

## CHAPTER I

### THE ECONOMY: DEVELOPMENTS AND POLICIES

In 1982 the central problems facing the economy in recent years became more acute: high inflation combined with a sluggish level of activity, and the growth of the current account deficit and the external debt. Gross national product rose by a mere 1 percent, a low rate even compared with the average for the past decade (3.3 percent); the business sector product did not grow at all. The import surplus expanded by about \$400 million; less defense imports (which declined this year), the civilian import surplus increased by \$1 billion. The net external debt rose for the second consecutive year by 15 percent to stand at \$15.5 billion. Despite the stagnation of GNP and the larger balance of payments deficit, inflation not only failed to weaken but it returned to its 1980 level (130 percent). The slight increase in economic activity was accompanied by continued slackness in the labor market: for the third straight year unemployment ran at 5 percent of the civilian labor force.

The marginal increase in the domestic product despite an 8 percent expansion of domestic demands can be attributed to special factors which this year dampened exports and stimulated imports. Exports retreated 2.6 percent, the first time they suffered a setback after many years of very rapid growth. The downturn was due to the combination of global recession and Israel's diminished ability to compete in foreign markets. In the last two years world markets were depressed and international trade slumped. The weakening of European currencies against the U.S. dollar and the real appreciation of the sheqel in relation to a basket of foreign currencies made it harder for Israeli goods to compete abroad. These influences were moderated by some reduction of taxes on labor and by the exchange rate insurance arrangement, which *inter alia* provided for the compensation of the country's exports to Europe for the strengthening of the dollar.

Since September 1982 there has been a growing lag in adjusting the exchange rate of the sheqel for the difference between the level of inflation in Israel and that of her trading partners; this is in accord with the government's policy of slowing the nominal depreciation of the currency in order to help leash inflation. Despite the slackening of domestic economic activity, inflation has not been reduced to the same extent as the depreciation of the sheqel, and consequently there has been a sizable real appreciation. The outcome of this and the other factors mentioned has been the intensification of the downswing in exports and in particular the growth of imports; these trends became more pronounced in the first quarter of 1983, when the civilian import surplus continued to swell, even surpassing the preliminary estimates.

**Table I-1**  
**MAIN ECONOMIC INDICATORS, 1977-82**  
 (Percent annual increase unless otherwise stated)

	1977	1978	1979	1980	1981	1982
<b>Resources and uses (in constant prices)</b>						
Total uses, excl. direct defense imports	3.0	4.6	6.8	-1.8	4.9	4.8
Gross domestic product	1.3	3.7	5.0	3.1	3.4	1.2
Gross domestic product of the business sector <sup>a</sup>	-0.1	3.3	5.4	3.4	3.9	0.4
Real disposable private income <sup>b</sup>	11.2	4.5	3.0	-1.6	16.2	-2.9
Private consumption						
Total	4.8	8.1	8.0	-2.7	11.0	7.5
Per capita	2.4	5.8	5.4	-5.0	9.0	5.5
Public consumption						
Total	-13.4	8.4	-8.7	9.1	6.3	-6.6
Excl. direct defense imports	-2.0	-1.4	2.5	3.5	0.7	4.6
Thereof: Civilian consumption	2.9	5.4	2.1	-1.2	0.7	0.1
Fixed capital formation	-11.4	5.3	12.4	-9.7	1.7	4.7
<b>Public sector liquidity absorption<sup>c</sup> (as a percent of GNP in current prices)</b>	21	20	25	23	16	23
<b>Balance of payments and international reserves (in \$ billion)</b>						
Imports	8.1	10.0	12.0	13.9	15.1	15.2
Exports	5.7	6.8	8.3	10.1	10.8	10.5
Import surplus	2.4	3.1	3.7	3.8	4.3	4.7
Foreign currency debt <sup>d</sup>	8.8	9.5	10.7	11.6	13.4	15.5
Foreign exchange reserves <sup>e</sup>	0.2	0.9	0.3	0.2	0.1	0.1
<b>Population, employment, and wages</b>						
Average population	2.3	2.2	2.5	2.4	1.8	1.9
Number of Israeli employed	2.9	4.6	2.3	1.1	2.0	1.4
Unemployment rate (as a percent of civilian labor force), absolute level	3.9	3.6	2.9	4.8	5.1	5.0
Monthly earnings per employee post (in current prices)	48	54	90	126	139	117
<b>Monetary (in current prices)</b>						
Money supply	39	45	31	98	78	111
Total liquid assets of the public	69	59	83	150	105	128
Bank credit to the public <sup>e</sup>						
December levels	74	80	101	110	82	138
Average level	68	84	80	103	103	102

