CHAPTER I

THE ECONOMY: DEVELOPMENT AND POLICIES

In 1980 Israel suffered from stagflation, i.e. a slump in economic activity accompanied by rapid inflation. Nevertheless, the accelerated advance of prices which had been evident since the end of 1978 was checked, and it stabilized at the level prevailing in the second half of 1979 (about 130 percent).

The worrisome deterioration in the balance of payments in 1979 was arrested this year: the civilian import surplus was reduced, reversing the previous year's trend. In 1979 the balance of payments had been adversely affected by an unfavorable structural change resulting from the second oil crisis and by an upswing in the business cycle; this gave rise to fears that the sizable import surplus could not be financed through unilateral transfers and long-term capital movements. After the contraction of the civilian import surplus in 1980 as a result of the policy measures introduced, the capital inflow proved sufficient to cover the import surplus and even to enlarge the Bank of Israel's foreign reserve holdings.

The first signs of an economic slowdown appeared in the second half of 1979, and can be mainly ascribed to the completion of the reshuffling of the public's assets portfolio begun after the foreign currency reform, the stringent monetary policy introduced, and a change in the public's expectations.

After the foreign currency reform in the final part of 1977 the public's financial assets portfolio swelled, resulting in a disequilibrium between its financial wealth, physical wealth, and income. In early 1978 the public began to adjust its assets portfolio, thereby increasing the demand for physical assets, notably housing and durable goods, but also other goods and services.

Because of the rapid monetary expansion which accompanied the reform, the Bank of Israel took countersteps in early 1979: it hiked the interest rate on nondirected (free market) foreign currency credit and restricted the growth of nondirected local currency credit by setting ceilings (under an agreement with the commercial banks). In addition to these measures, a large amount of money was pumped out of the economy in the second half of 1979 through the balance of payments (as a result of the growth of the private sector's import surplus and the shrinkage of short-term capital imports after they had become more expensive). These changes severely squeezed the public's liquid asset holdings (in real terms).

Table I-1

MAIN ECONOMIC INDICATORS, 1975–80

(Percent annual increase unless otherwise stated)

	1975	1976	1977	1978	1979	1980
Resources and uses (in constant prices)						
Total uses, excl. direct defense imports	1.3	1.7	2.7	5.2	6.3	–2.4
Gross domestic product	3.5	1.4	0.6	4.9	4.2	1.8
Gross domestic product of the business sector[a]	3.1	0.4	–0.7	5.2	4.3	2.1
Real disposable private income[b]	–0.8	–7.7	8.1	9.2	1.6	–1.6
Private consumption						
Total	0.6	4.3	4.3	7.8	5.7	–3.4
Per capita	–1.7	2.0	2.0	5.5	3.1	–5.6
Public consumption						
Total	10.0	–10.5	–13.5	12.1	–8.1	7.6
Excl. direct defense imports	–0.8	–5.2	–1.7	2.5	2.8	1.8
Thereof: Civilian consumption	4.6	5.5	2.9	5.4	2.3	–0.6
Gross domestic investment	4.2	–12.6	–9.1	4.1	14.0	–16.7
Public sector liquidity absorption[c] (as a percent of GNP in current prices)	20	25	22	20	25	25
Balance of payments and international reserves (in $ billion)						
Imports	8.0	7.9	8.4	10.3	12.4	14.2
Exports	4.0	4.7	5.9	7.0	8.5	10.4
Import surplus	4.0	3.2	2.6	3.3	3.9	3.8
Foreign currency debt[d]	6.5	8.1	9.5	10.9	12.8	14.2
Change in foreign exchange reserves[e]	0.1	0.1	0.2	0.9	0.3	0.2
Population, employment, and wages						
Average population	2.3	2.3	2.3	2.2	2.5	2.3
Number of Israeli employed	1.4	1.3	2.9	4.6	2.3	1.1
Unemployment rate (as a percent of civilian labor force), absolute figures	3.1	3.6	3.9	3.6	2.9	4.8
Monthly earnings per employee post (in current prices)	36.5	32.9	48.6	54.1	90.3	124.9

[a] Excluding imputed residential rents.
[b] From domestic sources.
[c] Revenue from taxes and property and entrepreneurial income, less subsidies (excluding the imputed subsidy component of credit) and net transfer payments.
[d] Gross foreign currency liabilities, less net foreign exchange reserves.
[e] Net reserves at the Bank of Israel, including investment of the appreciated value of foreign currencies in relation to the dollar.

