Chapter 1

The Economy: Developments and Policies

Per capita GDP continued to grow in 1996. This development was accompanied by continued momentum of investment in the principal industries, a decline in the unemployment rate to a level close to full employment, and an inflow of long-term capital, including investment by nonresidents. The inflation target set by the government was attained in effect, with only a slight deviation. Nonetheless, the rate of economic expansion slowed beyond both that of the last few years and the slowdown expected as the initial economic effects of the absorption of immigrants neared an end. The slowing of growth, mainly in the second half of the year, was due largely to security events, greater economic uncertainty, the more sluggish expansion of world trade, and the widening gap in the policy mix between the government's expansionary fiscal policy and contractionary monetary policy. In the context of the significant rise in the budget deficit, the current-account deficit widened substantially, and reached \$ 4.9 billion. Following an acceleration of the inflation environment towards the middle of the year, and expansionary fiscal policy, the Bank of Israel intensified monetary restraint, thereby helping to reduce the deviation of the rate of price increases from the inflation target. In view of the slowing of the growth rate at the end of 1996, apparently persisting into 1997, adherence by the government to its budget and inflation targets and accelerated implementation of structural reforms are needed in order to restore the economy to a path of sustainable growth befitting its potential.

Israel of the 1990s has a vibrant modern economy. Several positive dynamic processes evident in the last few years have made it more competitive, leading to marked progress in both financial and nonfinancial spheres of economic activity and economic ties with many countries. Israel can point to many achievements since the beginning of the decade: the successful absorption of immigrants, a surge in investment, an increase in the share of exports in GNP, the rapid rise of GNP and the standard of living, and the steep fall in the unemployment rate (Table 1.1). In many respects, Israel's economic strength and potential for growth are greater today than ever before. International

Israel's many economic achievements in the 1990s include: the successful absorption of immigrants, the rapid rise of output and the standard of living, and a marked reduction in unemployment.

credit risk ratings bear out this positive assessment of Israel's functioning and potential, indicating the improvement of recent years.

Buoyant investment in the principal industries persisted in 1996, with almost full employment.

There were both positive and negative economic developments in 1996. The main positive features were the continued growth in per capita GNP and in investment in the principal industries, the maintenance of the high level of long-term capital inflow, including investment by nonresidents, the attainment of the inflation target set by the government (with a slight deviation), and the reduction of the unemployment rate to a level closer to full employment. Certain macroeconomic pressures hindered economic performance, however, and the rate of economic growth was slower than in the last few years. The moderation of economic expansion went beyond what was expected from the near-fulfillment of the initial positive economic effect of immigrant absorption. Economic growth slowed mainly in the second half of the year, and this was reflected by a rise in the unemployment rate. As in former years, total productivity did not improve, so that the potential embodied in the immigrants' human capital, and the technological innovations implicit in the increase in investment of recent years, have not yet been fulfilled. The substantial current-account deficit grew, alongside the rise in the budget deficit and fall in the saving rate. Price increases accelerated towards the middle of the year, generating a significant deviation from the government's target, thereby causing the central bank to intensify monetary restraint. The slower growth of business-sector product—beyond both what had been expected and the slowdown in demand—together with the combination of fiscal expansion and monetary restraint, strengthened the forces exerting pressure for real appreciation and higher real long-term interest.

Economic growth was slower than in recent years.

The current-account deficit grew, in the context of a rise in the budget deficit and a decline in the saving rate.

The background to developments in 1996 included security-related incidents, mass immigration, the peace process, and the policy mix.

The main economic developments of 1996 should be regarded as a response to background conditions and basic factors which fall into three categories: 1. Factors unique to 1996: security incidents, which adversely affected economic activity; growing economic uncertainty as a result of these incidents and the early elections; the slowing of the expansion of world trade and, in contrast, the slight improvement in the terms of trade. 2. Structural factors: the near-completion of the initial positive effects of absorbing immigrants into the economy, and the continued utilization of the business opportunities created by the peace process. The further liberalization of the economy and penetration of new markets abroad also served to increase the demand for high-tech products relative to that for traditional products. 3. The policy mix: with a wider gap between policy tracks—fiscal expansion on the one hand and monetary restraint on the other. Fiscal discipline, which had begun to weaken in 1994, became even more lax in 1996. This was reflected not only by the growth of the budget deficit since 1995, considerably exceeding the limit determined in the Budget Deficit Reduction Law, but also by sluggish progress in the introduction of structural economic reforms, in addition to the rise in both real wages and public-sector employment, and the reversal of the declining trend of the net public debt/GDP ratio. Against this background, and in order to ensure that the government's inflation target was attained and that the economy did not adjust to a higher level of inflation than had prevailed in the last few years, contractionary monetary policy was adopted.

To offset fiscal expansion and attain the inflation target, contractionary monetary policy was pursued.

The policy mix of the last two years imposed an economic cost which could have been prevented by using a more balanced mix, i.e., a less expansionary fiscal policy, easing the extent of over-burdening of monetary policy. This, in turn, would have made it possible to attain the government's inflation target and achieve a higher growth rate. Given the economic environment of mid-1996, the absence of adequate monetary restraint on the part of the central bank would probably have led to the accommodation of two-digit inflation, considerably above the target rate—undermining economic stability, the credibility of policy, and Israel's economic standing—without leading to a lasting improvement in economic growth. In order to foster sustainable growth at a lower economic cost greater fiscal restraint is required, first and foremost.

The policy mix imposed an economic cost which could have been avoided had it been more balanced.

To make the slowdown that began in the second half of 1996 and apparently persisted at the beginning of 1997 as brief as possible, enabling a return to a growth path that is consistent with Israel's economic potential while maintaining a high level of employment and gradually reducing the inflation environment, economic policy must fulfill two necessary conditions. First, it must create a balanced policy mix that will enable it to meet the long-term goals set in the framework of the Budget Deficit Reduction Law and the inflation target. Secondly, it must implement structural changes, introduce reforms, and promote liberalization in various economic spheres, reducing

Creating a balanced policy mix and reducing public-sector involvement in the economy are vital for achieving Israel's growth potential in the next few years.