<sup>a</sup> Excludes imputed residential rents.

<sup>b</sup> From all sources.

<sup>c</sup> Revenue from taxes and property and entrepreneurial income, less subsidies (excluding the imputed subsidy component of credit) and net transfer payments.

<sup>d</sup> Gross foreign currency liabilities, less net foreign exchange reserves in the Bank of Israel, liquid assets in other financial institutions, and credit to foreign customers.

<sup>e</sup> Excludes credit for oil imports; since 1979 includes credit from overseas branches of Israeli banks.

Table I-1 (cont.)

	1977	1978	1979	1980	1981	1982
<b>Prices</b>						
Consumer price index (December levels)	43	48	111	133	101	131
Price deflator for gross domestic product, at market prices (average level)	43	55	81	127	127	121
<b>Productivity and labor costs (in constant prices)<sup>f</sup></b>						
Productivity (product per manhour)	1	2	0	2	2	1
Real unit labor costs <sup>g</sup>	6.1	3.3	4.6	-7.9	-0.8	4.2

<sup>f</sup> Business sector. (The product was calculated using an average of two estimates: by sectoral origin and a measurement from the costs side.)

<sup>g</sup> Business sector, with the product measured according to sectoral origin.

This year's steep increase (8 percent) in domestic demands encompassed all components. Public domestic consumption expanded because of a larger defense expenditure in the wake of Operation Peace for Galilee. The heavier private consumption spending is mainly explained by the long-run trend in disposable income, which rose following a sizable growth of disposable current income in 1981. The increased investment in fixed assets and inventories was influenced *inter alia* by the fall in real interest rates, the availability of more medium- and long-term credit, and the raising of capital on the Tel Aviv Stock Exchange. The incremental domestic demands were diverted to imports, mainly because of the decline in their relative price, especially in the case of European goods. The real appreciation of the sheqel and the feeling that this would not last for long induced a preference for foreign over domestically produced current consumption goods and the advancing of purchases of durables as well as of investment in fixed assets and inventories. This should be viewed in the light of the general propensity to buy foreign products with a rise in living standards. All these factors explain the small contribution of domestic demands to the growth of product and their strong impact on imports. On the other hand, the flagging of exports resulted in a smaller purchase of intermediates from abroad; nevertheless total civilian imports (excluding capital services) rose in 1982 by 10 percent in real terms, compared with a 4 percent average increase in 1976-81. The upswing in imports began in 1981, and it deviated markedly from the long-term stable trend in the weight of the import component in final uses. It should be pointed out, however, that this year's larger import was to some extent a compensatory response to the heavy depletion of stocks in 1980.

The deficit on current account, as stated, rose strongly in the last two years—from an average of \$850 million per annum in 1978-80 to \$1.4 billion in 1981 and \$2.1 billion in 1982. This occurred despite the fall in oil and other product prices in the international market. A striking development this year was an approximately \$1 billion increase in the private sector deficit; this was due entirely to a larger import

surplus, whereas the sector's unilateral transfer receipts have remained stable for the past several years. The public sector's import surplus shrank in 1982 owing to a smaller defense import bill (after increasing in 1981); this was accompanied by a decline in defense-related unilateral transfers.