Table I-1 (cont.)

	1975	1976	1977	1978	1979	1980
Prices						
Implicit price deflator for GNP (at market prices)	37.9	26.8	42.6	55.7	83.0	127.7
Index of private consumption prices	40.4	28.8	36.2	53.8	78.6	129.3
Consumer price index (December levels)	23.5	38.0	42.5	48.1	111.4	132.9
Monetary (in current prices)						
Money supply	21.6	27.1	38.8	45.0	30.5	97.7
Total liquid assets of the public	28.6	25.9	68.5	59.3	82.5	147.0
Bank credit to the public[f]	69.0	36.6	74.4	79.9	101.4	110.0
Productivity and labor costs (in constant prices)[g]						
Productivity (product per manhour)	—	0.4	-1.3	1.5	0.1	3.9
Real wages per unit of product	—	2.3	7.0	1.4	1.5	1.5
Real unit labor costs	—	12.3	0.0	-2.2	5.6	-2.2

[f] The change in 1979–80 according to a revised definition (excluding credit for oil imports).
[g] Business sector.
[h] Excludes the subsidy component of government credit.

In 1979 the public expected a heavy domestic government expenditure in connection with the military redeployment in the Negev. These expectations proved to be exaggerated, for much of the work was carried out by foreign companies, and that performed by Israelis was spread over a longer period than originally planned; the outcome was the buildup of a stock of idle earthmoving and transportation equipment and manpower redundancies. Given the rise in the real cost of labor to employers (over and above the growth of labor productivity), these overoptimistic expectations eventually dampened demand for labor and investment.

The fiscal and monetary steps taken at the end of 1979 sharply depressed economic activity at the beginning of the following year. This policy was designed to blunt the erosion in the balance of payments and to tone down inflation, but its immediate impact was particularly strong, for it was apparently accompanied by a change in the public's expectations concerning the business outlook and employment situation. The subsidies on basic items (food, transportation, fuel, and electricity) were scrapped or trimmed, and the consequent rise in their prices squeezed real incomes. The public gained the impression that the government was determined to persist in its policy of restraint, and this heightened its pessimism regarding future incomes and employment opportunities. This goes a long way to explain the noticeable sagging of private consumption and employment in the first months of 1980. Added to this was the impact of the monetary measures which were introduced in November 1979 and largely maintained throughout the following year. The credit ceilings agreed upon with the banks were replaced by ceilings set by the Bank of Israel by virtue of its legally invested powers, and they resulted in the curbing of nondirected credit for domestic purposes. To help harness inflation targets were set with respect to the nominal expansion of total bank credit (directed and nondirected alike), and these of course determined the nondirected credit ceilings. Prices rose faster than anticipated, and since there was only a partial adjustment to this precipitate increase, total bank credit shrank in real terms.

The government acted to arrest the real growth of its budgetary expenditure in fiscal 1980/81: public civilian consumption declined, and the rapid uptrend in public sector employment was checked. Nevertheless, the public sector's total domestic demand rose 3 percent in real terms, mainly because of a heavier defense spending in connection with the military redeployment in the Negev and a much higher volume of public-initiated residential building. Real tax revenue (direct and indirect) fell off due to the contraction of imports, domestic production subsidies were axed, while transfer payments to the public stabilized. The public sector demand surplus did not change in real terms, and its weight in GNP held steady. Had it not been for the economic slowdown, which reduced indirect tax revenue (especially from imports), the demand surplus would have even declined. It can therefore be said that the government budget did not have an expansionary fiscal effect on economic activity in 1980. The demand surplus, however, was high, and this was the main source of the liquidity injection this year.

The severe slump in economic activity was short-lived, and domestic demands and the level of activity gradually rebounded, although they were still low at the end of the year, and the labor market remained weak.

The economy began to move out of its slump in the second quarter of 1980, as a result of several factors: the fading of expectations that the government would persist in its restrictive fiscal policy, the gradual reshuffling of the assets portfolio of the public and firms alike, and the high interest rates prevailing in the economy due to the curbing of credit. The last development contributed to the drawing down of inventories during the year, which in turn was a major reason for the slackening of domestic demands. These factors fully ran their course toward the end of 1980.