Table 1.1
Israel: Basic Economic Data,[a] 1986–96

	1986–89	1990–91	1992–95	1996
Mean population ('000s)	4,405	4,803	5,327	5,676
Population growth rate (percent)	1.6	4.7	2.8	2.6
Israeli persons employed ('000s)	1,422	1,535	1,808	2,013
GDP (NIS million, 1996 prices)	196,340	223,827	265,683	303,686
GDP ($ million, 1996 prices)	61,587	70,209	83,339	95,259
Per capita GDP ($, 1996 prices)	13,977	14,617	15,630	16,783
Growth rate of GDP (percent)	3.7	6.2	6.0	4.4
Unemployment rate (percent)	7.1	10.1	9.0	6.7
Inflation rate (percent)	18.2	17.8	10.8	10.6
Current-account deficit (percent of GDP)	−1.9	−0.2	2.3	5.1
Foreign-exchange reserves ($ million)	5,461	6,886	7,186	11,791
Net foreign debt (percent of GDP)	43.9	27.6	25.6	20.5

[a] Annual averages.
SOURCE: Based on CBS data.

the share and involvement of the public sector, thereby releasing resources for use by the private sector and stimulating technological progress. The fulfillment of these conditions is in the hands of the policy-makers. Maintaining the positive economic climate that resulted from the peace process will help to bring the economy closer to its long-term objectives.

The discussion below of the main economic developments of 1996 is followed by an outline of the policy required to attain Israel's economic objectives.

MAIN DEVELOPMENTS

GDP grew by 4.4 percent.

The principal feature of Israel's economic development in 1996 was the slowing of the growth rate in comparison with the early 1990s (Figure 1.1). GDP rose by 4.4 percent, after an annual average rate of about 7 percent in 1994–95. The growth rate of business-sector product also moderated, to 5 percent in 1996 compared with an annual average of around 8.4 percent in 1994–95, while the growth rate of industrial production slowed to 5.4 percent, after 7.9 percent in 1994–95. Nevertheless, the annual average employment rate in 1996 was nearer to a full-employment level—the unemployment rate was 6.7 percent—even though the labor market was more open to foreign workers. The slowdown of growth occurred mainly in the second half of the year, when GDP rose by an annual 2 percent, and industrial production growth also slowed significantly. The unemployment rate rose in the last quarter.

Figure 1.1
Growth Rate of GDP, 1990-96

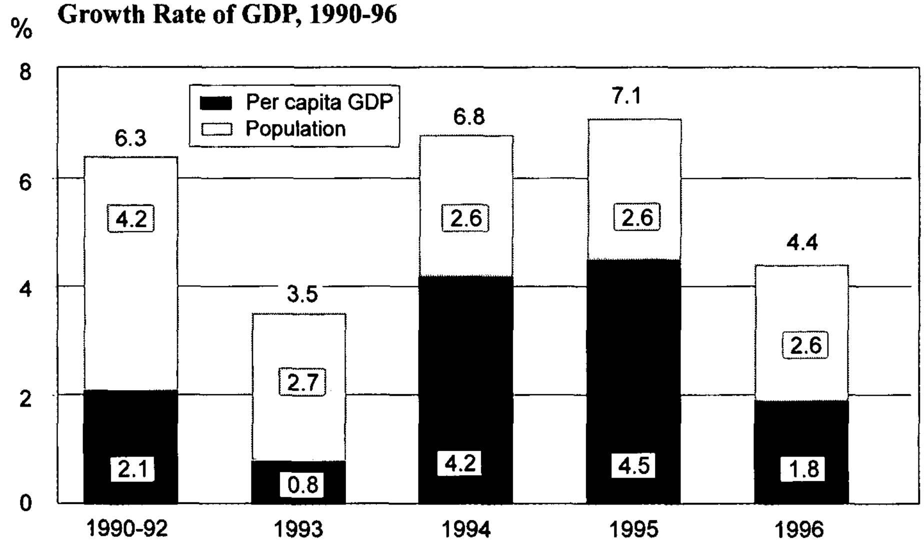


Table 1.2
Conditions of Business-Sector Production, 1990–96

(annual change, percent)

	1990–92	1993	1994	1995	1996
Business-sector product	7.8	3.7	7.9	8.9	5.0
Domestic labor inputs	5.5	5.5	9.6	8.2	3.7
Civilian labor force[a]	5.8	3.1	5.2	6.6	3.4
Gross physical capital stock	3.1	5.4	7.0	8.5	8.2
Total productivity	3.0	–1.6	–0.8	0.5	–0.2
Yield on gross capital[b]	13.5	14.4	13.3	12.9	11.7

[a] Including foreign workers and workers from the Autonomy and the administered areas.
[b] Actual yield, before tax.

slower rise than in 1995 in consumer durables purchases. The pattern of private consumption in 1996 is connected *inter alia* with the increase in disposable income and sharp rise in the stock of consumer durables in recent years.

The standstill in total productivity persisted.