The expansion of the import surplus without a corresponding growth in unilateral transfers increased the net external debt by 15 percent, for the second year in a row. Most of this year's additional capital import was supplied through the commercial banking system, a development made possible by the lifting of the restrictions on the procurement of medium- and long-term capital from abroad. The capital inflow was more than enough to cover the current account deficit, and consequently the country's international reserves expanded. The formidable \$2 billion growth of net liabilities to foreigners increased the economy's debt burden, and this against the background of a stagnant product and falling exports. A disturbing development was the fact that the sizable growth of the current account deficit in recent years served primarily to expand public and private consumption, and only to a minor degree to stepping up investment; in other words, only a relatively small share of the incremental external debt served to expand the economy's capital stock, since the national saving rate dipped sharply in each of the last two years.

Total public consumption declined 7 percent owing to a much smaller defense import after completion of the military redeployment in the Negev. On the other hand, public domestic consumption rose 5 percent, well above the average rate for the last few years. This year's big increase reflected real stability in civilian consumption and a steep 9 percent rise in domestic noncivilian consumption. The latter is explained primarily by the war in Lebanon, whose impact on demands will not be confined to the current year, since it was decided to spread the replenishing of stocks of military supplies and equipment over several years. While this lightened the economic burden in 1982, it will entail a heavy noncivilian spending in the coming year; this will severely impede economic activity in the future and make it harder for the government to cut its budget.

The government decided to counteract the expansionary influence of the larger domestic defense spending by raising taxes and slashing subsidies and transfer payments. Taxes were stiffened in the second half of 1982 following the outbreak of war in Lebanon: the value added tax was increased by three percentage points, a levy was imposed on imports and on the sale of securities on the stock exchange, a compulsory loan was introduced, and a travel tax went into force for a limited period. These changes, together with the bigger import of highly taxed products, caused the public sector's net tax revenue (taxes less subsidies and transfer payments) to shoot up 47 percent in real terms, after falling 24 percent in 1981. Net tax revenue has fluctuated sharply in recent years, mainly because of the frequent changes in the government's policy of subsidizing basic products and services. The hiking of taxes in 1982, combined with the cutting of subsidies on basic commodities and services, pushed up Israel's tax burden to its highest level in the past decade. What is more, the gross tax component in GNP came to fully 50 percent; this reflected the government's

increased intervention in the economy, and it will have an adverse effect on the economy's growth potential and efficient resource allocation.

The amount of liquidity absorbed through taxes exceeded the increase in the government's domestic demands, with the consequence that the public sector's real demand surplus contracted appreciably: in relation to GNP it declined to 9 percent (similar to the figure for 1978–80), after it had risen in 1981 to 16 percent. But it is important to note that the dampening effect of taxes on private consumption is outweighed by the expansionary effect of an increased public consumption. Furthermore, since private consumption is mainly determined by the public's assessment of its long-run income trend, the effect of tax changes, which the public regards as a transitory factor, is not great, and so the raising of taxes in 1982 was not accompanied by the reduction of consumption. In fact, despite a fall in disposable income, private consumption continued to expand this year as well, as consumers drew on their savings to finance their extra spending. In 1981 there was an opposite development: the growth of consumption lagged behind that in disposable income.

Real wages and gross private income from economic activity declined by less than 1 percent in real terms, but the expansion of net tax revenue depressed disposable income from all sources by 3 percent, after a real 16 percent rise last year. Despite the contraction of disposable income, private consumption rose 7.5 percent; to some extent this reflected an adjustment to the disposable income trend, which had risen strongly in 1981. There were also several factors specific to 1982 which caused consumption to grow faster than warranted by the long-run disposable income trend: the belief that the reduction of the prices of imported consumer goods in general and of durables in particular would be short-lived since the present real rate of exchange could not be maintained for long, the abundant liquidity in the economy at the beginning of 1982, and perhaps also the expansion of the public's wealth due to the sharply rising market value of the shares traded on the Tel Aviv Stock Exchange. As in 1981, most of the growth of private consumption occurred in durables (19 percent), in particular private cars. The bulk of the incremental private consumption, and not only of durables, was diverted to imports, and so the contribution of this final demand to domestic economic activity was marginal, amounting to only 1 percent.