The import surplus did not change during 1980 in nominal terms in spite of the steep 46 percent rise in oil prices (which came on top of a 62 percent jump in 1979), a much larger defense import bill, and the protracted global inflation. The stabilizing of the import surplus can be credited to a sharp quantitative drop in the civilian import surplus, due both to the vigorous expansion of exports despite the depressed state of Israel's overseas markets and to the contraction of imports. These two developments can be mainly ascribed to the faltering of domestic demands: domestic production was diverted to export, while the reduction of private consumption resulted in a smaller import, a trend accentuated by the destocking of imported inputs because of the credit squeeze and high interest rates. It therefore seems that the strengthening of the balance of payments was also cyclical in nature, stemming from the low level of economic activity and destocking; hence it did not fully constitute a long-term structural change for the better.

The restrictive fiscal and monetary measures cooled economic activity in 1980, thereby easing the balance of payments strain. Regarding inflation, the loosening of the labor market and the weakening of economic activity in general halted the acceleration of inflation, but not enough to retard it in the short run. In order to quickly leash the mounting of prices with a minimum of harm to economic activity and employment, the authorities should have taken further action compatible with the special nature of the inflationary process of late. In the last two years inflation has been largely stoked by the public's expectations of a sustained rapid advance of prices. The indexation of most financial assets in the economy and the almost automatic adjustment of the government budget to the prevailing rate of inflation generate a liquidity injection, which in turn permits the realization of the inflationary expectations. Breaking these expectations is essential for slowing inflation without overinhibiting economic activity and employment, and it necessitates strict adherence to the nominal fiscal and monetary goals. A package deal covering prices, wages, and profits is called for in order to ensure that they develop in line with the targets set. In other words, breaking the expectations requires a resolute, consistent monetary and fiscal policy that will achieve the nominal goals designed to bring inflation under control.

It is this conception that has motivated monetary policy since the middle of 1979: the determination of nominal targets for credit expansion while allowing a partial adjustment for any deviation from the objectives laid down with respect to inflation. (During the past two years there has in fact been a marked reduction in total bank credit to the public.) This is intended to stabilize inflation in the long run at the target rate. It should be stressed, however, that the policy regarding bank credit cannot in itself solve the problem of inflation, and its efficacy is in any case limited. It must be accompanied by a stringent restriction of nominal fiscal expenditures, wages, and profits. Persistence in a concerted fiscal-monetary policy aimed at achieving the objectives with respect to the budget, prices, and credit would create a favorable climate for an overall arrangement (i.e. a package deal) between the government, employers, and employees, which would significantly cool inflation without harming economic activity and employment.

Economic policy must strive to renew the growth which has been arrested since the Yom Kippur War. The oil shocks of 1973–74 and 1979–80, coupled with the sharply higher defense bill since the war, have increased the import surplus even without any vigorous growth; notwithstanding the larger volume of U.S. government aid, the difficulty encountered in financing the import surplus has been the principal factor in the lackluster performance of the economy. The resumption of growth while reducing the import surplus entails an increase in domestic saving and the curbing of private and public consumption in order to divert resources to stepping up the production of export goods and import substitutes, whose benefit to the economy is undisputed.

A precondition for the renewal of economic growth is a significant harnessing of the protracted inflation, which is apparently one of the causes of the stagnation of productivity in recent years. It is reasonable to assume that inflation has adversely affected the performance of the economy in areas influencing productivity, in that it has shifted the focus from production to finance, thereby weakening the relationship between technological productivity and economic efficiency on the one hand and profits and wages on the other. The frequent variations in relative prices, along with the growing uncertainty and the inevitable lagged adjustment of the tax system to the rapidly changing conditions, all these have apparently had a negative effect on resource allocation.

Ensuring the relative profitability and increased competitiveness of Israel's exports and import substitutes is a major condition for reducing the import surplus and mending the balance of payments while maintaining full employment. It should be emphasized that the weight of exports is very large: the proportion of business sector product marketed directly and indirectly abroad has reached 38 percent. Thus it will not be possible to ensure the profitability of the tradable product through partial arrangements and price supports; this can be done only by implementing an overall policy. A cardinal factor in maintaining the competitiveness of exports and import substitutes and even bolstering it lies in the incomes policy pursued. Even when the terms of trade are stable, the real increase in labor costs to employers must be kept below the growth of productivity, so that per unit labor expenditures will decline. In view of the worsening of the terms of trade in the last two years, the importance of a policy of incomes restraint has increased immeasurably. The deterioration in the terms of trade in effect constitutes an external tax which reduces real national income; i.e. the dearer cost of imported inputs necessitates the restraining of real wages if export profitability is to be preserved. Attempting to protect real wages when productivity is stagnant aggravates the employment problem and prevents a structural improvement in the balance of payments.