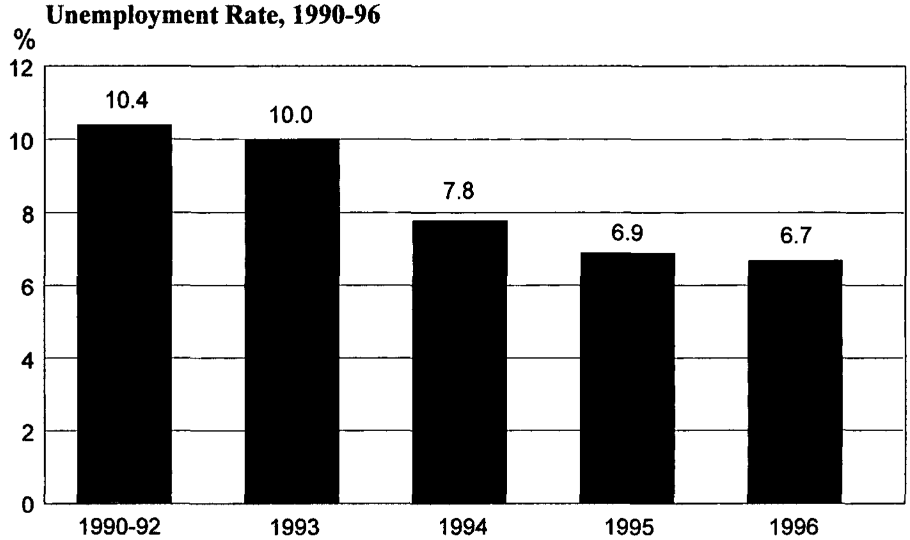
Business-sector product rose by 5 percent in 1996, compared with an annual average of 8.4 percent in 1994–95. Most of the increase was due to the rise in inputs: gross physical capital stock expanded by 8.2 percent, and labor inputs by 3.7 percent—the latter markedly lower than the increase in 1994–95 (Table 1.2), and some decline in the effect of the immigrants' entry into the labor market. Despite the immigrants' high level of human capital and the surge in investment since 1990, productivity has remained static. There was a further fall in the yield on gross capital in 1996, following the decline of the last two years. The growth rate of GDP fell during the year, especially in the last two quarters.

The demand for highly-skilled labor rose rapidly and unemployment fell.

Demand for highly-skilled labor soared, converging with its supply constraint, alongside a decline in the unemployment rate (Figure 1.3), causing real wages and employment in high-tech industries to rise. The entry of a significant number of foreign workers into the traditional industries brought wages in these industries down, and the number of employees in those producing tradable goods fell. Looking towards the future, the rate of expansion of the civilian labor force is increasingly becoming an effective barrier to the expansion of highly-skilled labor input, impeding Israel's ability to grow rapidly.

Aggregate demand expanded faster than supply. As a result, the share of the civilian import surplus in GDP grew, and there was real local-currency appreciation. The rate at which supply grew also slowed beyond what was expected given the fulfillment of the positive effects of the absorption of immigrants. The failure of supply to respond fully to the level of demand and the attendant real appreciation appears to be due to a combination of factors unique to 1996, the cyclical factors described above, and policy and structural factors. The latter included the unbalanced policy mix of fiscal expansion

Figure 1.3
Unemployment Rate, 1990-96



The main causes of the inadequate response of supply to the rise in demand were the policy mix, the shift in the composition of demand to high-tech industries, and the persistent decline in profitability.

giving rise to monetary restraint, which within a short span of time reinforced the tendency towards real appreciation; the cumulative effect of the persistent decline in profitability; and the shift in the composition of demand towards high-tech industries and away from the traditional industries.

There was slightly less inequality in the distribution of net income in 1995 (the last year for which data are available). Inequality in the distribution of wage income continued to grow, however, apparently because of the rise in demand for the products of high-tech industries and fall in demand for those of the traditional ones. The entry of foreign workers into the labor market at times of excess demand for labor changes the relative wages of highly skilled and less skilled workers, and in the short and medium term this increases inequality between the two categories. In this context, note that the proportion of families below the poverty line is still higher than it was before the influx of immigrants.

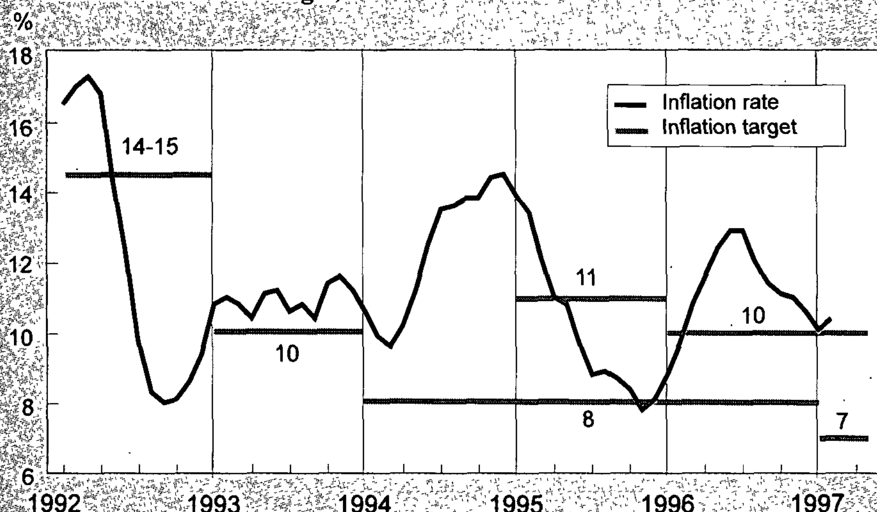
THE BALANCE OF PAYMENTS

Continuing the 1995 trend, the total import surplus and the current-account deficit grew rapidly in 1996.

Balance-of-payments developments in 1996 deepened trends that had been evident in 1995—a rapid rise in both the total import surplus and the current-account deficit (Table 1.3). The former reached an annual average of $ 12 billion in 1995-96, while the latter averaged $ 4.4 billion—about 4.8 percent ofGDP.

The widening of the current-account deficit in the last two years can be expressed in terms of changes in the saving and investment rates. Most of the rise in the current-

Figure 1.2
Inflation Rate and Target, 1992-97[a]



[a]Inflation rate calculated as average of last 12 months (latest figure: February 1997). Target for 2001: inflation rate as in OECD countries.

Other significant economic developments of 1996 were: 1. The deficit on the current account rose to $ 4.9 billion, in the context of the decline in the saving rate and the increase in the public-sector deficit, with the budget deficit significantly exceeding the level set in the Budget Deficit Reduction Law. 2. The inflow of long-term capital increased. 3. There was real appreciation, expressed in a 4 percent decline in the ratio of export prices to those of business-sector product and a 3 percent fall in that of tradables to nontradables in the CPI (Consumer Price Index). 4. Real long-term interest rates rose slightly, to about 4.4 percent.

Increased capital inflow and real appreciation were evident in 1996.