Gross domestic capital formation was 14 percent up on 1981; this was the net outcome of a slight increase in inventories (which had been heavily run down in the two preceding years), a 10 percent growth in fixed nondwelling investment, and a 4 percent decline in housing. Despite the overall growth of investment, this final demand was one of the factors that depressed the product a bit, since investment in residential and nonresidential construction, which have a high domestic product content, fell off 4 percent. The additional investment was concentrated in machinery, equipment, and transport equipment (up 16 percent), which have a high import component; domestic production of equipment actually declined 1 percent. This year's heavier spending on fixed assets and inventories was influenced by the fall in real interest rates, the much larger volume of long-term credit, and the raising of capital on the stock exchange. To some extent it also resulted from the advancing of

purchases in anticipation of a change in the real exchange rate. Despite the sharply higher expenditure on machinery and equipment, total non dwelling investment did not greatly exceed estimated discards; consequently, investment net of discards augmented the capital stock by only 4 percent, compared with 3 percent last year. This was consistent with the low economic growth rate in recent years. Nevertheless, some of the new investments will increase the economy's growth potential as they were made in new technologies.

Capital spending by the public sector rose 4 percent, after sagging noticeably in previous years. In public sector companies the downtrend continued in 1982. In infrastructure investment a growing shortage has become apparent in several areas. This is explained by the fact that whenever it is decided to cut public sector expenditures, investment is the first to suffer, since the effects of a reduction here are not felt in the short run. It should be emphasized, however, that in the long run this adversely affects the economy's growth potential.

The sluggish level of economic activity in 1982 can also be discerned in the labor market: the proportion of the unemployed civilian labor force remained, as in the two preceding years, at 5 percent. Nevertheless, several indicators suggest a worsening of the employment situation: the labor force participation rate turned down, mainly in the youngest and oldest age group, where the prospects of finding work in the present conditions are slimmer; in the other age groups the war in Lebanon also had an effect. In view of the change in the schooling and age structure of the population, the drop in the labor force participation rate was even sharper than indicated by the data. The development of the participation and unemployment rates was also reflected by a decline in the employment rate (the proportion of employed in the total working-age population). The number of employed rose to the same extent as the labor force, but the number of hours worked per employed declined, so that on balance the labor input was flat.

Product per manhour in the business sector did not grow in 1982, and the product per employed even inched down 1 percent. Since the capital stock per manhour rose this year, overall productivity apparently declined. However, this probably indicated that employment was greater than required for the current level of activity. In other words, there was apparently hidden unemployment in the economy. This can be attributed to the difficulty of laying off redundant labor, both because of employers' reluctance to lose skilled workers and because of the financial cost involved; this reluctance to reduce their workforce may also reflect employers' expectations of an imminent rebounding of activity.

Real wages per employee remained stable, after going up steeply last year. Wages per unit of output, from the standpoint of employers, even increased in spite of the weakening demand for labor. Unit labor costs have fluctuated in recent years, but the general level is high following a steady and sharp rise in 1972-79. It should be noted that the rigidity of real wages diminishes the possibility of a real depreciation of the sheqel and a change in relative prices in the economy. The heavy net tax burden on labor goes some way to explain the high labor costs. Alleviation of this burden would encourage the shifting of workers from the public to the business sector, expand

employment and product, and mitigate the existing distortion in the relative prices of capital and labor.

The three-digit inflation which had prevailed since mid-1979 continued in the year reviewed. After slowing down in 1981, the advance of prices accelerated in 1982, when they went up at the same rate as in 1980: the consumer price index rose 130 percent in both 1982 and 1980, compared with 100 percent in 1981. Other price indexes reveal a similar picture.

These year-to-year variations in the inflation rate were directly related to the frequent and drastic changes in the policy of subsidizing controlled basic products and services: the cutting of price supports in 1980 and 1982 and a heavier subsidization in 1981. In contrast to the sharp swings in controlled prices, uncontrolled items moved up at a relatively even pace. The latter evidently were not greatly influenced by the direct fixing of controlled prices. The fairly steady rise of uncontrolled prices over the last three years and the fact that the general price index moved up at the same rate in 1980 and 1982 suggest that the hiking of subsidies in 1981 did not significantly alter the basic rate of inflation; this is determined in the long run by the excess demands and monetary developments in previous years.

