shares went down 27 percent in real terms. In addition, there was a real decline in bank credit and a rise in the bank lending rate. The nominal growth of bank credit reached 12 percent a month in the fourth

[2] For details of the bank share arrangement see Chapter VIII.

quarter, but since this was far below the 16 percent average monthly price advance during this period, the volume of credit contracted 9 percent in real terms.

As already mentioned, under the bank share arrangement the government has indirectly guaranteed the future value of these securities. Since it is unclear how well the commercial banking system will fare in the years ahead, to some extent the public regards the arrangement as constituting a government debt. Estimates of its magnitude vary widely, and depend on the degree to which the banks increase the efficiency of their operation and improve their profitability in the coming years. It should be emphasized that apart from this commitment, the government's domestic debt did not grow in 1983, after it had risen steeply from the early 1970s; the government deficit was this year reflected primarily by an increase in the external debt. After standing at 50 percent in 1970, the domestic debt-GNP ratio moved up steadily to reach 115 percent in 1980, at which level it tailed off in the last three years. This high domestic debt makes it hard for the government to continue financing a budget deficit of the present dimensions by increasing its domestic liabilities, and it must therefore slash its expenditures if it wants to keep them from pushing up the external debt.

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Economic developments in the last two years have clearly demonstrated that the concentration of policy on one of the prime objectives while relegating others to second place is fraught with many dangers. The spiraling of inflation to an all-time high and the swelling of the current account deficit call for a policy that will simultaneously improve the balance of payments and retard inflation.

This can be achieved only by a comprehensive policy providing for a significant real cut in government spending, the encouragement of private saving, continuation of a stringent monetary policy, and a package deal to stabilize prices. In the last few years the rate of saving has dipped sharply; this trend must be reversed, for unless the public is ready to forgo consumption today in favor of investment, the prospects of increasing consumption in the future will be dim. Promoting saving necessitates the maintenance of a real positive return to the saver and confidence in and the stability of financial assets. Government expenditure must be reduced substantially for several years. The system of direct taxes, which has been badly warped by the high inflation, has to be reconstructed and the government must refrain from printing money to help finance its deficit.

The anti-inflation fiscal and monetary measures must be accompanied by an agreement between all the parties concerned which will permit the immediate slowing of inflation with minimum adverse effects on employment.