During 1996 the CPI rose by 10.6 percent (Figure 1.2), slightly above the upper limit of the inflation target (8–10 percent) set by the government. The inflation environment this year is in line with the average in Israel during 1992–96. A notable feature of 1996 was the mid-year turnaround in the rate at which prices rose—from an annual rate of 15.9 percent in the first half of the year to one of 6.8 percent in the second half. Both the trend shift and the attainment of the inflation target are closely connected with contractionary monetary policy. Inflation expectations eased markedly during the year, the money supply rose at a rate consistent with the inflation target, and average local-currency depreciation moderated—to 3.5 percent against the currency basket and 5.9 percent against the dollar.

The CPI rose by 10.6 percent, slightly above the upper limit of the target range.

SUPPLY AND DEMAND FACTORS

Alongside the slower increase on the supply side than on the demand side, the share of the import surplus increased, and there was real appreciation.

The slowing of GDP growth in 1996 is reflected in the composition of aggregate supply and demand. On the demand side, the slowdown was led mainly by exports and investment in construction (both residential and nonresidential). On the supply side, the expansion of business-sector product was more sluggish than expected given the near-realization of the initial positive effects of the economic absorption of mass immigration and the slowing of demand. As a result, the share of the import surplus in GDP rose alongside real local-currency appreciation and the more modest rate at which supply grew.

The slowdown in the rate of increase of exports, to 4.6 percent, was due mainly to a fall in services exports.

Goods and services exports rose by 4.6 percent in 1996, compared with an annual average of some 12 percent since 1992. These two components of exports developed unevenly, with events unique to 1996 as well as long-term trends having a considerable effect. Goods exports (excluding diamonds) rose by 7.9 percent in 1996, similar to the 1995 rate. Most of the rapid expansion of exports was in high-tech industries, which produce mainly for markets abroad, while exports of traditional industries shrank. These export trends appear to have been affected by the continued process of trade liberalization, the penetration of new markets by high-tech products, and the trend of real appreciation in recent years. In contrast to the positive developments in goods exports, services exports fell by 0.9 percent in 1996, after rising by 14.5 percent in 1995. The trend change was due to the steep decline in the export of tourism services, reflecting the persistent drop in incoming tourism since the wave of terrorist attacks in March 1996.

The decline in services exports resulted from a sharp drop in the export of tourist services, due to security-related incidents.

Another important factor moderating the pace at which domestic demand grew was domestic investment, which rose at an annual rate of 7 percent, compared with 11 percent in 1995. This reflects mainly far slower growth of investment in construction, both residential and nonresidential, and a fall in the share of inventory in investment. The marked expansion of investment in plant and equipment persisted, however, raising the capital/labor ratio after this had fallen in the wake of the influx of immigrants. Much of the slowdown in the rate at which construction investment rose appears to reflect the partial completion of the adjustment processes that began at the begining of the decade, and indicates the gradual convergence of housing stock and capital stock in the principal industries (e.g., the stock of industrial structures) to their appropriate levels.

The fall of investment in construction and the increase in that in plant and equipment reflected the approach of stocks to the level required in the wake of mass immigration.

The other components of aggregate demand continued to expand at a similar rate to that evident in the last four years. Public consumption (excluding defense imports) rose by 3.5 percent in 1996, the same as the annual average since 1992. Private consumption increased by 5.5 percent, slightly below the annual average since 1992 but still above the growth rates of GDP and the population. There was a markedly

Table 1.3
Balance of Payments, 1990–96

($ billion, annual rates)

	1990–92	1993	1994	1995	1996
Import surplus	6.4	7.9	9.3	11.1	12.8
Current-account deficit	–0.1	1.1	2.3	3.9	4.9
Implied capital imports[a]	–0.4	2.6	2.4	5.1	8.4
Rise (–) in foreign-exchange reserves	0.3	–1.5	–0.0	–1.2	–3.5
Foreign-exchange reserves[b]	6.5	7.1	7.3	8.7	11.8
Net foreign debt	16.5	17.7	18.4	20.2	20.0

[a] Including errors and omissions.
[b] Held by central monetary institutions at end of period.

account deficit resulted from a marked decline in the gross saving rate—from 20.5 percent of all income in 1990–92 to an annual average of 17.5 percent in 1995–96 (Table 1.4). This makes 1996 the fourth consecutive year in which the saving rate fell. Public saving was relatively low, and even negative in 1995–96, reflecting the rapid rise in the budget deficit. The investment rate remained high, however, its share of total income rising more moderately than at the beginning of the decade.

The current-account deficit of over 4–5 percent of GDP in the last two years gives cause for concern. The deficit is large compared both with the past and with other countries. What is particularly worrying is the fact that most of the growth of the deficit is due to the decline in the saving rate rather than to the rise in the investment rate. Moreover, there is no guarantee that basic economic forces and foreign trade and funding sources will continue to support the current deficit at a reasonable cost for very long. One of the lessons of the past is that appropriate deficit-reduction policy measures introduced in time serve to minimize the damage to the economy caused by sharp shifts in capital flows, and reduce the likelihood of a financial crisis.

Capital inflow exceeded the current-account deficit financing requirement.

In spite of the rise in the current-account deficit in the last two years, no particular difficulties have yet arisen with regard to its financing. Implied capital imports averaged an annual $ 6.8 billion in 1995–96, and more than $ 8 billion in 1996This capital inflow exceeded the amount required to finance the current-account deficit, enabling the official foreign-exchange reserves to grow to an unprecedented $ 12 billion at the end of 1996. They continued to rise substantially at the beginning of 1997, too.

The improvement in Israel's geopolitical situation and the globalization of world capital markets made nonresidents more willing to invest in Israel.