The much heavier subsidization in 1981 reduced the rate of inflation that year only because of its direct and immediate impact on controlled items. But in the long run the price supports have an opposite effect: increasing subsidies engenders a monetary expansion and stimulates domestic demands, which after a time is reflected in the acceleration of inflation or an increase in the import surplus. It can therefore be assumed that the movement of prices in 1982 was influenced by the rapid monetary expansion in 1981, in particular in the second half of the year. Whether the raising of subsidies will result primarily in the aggravation of inflation or the growth of the import surplus largely depends on the real exchange rate: the lower this rate, the more demands will shift to imports. Had it not been for the diversion of domestic demands to imports following the real appreciation of the sheqel, GNP and inflation probably would have been higher this year than they actually were. From mid-1981 until the third quarter of 1982 inflation gradually accelerated, accompanied by a fall in the real rate of exchange; as a result of the latter development, the surging of demands led to the expansion of the import surplus.

In view of the reduction of the government demand surplus in the course of 1982, in particular in the last six months, a concerted effort was made to reduce inflationary pressures from the costs side: a slower depreciation of the currency, a more modest hiking of controlled prices, and refraining from nominal interest rate increases. These measures were accompanied by an agreed change at the beginning of 1983 in the cost-of-living allowance arrangement, whereby the allowance is now adjusted according to the rise in the consumer price index in the preceding quarter, instead of the average rise in the previous two quarters. This change makes for a quicker adjustment of wages to price developments, and is intended to curb the growth of real wages when inflation is weakening.

It is still too early to fully assess the policy adopted in September 1982. While in the final quarter of 1982 and the first quarter of 1983 inflation ran at a lower rate than in

the previous two quarters, the degree to which it tailed off did not exceed the direct effect of the slower increase of controlled prices and the slower depreciation of the sheqel. Because of seasonality in the movement of prices, they should be compared with the corresponding period in the previous year. Such an examination shows that between October 1982 and April 1983 inflation actually accelerated compared with the same months last year. It should be noted that the policy involved a renewed increase in subsidies, a real appreciation of the sheqel, and the expansion of the import surplus.

The uptrend in prices seems to be a fairly permanent feature in Israel, owing to the public's deep-rooted expectation of the persistence of the inflationary process. Partial measures, such as a slower depreciation of the currency, are not in themselves sufficiently effective to combat inflation, and they are liable to have undesirable repercussions in other areas. Only a consistent, comprehensive anti-inflationary policy—which combines monetary and fiscal measures (including a real cut in public sector spending and a smaller government reliance on Bank of Israel loans for financing its expenditures), and which is coordinated with price, wage, and incomes policy and the easing of the tax burden on labor—can enhance the prospects of restraining inflation with a minimum negative effect on employment.

Together with the acceleration of inflation from 100 percent in 1981 to 130 percent, the year reviewed witnessed a faster nominal growth of the principal monetary aggregates. The public's liquid financial asset holdings expanded by 128 percent, as against 105 percent in 1981, and total financial assets grew by 195 percent (28 percent in real terms), compared with 134 percent the year before. In real terms liquid financial assets declined about 1 percent (mainly in the second half of the year), but including bank shares, which are highly liquid, this aggregate rose 13 percent in real terms, following a 16 percent increase last year. In view of the growth of this aggregate, the year reviewed can be characterized as one of monetary expansion, although to a lesser extent than in 1981.

In Israel most of the liquid assets are linked to the exchange rate or the consumer price index. The prolonged and mounting rate of inflation during the past decade prompted the public to gradually increase the share of indexed assets in its liquid portfolio to 84 percent by the end of 1981. The altering of the portfolio mix was largely made possible by the highly elastic supply of liquid indexed assets. It follows that most of the nominal monetary expansion in 1981 and 1982 (about 90 percent of the nominal increase in liquid assets) automatically stemmed from the inflation-proofing of the assets. Their real growth is also influenced by fluctuations in the real exchange rate of the sheqel and in the real market value of government bonds. In 1982 the real appreciation of the sheqel was partly responsible for the drop in the real value of the assets linked to the exchange rate.