The taxes imposed on labor, such as national insurance contributions, the employers tax, and the payment of income tax by the employer instead of the employee, are an important component of labor costs. Under the conditions prevailing in the Israeli economy income tax on wages also has an effect, for it has more than once happened that in negotiating wage agreements employees referred to wages net of the tax paid by the employer. The reduction of these taxes would help to bring down labor costs, thereby permitting the growth of employment while improving the competitive standing of domestic production and easing pressure on prices from the costs side. Such a step, which decreases the government's revenue, must of course be accompanied by a corresponding pruning of its expenditures in order to avert an increase in its demand surplus. Moreover, making domestic production more competitive would diminish the need for export supports in the form of subsidized credit.

Supporting exports through cheap credit has several drawbacks: the size of the subsidy is dependent on the degree of inflation and alternative interest rates, and is therefore subject to considerable uncertainty; the allocation of credit is not related to value added; and expanding credit proportionally to the nominal growth of exports sharply pushes up its weight in total bank credit, thus impairing the Bank of Israel's ability to manage a proper monetary policy.

Economic growth accompanied by an improvement in the balance of payments, i.e. a contraction of the import surplus, implies a decrease in the relative share in GNP of domestic uses: investment, private consumption, and public consumption. As to investment, oversubsidization must be prevented, as this creates a differential between the benefit of a project to the economy and that to the entrepreneur; avoiding excessive subsidization would therefore ensure greater selectivity in investment. In order to eliminate this distortion, it was decided in the middle of 1979 to link development loans. Full implementation of this decision will end the subsidy, whose size is mainly a function of the inflation rate and which detrimentally affects resource allocation, besides arbitrarily altering the distribution of the nation's wealth. Fiscal legislation has not been adapted to the high rates of inflation, and for this reason as well many distortions have arisen in resource allocation and the distribution of wealth. The tax laws must be amended as quickly as possible in the light of the prevailing inflation, and this in place of the provisional arrangements, which are deficient in many respects (such as the inventory tax concession).

To achieve a better allocation of capital in the economy the government must reduce its intervention in the capital market to a minimum and shun financial intermediation. It is preferable to encourage saving and investment through direct grants rather than by fixing interest rates. Without minimizing the importance of improving the composition of investments and the capital utilization rate, it is clear that sustained economic growth also necessitates the stepping up of investment. What is more, the renewal of rapid growth will entail, once the existing production capacity is fully utilized, an increase in the share of investment in GNP. It follows that the burden of reducing the import surplus will have to fall primarily on consumption (private and public), which must be kept from growing faster than GNP so that the required resources can be diverted to trimming the import surplus and expanding capital formation.

To restrain private consumption it is necessary to increase the rate of private saving or to dampen the growth of incomes through taxation. But the possibilities here seem to be limited. The rate of private saving is already fairly high, and in the present circumstances it is not desirable to stiffen taxes because of the negative effect this would have on work incentives, tax morality, and inflation. It is nevertheless important to persist in the effort to collect a true tax.

The solution must therefore center on curbing the expansion of public consumption (civilian and noncivilian alike). While Israel's basic security needs make a very large defense budget inevitable, its size should not be divorced from either the social goals or the economic constraints. It must be emphasized that restraining the government budget in the coming years would pave the way for economic growth, and thus make it possible to increase the amount allocated to public consumption in the future without increasing its weight in total resource use.

The dimensions of inflation, the stagnation of the product and productivity, and the worsening terms of trade are the chief problems facing the economy. Economic policy must strive to bring about a resumption of growth while braking the advance of prices and ensuring a continuing structural improvement in the balance of payments. To achieve these aims requires a balanced application of policy measures—first and foremost, the reduction of the public sector demand surplus by adhering to the budget, whose nominal growth should be compatible with the objectives with respect to inflation.

Raising taxes heightens inflationary pressures from the costs side and creates work disincentives; the demand surplus must therefore be pruned primarily by cutting public spending and improving tax collection. Supporting exports through subsidized credit must be gradually phased out and replaced by other means, such as easing taxes on labor. It is also necessary to reduce the excessive protection of domestic production against competing imports which is accorded in several areas. Freeing monetary policy from the need to subsidize export credit would expand the policy base and increase the possibilities for mastering inflation. To make monetary policy more efficient and to improve the saving-investment process, the government must diminish its intervention in the capital market and its reliance on it for financing the budget, and endow the bond market with the flexibility required for fulfilling its role as a monetary policy instrument.