Much of the capital inflow of the last two years reflects the expansion of long-term loans and foreign direct investment. With the improvement in Israel's geopolitical situation (and risk rating) and the globalization of world capital markets, there is growing readiness on the part of international elements to invest in Israel and offer sources of finance to the business sector. The inflow of short-term capital is due

Table 1.4
Saving, Investment, and the Current Account, 1990–96

	(percent of income,[a] annual rates)				
	1990–92	1993	1994	1995	1996
Gross saving rate	20.5	20.3	18.6	17.8	17.1
Public	−0.6	0.6	0.8	−0.7	−1.7
Private	21.1	19.7	17.8	18.5	18.8
Gross investment	20.8	21.7	21.6	22.1	22.0
of which Principal industries	12.4	14.7	15.5	14.9	14.5
Transfers on capital account	0.4	0.3	0.3	0.3	0.3
Net balance of payments on current account	0.1	−1.1	−2.7	−4.0	−4.6

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

mainly to credit taken abroad by domestic businesses, largely because of the interest-rate differentials (relative to the risk premium) between Israel and abroad.

Real appreciation was higher in 1996 than the average of the last few years. The cumulative real appreciation of recent years probably contributed to the impairment of profitability in the tradables segment, especially of its traditional export industries.

FISCAL POLICY

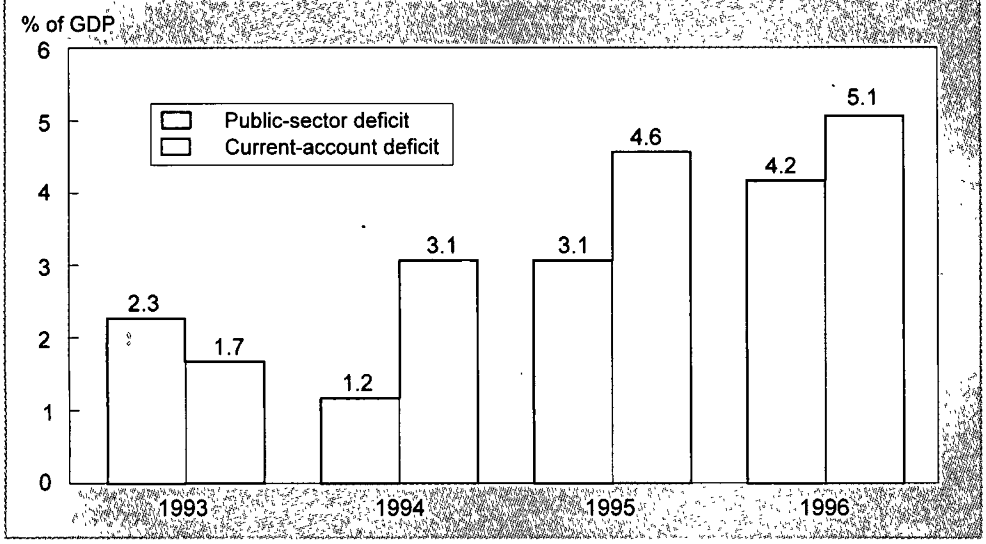
Since 1995 the 'twin deficits' phenomenon has developed: both the public-sector deficit and the current-account deficit have risen.

Fiscal developments in 1996, like those in the area of the balance of payments, constituted a continuation and deepening of those of 1995. In the last two years, in view of the falling unemployment rate, the 'twin deficits' phenomenon has developed—with both the public-sector deficit and the current-account deficit rising (Figure 1.4).

On the basis of several indicators, fiscal policy can be defined as expansionary in 1996 (Table 1.5). First, for the second year in succession the government exceeded the deficit limit set in the Budget Deficit Reduction Law by a significant amount. Its domestic deficit rose to NIS 14.4 billion, representing 4.7 percent ofGDP—a NIS 6.8 billion deviation from the limit specified in the 1995 Budget Law (2.5 percent of GDP). Much of the deficit was financed by government injection. Secondly, public consumption (excluding defense imports) rose by 3.5 percent in 1996, contributing to the expansion of aggregate demand. The real decline in net revenues from direct taxes (net taxes *less* net transfer payments), which increased households' disposable income, also had an expansionary effect. The number of public-sector employees continued to rise too, by 3.8 percent, in line with the rapid increase in the last few years. These developments were reflected by a trend shift in 1996, and the

The government's domestic deficit was 4.7 percent of GDP, compared with the 2.5 percent specified by law.

Figure 1.4
'The Twin Deficits': The Public-Sector Deficit and the Current-Account Deficit, 1993-96



net public debt/GDP ratio, which had been declining since 1986, began to rise—from 89.3 percent of GDP in 1995 to 89.7 percent of GDP in 1996.

The deviation from the deficit target was due mainly to the failure of tax receipts to meet the forecast level.

Whereas most of the deviation from the target deficit can be explained by the failure of tax receipts to meet their forecast level, this does not minimize the negative role played by fiscal policy in determining a level of government expenditure very close to what turned out to be an overestimate of these receipts. This expenditure path was not amended, and no budget cuts were made, not even when updated figures which became available during the year—showing that most of the deviation was not due to a slowing of the rate of growth—required this. These developments impaired the credibility of the Budget Deficit Reduction Law.

The rise of the budget deficit in 1996 is particularly grave in view of the large current-account deficit and similar developments in 1995. In this situation fiscal discipline is required, creating the conditions for a reversal of the trend. Fiscal policy had an expansionary effect, however, serving to aggravate the balance-of-payments problem. Both the outgoing and the incoming governments refrained from making significant budget cuts in 1996, even though during the year the forecast of tax receipts turned out to be over-optimistic. The new government decided to introduce cuts only in the 1997 budget, when the total deficit target was set at 2.8 percent of GDP, regarded as a necessary condition for attaining a significant improvement in the current-account deficit. While there was no crisis in 1996, it is reasonable to assume that postponing budget cuts and widening the gap between forecast and actual tax receipts during the year intensified uncertainty regarding economic policy.

Table 1.5
Main Indicators of Fiscal Policy, 1990–96

(percent of GDP, annual rates)

	1990–92	1993	1994	1995	1996
Domestic budget deficit					
Legal limit	6.2[a]	3.2	3.0	2.75	2.5
Actual	4.9[a]	2.4	2.0	3.2	4.7
Total public-sector deficit	4.0	2.3	1.2	3.1	4.2
Public-sector domestic deficit	7.2	4.1	2.4	4.3	5.3
Total net public debt	111.1	100.4	93.7	89.3	89.7
of which Public domestic debt	92.5	80.3	74.3	72.8	76.1

[a] For 1992 only.