Because of the low weight of unlinked assets in the public's portfolio, the sheqel base in the financial system is also small. The absence of a significant unlinked asset base greatly hampers the conduct of monetary policy. In the second half of the year several important steps were taken to reduce the liquidity of Patam local residents' foreign currency deposits and to render their holding less attractive, while inducing

the public to switch to unlinked Israeli currency deposits and unlinked credit. What was common to all these measures was the encouraging of the public to hold assets and liabilities that do not immediately and fully adjust to unexpected rises in the price level. These steps were intended to pave the way for a shift from the regulation of credit through the imposition of ceilings to its indirect regulation by influencing the monetary base.

The Bank of Israel's measures led to significant changes in the liquid assets portfolio mix in 1982, mainly in the second half of the year: the proportion of unlinked assets (money, negotiable certificates of deposit, and sheqel time deposits) expanded from 14 to 20 percent during the last six months of 1982, and the weight of Patam declined from 54 to 49 percent. The latter development is also explained by the slow depreciation of the sheqel in the first quarter of the year, which depressed the expected return on these deposits.

In addition to the linkage of assets to the exchange rate or the consumer price index, monetary developments were influenced by the public sector's liquidity injection, the absorption of liquidity through private sector purchases of foreign currency from the Bank of Israel, and the changes in bank credit.

The government's domestic demand surplus shrank noticeably in real terms in 1982, after an extraordinary increase last year, and in relation to GNP it returned to its 1980 level. The surplus was reduced because of a smaller subsidization of basic products and services and the hiking of taxes after the outbreak of war in Lebanon (the extra revenue from this source far exceeded the war-related expenditures in 1982). In contrast to the contraction of the demand surplus, the government's financial activities generated a much larger injection this year, since net credit to the private sector was stepped up in real terms while net real borrowing from the public declined. Both the public sector's demand surplus and its financial activities contributed to the growth of liquid asset holdings from IS14.6 billion to IS32.2 billion.

The big increase in the private sector's balance of payments deficit on current account (approximately \$1 billion) was financed primarily by a larger capital inflow, principally through the banking system following the lifting of the restrictions on medium- and long-term foreign borrowing. To a lesser extent it was financed by a heavier purchase of foreign currency by the private sector from the Bank of Israel, chiefly in the first half of the year. These purchases absorbed IS23.3 billion in 1982, compared with IS13 billion the year before.

The Bank of Israel's monetary target for 1982 was to prevent a real increase in bank credit to the private sector. It also acted to reduce the differential between the various interest rates on credit and between the bank lending and borrowing rates, and to increase the share of unlinked credit. In the first three quarters of 1982 it resorted to administrative ceilings to restrict the growth of Israeli and foreign currency credit, but in the course of the year it began to develop another tool for controlling the flow of Israeli currency credit. Since it was unable to conduct open-market operations on the required scale, it decided to combine lending at the discount window (designed to supply banks with sheqel-denominated resources) with

changes in the liquidity ratios; it also stiffened the fines for liquidity deficiencies. In November the Bank abolished the ceilings on Israeli currency credit, but because of the need to curb short-term capital imports, which are liable to thwart the desirable development of credit, it extended the ceilings on free market credit in foreign currency and even lowered them in order to counteract the effect of the expansion of Israeli currency credit. The abandonment of administrative techniques as the principal monetary policy tool stemmed from recognition of the fact that the prolonged imposition of credit ceilings on individual banks eventually leads to serious distortions in the allocation of credit and reduces competition between the banks. In addition, a gray credit market has sprung up, narrowing the scope in which monetary policy can operate effectively.