Since 1994 fiscal discipline has become more lax, as is reflected not only by the way the budget has been implemented but also by the failure to introduce significant structural economic reforms. The rapid growth of recent years has not been utilized to reduce the relative share and economic involvement of the public sector and release resources, making them available to the private sector, and in fact public-sector employment has grown substantially in this period.

MONETARY POLICY, INFLATION, AND THE EXCHANGE RATE

The main object of monetary policy in 1996 was to attain the inflation target.

Monetary policy in 1996 was aimed mainly at attaining the government's inflation target of 8–10 percent, while maintaining the crawling exchange-rate band. The inflation target in the form of a specified range for price rises was introduced in Israel at the end of 1991, in the context of the move to a crawling band for the exchange rate. In the last few years there has been a gradual change in the way monetary policy is implemented—from an approach that focused on the direct effect on the nominal exchange rate, to one directly aimed at attaining the inflation target. A credible inflation target should affect wage- and price-setting processes as well as inflation expectations. The inflation target thus provides a framework and direction for the formulation of monetary policy.[1] Hence, when a variety of indicators of the inflation outlook during the year pointed to pressures that seriously endangered the attainment of the target, the Bank of Israel raised the nominal interest rate on its monetary sources in order to reduce inflation and narrow the deviation from the target.

The Bank of Israel raised the nominal interest rate during the year to reduce inflation.

[1] The current implementation of monetary policy is very similar to that of many central banks in countries with inflation targets, e.g., New Zealand, Canada, Britain, Sweden, Finland, Spain.

Table 1.6
Indicators of Inflation, 1990–96

(annual average change, percent)

	1990–91	1992–95	1993	1994	1995	1996
CPI (during year)	17.8	10.8	11.2	14.5	8.1	10.6
CPI (year-on-year)	18.1	11.3	10.9	12.3	10.0	11.3
CPI excluding housing	14.5	9.7	8.5	9.4	8.8	9.9
CPI excluding housing & fruit and vegetables	15.1	9.7	9.0	8.7	9.3	10.2
Wholesale price index	13.8	9.2	8.2	7.9	10.7	8.6
Exchange rate (against currency basket)	11.4	8.6	12.1	7.8	4.6	3.5

The most prominent feature of inflation in 1996 was the reversal of its trend close to the middle of the year (Figure 1.2). From January to May consumer prices rose by 15.9 percent, annual rate, considerably faster than in the comparable period in 1995, and well above the inflation target. From June to December, however, prices rose at an annual rate of only 6.8 percent, so that the deviation from the inflation target for the year was relatively small.

The most prominent feature of inflation in 1996 was the reversal of its trend close to the middle of the year.

The CPI rose by 10.6 percent during 1996, compared with 8.1 percent in 1995. Disregarding the slight deviation from the 1996 target, these increases were within the range of the inflation targets set by the government. Since 1992 Israel's inflation environment has been within a 9–12 percent range (Table 1.6), compared with an annual average of 18 percent in 1986–91. The current rate is still significantly higher than the rate of inflation in advanced economies, however.

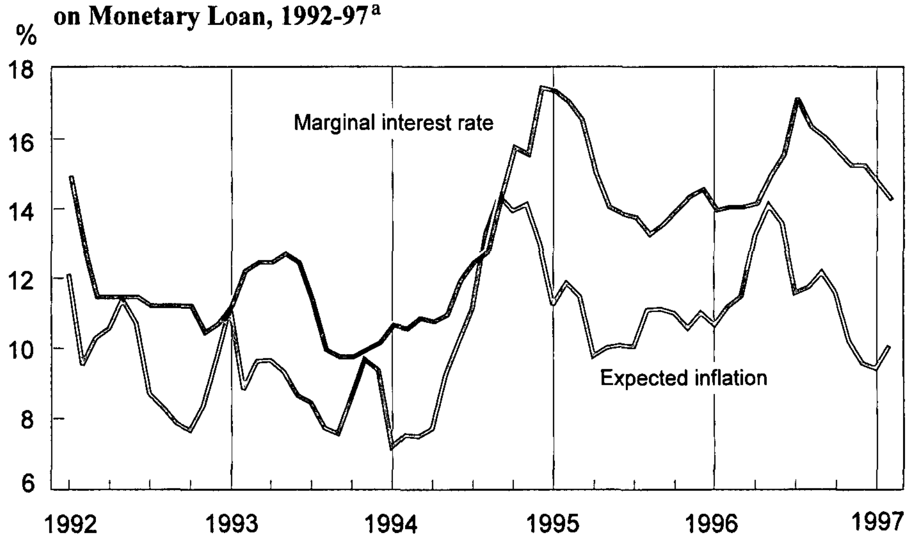
Since 1992 Israel's inflation environment has been an annual rate of 9–12 percent.

Monetary policy played a leading role in narrowing the gap created in the first five months of 1996 between the rate of price rises and the inflation target set by the government. The slower rate of expansion of economic activity during the year also appears to have eased inflationary pressures in the second half of the year. The interest-rate—both nominal and real—on the Bank of Israel's sources (according to inflation expectations derived from the capital market) was not uniform during the year (Figure 1.5). Towards the middle of the year the Bank raised the nominal rate of interest sharply; this was followed by a marked moderation of inflation and inflation expectations. As a result, real interest on the Bank of Israel's sources rose considerably. M1 rose by an average of 15 percent in 1996, consistent with the inflation target and the rate of growth.

Monetary policy was primarily responsible for narrowing the gap between price increases and the inflation target.

The main channels through which monetary policy affected the inflationary environment in 1996—over and beyond its effect through M1—were inflation expectations (for the next twelve months) and the nominal exchange rate. These effects

Figure 1.5
Expected Inflation and Marginal Interest Rate on Monetary Loan, 1992-97[a]



[a] Expected inflation is derived from the yield gap between nominal and indexed bonds on the capital market (latest figure: February 1997).

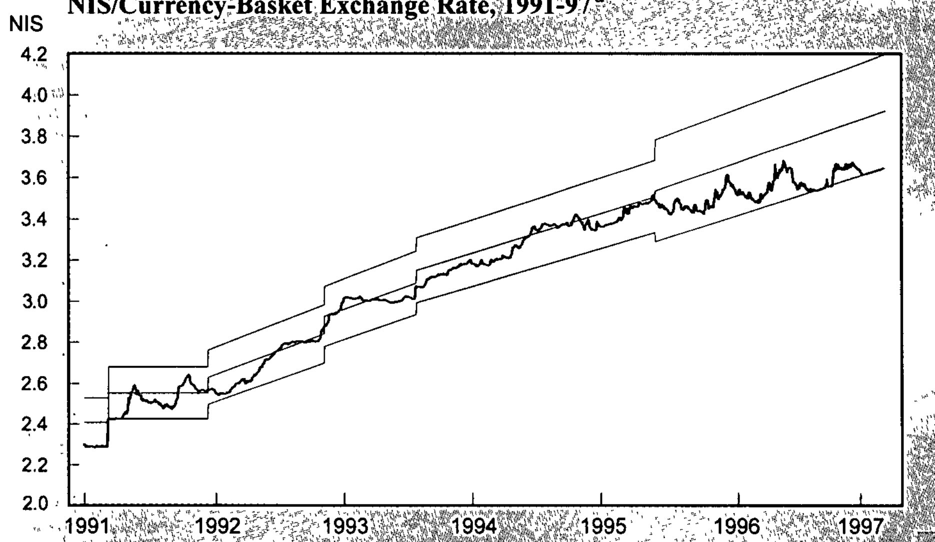
seem to have operated more quickly in 1996 than hitherto. Expectations rose gradually, from 11 percent annually (gross estimate) in the last quarter of 1995 to 14 percent by May 1996. In July, after several interest-rate hikes, expectations declined, reaching 9.6 percent in December—within the target range (Figure 1.5).

From February 1996 the Bank of Israel allowed market forces to exert their full influence on the exchange rate within the band.

The end of intervention, in mid-February 1996, in the foreign-exchange market by the Bank of Israel within the limits of the exchange-rate band represents an important shift in exchange-rate policy in 1996. Since then, the Bank has allowed market forces to affect the exchange rate against the currency basket within the crawling band, with the private sector having no effect on the foreign reserves. This contrasts with foreign-exchange policy of previous years, when the central bank intervened to ensure that the exchange rate remained close to the midpoint rate of the band. This policy change, which was made possible by the improved functioning of the foreign-exchange market and the transition to two-sided foreign-currency trading, enabled monetary policy to have a greater effect on prices via the nominal exchange rate. The NIS/currency basket exchange rate did not develop uniformly throughout the year (Figure 1.6). Against the background of interest-rate differentials in the second half of the year and persistently high inflow of capital (of different types), the rate of nominal depreciation moderated, and the exchange rate fell to the lower limit of the band. For two consecutive months the annual rate of nominal depreciation matched the slope of the band. During

The NIS depreciated by a modest 3.5 percent on average against the currency basket.

Figure 1.6
NIS/Currency-Basket Exchange Rate, 1991-97[a]



[a]Latest figure: March 1997.

that period, the Bank of Israel defended the band's limit, absorbing excess supply in the foreign-currency market. In annual average terms, the NIS depreciated moderately, by 3.5 percent and 5.9 percent against the currency basket and the dollar respectively.

During 1996 the Bank had to undertake considerable offsetting and sterilization activity in order to prevent the potentially expansionary effect on the monetary base and M1 of the injection associated with the budget deficit and that arising from absorption of the public's supply of foreign currency (in the course of defending the lower limit of the band). Sterilization connected with the purchase of foreign currency by the Bank of Israel imposed a quasi-fiscal cost on both the Bank and the public sector, since the interest which the Bank paid on local-currency assets sold as part of its sterilization activity exceeded the yield received on the foreign exchange purchased. Developments in the foreign-exchange market at the beginning of 1997 highlight the fact that the burden of sterilization mainly reflects the problem of having an inflation target together with a crawling exchange-rate band. When the inflation target necessitates maintaining a certain level of interest, and given long-term capital inflow, the exchange rate is liable to reach one of the band's limits. The central bank must then intervene to defend the band, and this requires sterilization of the resultant monetary injection, with all that this implies. The quasi-fiscal cost of sterilization rises as the stock of foreign-currency assets purchased during its implementation grows. This stock has risen rapidly in early 1997, as has that of local-currency deposits at the Bank of Israel.

The Bank of Israel was obliged to offset the expansionary effect of the government injection and that resulting from foreign-exchange conversions.

Table 1.7
Monetary Indicators, 1990–96

(annual change, percent)