The growth of bank credit (excluding that for oil imports) did not trace an even path over the year: in the first three quarters the nominal rise accelerated, but it lagged behind the rate of inflation, with the result that there was a real decline. In the final quarter there was a rapid real expansion (apparently due partly to the reversal of the process of disintermediation outside the banking system,<sup>1</sup> which had intensified when the ceilings were in force), and therefore the Bank of Israel acted to restrict the banks' lending operations. The measures taken reduced the volume of bank credit in the first part of 1982, and by the end of April the outstanding real balance was virtually back to its level when the ceilings were lifted. Over the year as a whole bank credit (excluding oil) expanded by 138 percent, as against 82 percent in 1981; this represented a 3 percent real increase. The average nominal growth in each of the last three years was about 103 percent; in real terms there was an 8 percent drop in 1982.

The real interest on free market credit in the form of overdraft accounts and in foreign currency fell in 1982, while that on directed credit was raised. The real overall cost (before tax) of total short-term credit dropped sharply this year. It should be noted in this connection that the amendment of the income tax law (taxation under inflationary conditions) significantly increased the posttax cost of financing for firms that could deduct interest expenditure from their income but failed to take full advantage of this right. The lowering of the pretax interest rates was one of the factors that kept the business sector product and employment from falling more than they actually did in 1982.

The measures adopted to expand the unlinked monetary base can make an important contribution to the conduct of an effective monetary policy. In order to exploit the advantages inherent in this strategy, the Bank of Israel began to plan the issue of nonindexed 90-day treasury bills as the main instrument for its open-market operations. Such operations entail, of course, more flexible nominal and real interest rates than were in force in 1982.

As stated, the government's domestic demand surplus was reduced in 1982 after an exceptional increase the year before, and in relation to GNP it returned to its 1980 level. Nevertheless there was a much larger injection this year, which originated in the

<sup>1</sup> By "disintermediation outside the banking system" we refer to the provision of credit other than through the commercial banks, especially when the ceilings were in force and there was a big spread between bank borrowing and lendings rates.

government's financial activities. Net government credit to the private sector was stepped up in real terms, and net borrowing from the public fell off — a development which reflected *inter alia* a sharp drop in the private sector's financial saving. The net injection into the liquid asset base was therefore similar to its real level in 1981 despite the contraction of the demand surplus. In the first months of 1983 the demand surplus continued to shrink and the government injection declined.

It can be said that in 1982 as well the public sector injection was the decisive but not the sole factor in the monetary expansion, as it directly influenced the growth of the monetary base. Dampening the monetary expansion must rest first and foremost on reducing the public sector injection, mainly by cutting public spending and refraining from the receipt of Bank of Israel credit for financing the current deficit; this may have a crucial impact on the inflationary process in the long run. The government injection is a prime cause of the monetary expansion, since it directly influences demands and the price level, unlike the linkage of financial assets, which is essentially a secondary factor that accompanies the rise of prices.

The dimensions of domestic inflation and the aggravation of the fundamental problems in two all-important areas—the balance of payments and economic growth—calls for the effective combination of fiscal and monetary policy with price, wage, and incomes policy. The basic economic situation cannot be altered without a significant reduction of government spending which would release resources for investment and export production.

The national saving rate has drifted steadily downward since the early 1970s, and this has been one the major causes of the slowing of growth and the deterioration in the balance of payments. This trend must be reversed, for unless consumption is reduced in the present in favor of expanding investment, the chances of increasing consumption in the future will be much slimmer.

Along with the dampening of private and public consumption, a continued effort must be made to enlarge the country's economic infrastructure and to change the structure of the economy by increasing the weight of the business sector at the expense of the disproportionately high weight of the public sector. In the present circumstances gross taxes should not be raised, for they were increased appreciably during the past decade and their present level is already having a negative effect on resource allocation and the labor supply.

In order to prevent a further shifting of demands from domestic manufactures to imports, the continued competitiveness of industries producing goods traded in the international market must be ensured. This can be achieved if the balance between exchange rate variations and the movement of prices and costs in Israel in comparison with other countries is preserved, and especially if the tax burden on labor is lightened further. Lowering the taxes on labor would make it possible to increase employment while enhancing the economy's ability to compete in foreign markets, thereby easing pressure on prices from the costs side.

The renewal of growth while restraining the rise of prices therefore depends on the reduction of public spending and the rate of taxation alike, while preserving the competitiveness of the economy.