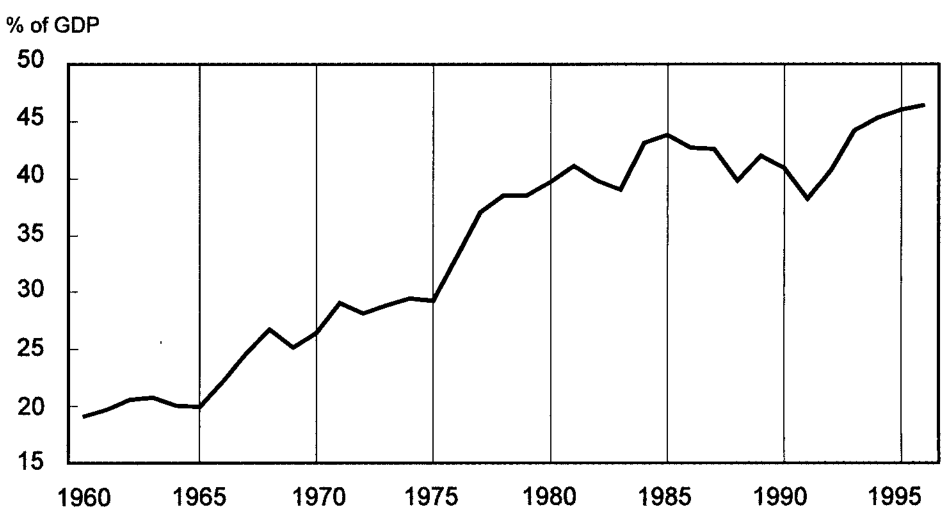
	1990–92	1993	1994	1995	1996
M1[a]	25.6	24.0	21.0	8.0	15.0
Credit	32.8	44.9	28.1	26.2	21.6
Expected inflation	14.6	9.0	12.9	10.8	11.7
Nominal interest on					
Bank of Israel sources	14.2	11.3	13.4	15.5	16.1
SROs (CDs)	12.1	9.7	11.6	13.3	13.8
Nondirected credit[b]	24.2	16.5	17.4	20.2	20.7
Average currency-basket interest	7.7	4.7	4.8	5.4	4.7
Real interest on 5-year bonds	1.9	2.8	2.9	4.1	4.4
Nominal average share yield	52.5	49.9	−10.4	−13.9	0.3

[a] Rise in annual average. M1 = cash in the hands of the public *plus* demand deposits.
[b] In local currency.

Demand for short-term local-currency assets, savings plans, pension funds, and life-insurance plans, increased, alongside large-scale withdrawals from the provident funds.

In the capital market, the process of adjustment of the public's asset portfolio continued in 1996; it, too, was affected by the mix of expansionary fiscal policy and the monetary restraint it made necessary. Alongside the rise in demand for short-term, unindexed local-currency assets savings plans, pension funds, and life-insurance (invested mainly in subsidized nontradable assets), there were large-scale withdrawals from the provident funds. Towards the middle of the year the Bank of Israel and the

Figure 1.7
Share of Exports in Business-Sector Product, 1960-96



Ministry of Finance announced that a safety net would be extended in order to moderate fluctuations in bond prices, and this helped to stem the flow of withdrawals from provident funds.

FUTURE OBJECTIVES

In order to realize Israel's potential economic growth in the next few years while maintaining high employment and increasing productivity, gradually approaching the inflation environment of the advanced economies, and continuing to absorb immigrants, changes must be made in economic policy. A business environment is required in which expected profits will act as an incentive, increasing investment in physical capital and R&D, expanding the highly-skilled labor force, and leading technological improvements in the production process. Based on the experience of Israel and other emerging economies, integrating into the world economy is a precondition for achieving these objectives. In most cases, integration of this kind has given rise to export-oriented growth; this can be achieved in Israel by the rapid expansion of high-tech industries, which have a comparative advantage and have provided the main impetus for the rising share of exports in GDP in recent years (Figure 1.7).

Closer integration into the world economy is a precondition for Israel's continued growth.

To ensure that the slowdown of the growth rate which started in the second half of 1996, and appears to have continued at the beginning of 1997, is as short-lived as possible, and that Israel returns to a path of sustainable growth in accordance with its potential, economic policy must fulfill two vital conditions: first, it has to create a balanced mix of fiscal and monetary policy while maintaining macroeconomic stability, and second, it must implement structural reforms intended to increase competition and support technological innovation.

Future growth depends on a balanced policy mix, greater competitiveness, and enhanced technological progress.

The Budget Deficit Reduction Law and long-term inflation targets provide the main framework for attaining the government's economic objectives. The former sets the upper limit of the total budget deficit in 1997 at 2.8 percent of GDP, and this will be lowered gradually to 1.5 percent by the year 2001. Regarding inflation, the government has set a target range of 7–10 percent for 1997, as the first step in the gradual approach to the inflation rate prevailing in the OECD by 2001.

The Budget Deficit Reduction Law and long-term inflation targets provide the main framework for attaining the government's economic objectives.

The government has decided on several fiscal measures to ensure that it attains the 1997 budget deficit target of 2.8 percent of GDP, but the experience of the last two years—when there were significant deviations from the maximum legal deficit—indicates that this is not certain to succeed. A mechanism must hence be established for periodic (e.g., quarterly) government reporting and discussion of budget performance vis-à-vis the targets, and for drawing operative conclusions about policy.

There may also be good reason to amend the Budget Deficit Reduction Law to include a long-term limit on public-sector expenditure (excluding interest payments) so that its share of GNP will gradually decline; this would also enable the tax burden to be eased.

In order to reach the government's long-term inflation target, appropriate monetary policy must be adopted. The main condition enabling monetary policy to make its full contribution to achieving the inflation target efficiently is a fiscal policy of abiding by the Budget Deficit Reduction Law, chiefly by reducing government expenditure. Maintaining the central bank's flexibility and ability to respond to new conditions as they emerge—by means of the instruments available to it—will help to attain this goal. If these requirements are met, a more balanced policy mix than has existed since 1995 may be achieved.

Greater infrastructure investment will boost growth and productivity.

At the same time, faster implementation of reforms to increase competition and eliminate economic distortions is necessary. Business-sector development in the coming years depends largely on greater competition and reduced government intervention in the economy, mainly through privatization. In addition, it is important to increase infrastructure investment. Creating an appropriate physical infrastructure will help to boost growth and raise productivity. The preservation of a positive economic atmosphere resulting from the peace process will help the economy advance towards its objectives.

Reducing the government's role in the capital market, and eliminating tax inconsistencies will *inter alia* help halt the decline in the private saving rate.

Considerable structural changes are needed in the next few years in the capital market, which is a major factor in growth. These changes are vital for achieving a significant rise in the private saving rate and reducing the government's involvement in the market. The main steps include cutting the share of earmarked government bonds in the portfolios of institutional investors, and regulating taxation, in order to eliminate the distortions in net yields between different kinds of assets and investors. More rapid financial liberalization—mainly by giving the private sector (including institutional investors) broader access to investments overseas and ensuring conditions that will make the NIS fully convertible in the near future—is also essential.