

# 1

## THE ECONOMY: DEVELOPMENTS AND POLICIES

The salient development in 1988 was the slowdown in economic activity: after two years of rapid expansion of demand and product, the business sector product increased this year by a mere one percent. Exports contracted in 1988, after many years of growth; private consumption, which had gone up rapidly in the two preceding years, increased by 3 percent; investment, which had risen substantially in 1987, shrank in 1988, and domestic public consumption, reduced in 1985 and 1986, rose in 1988 by 3 percent, similar to its increase in 1987. The slack in economic activity, which became visible towards the end of the previous year, was centered in the tradeables sector where the product of industry and agriculture contracted, whereas the product of the services industries and construction expanded. In the labor market these developments were reflected in a stagnant labor input, higher unemployment and—as the year went on—a halt to the rise of real wages.

Despite a slower rise in production costs and the slack in economic activity there was hardly any decline in the inflation rate of 1988 as compared to 1987. The exchange rate of the sheqel against the 5-currency basket remained stable, and the process of real appreciation continued, i.e. prices of nontradeables rose faster than those of tradeables, for the third year running.

The external current account remained relatively stable in 1988, with a fall in the volume of exports, no change in imports, and an improvement of the economy's terms of trade. The capital account, on the other hand, reflected a speculative cycle induced by the public's expectations of devaluation. These became stronger towards the end of the year, and resulted, in the last quarter, in private sector purchases of foreign currency of about \$2 billion. These expectations abated in early 1989, following a devaluation of the currency, and the foreign reserves increased again.

The rapid expansion of world trade in 1988 suggests that the recession in the tradeables sector was predominantly due to domestic factors—primarily, a cumulative fall in profitability resulting largely from the excessive rise of real wages since the stabilization program, and the exposure of problems rooted in the period of rapid inflation.

TABLE 1.1

**Main Economic Indicators, 1983-88**

	1983	1984	1985	1986	1987	1988
<b>Demand, economic activity, labor market</b>						
	<i>Percent real change</i>					
Public consumption, excl. direct defense imports	2.2	1.3	-0.8	-2.9	2.8	2.8
Private consumption	8.3	-6.8	0.5	14.2	8.4	3.0
Fixed investment	12.6	-11.3	-7.8	-0.6	13.0	-1.2
Gross domestic product	2.6	2.3	3.9	3.6	5.2	1.6
Business sector GDP	3.1	2.6	5.3	5.7	7.0	1.1
Business sector employment	4.6	1.5	0.1	2.1	4.5	3.0
Total productivity (business sector)	-0.2	-0.3	4.2	3.4	3.5	-0.1
Gross wages, total economy <sup>a</sup>	5.9	-0.4	-9.0	7.8	7.9	6.2
Real unit labor costs, business sector	4.4	-5.0	-0.7	5.8	4.2	0.6
Unemployment rate, percent (absolute level)	4.5	5.9	6.7	7.1	6.1	6.4
Gross national saving rate, percent (absolute level)	16.1	18.2	21.7	19.1	16.5	15.9
<b>Balance of payments and external debt</b>						
	<i>\$ billion, current prices</i>					
Current account deficit <sup>b</sup>	2.0	1.4	-1.2	-1.6	1.0	0.7
Unilateral transfers	2.7	3.3	5.0	5.4	4.8	4.7
Import surplus (excl. defense imports)	3.7	3.2	2.0	2.6	3.3	3.2
Exports of goods and services	10.5	10.8	11.2	12.1	14.3	15.7
Imports of goods and services	15.2	15.5	15.1	16.0	20.1	21.0
Net external debts	17.5	18.9	18.6	18.3	18.3	18.6
	<i>Index, 1980 = 100</i>					
Relative price of exports <sup>c</sup>	90	91	91	80	76	74
Relative price of imports <sup>c</sup>	84	86	93	81	79	74
<b>Prices, fiscal and monetary data</b>						
	<i>Percent</i>					
Consumer price index <sup>d</sup>	191	445	185	19.6	16.1	16.4
Wholesale price index <sup>d</sup>	202	447	153	15.1	20.9	15.8
Sheqel/currency basket exchange rate <sup>d</sup>	206	462	154	6.0	13.9	0.7
Interest rate on overdraft facilities	182	771	453	59.6	60.9	46.0
Average interest rate on credit <sup>e</sup>	209	602	232	29.5	38.0	32.5
	<i>Percent of GDP</i>					
Domestic public sector deficit <sup>f</sup>	7.2	16.4	7.2	1.6	1.5	4.5
Total public sector deficit <sup>f</sup>	7.1	17.8	1.6	-2.8	0.3	3.6
Tax revenue <sup>g</sup>	46.1	38.1	44.9	48.0	47.2	45.9
Unlinked short-term assets <sup>h</sup>	6.3	5.4	9.4	13.8	18.6	19.3
Total short-term assets <sup>h</sup>	34.5	34.9	37.3	36.6	39.2	39.4
Total financial assets <sup>h</sup>	164.3	148.6	173.4	175.2	182.0	174.7
Total bank credit to the public <sup>h</sup>	20.9	20.0	22.3	23.5	29.0	34.5

<sup>a</sup> Nominal wages deflated by the CPI.

<sup>b</sup> A minus sign denotes a surplus. In analyzing current account trends, advance payments on defense imports should be deducted (see Chapter 7).

<sup>c</sup> See Table 7.1.

<sup>d</sup> Percent annual change.

<sup>e</sup> Average annual interest.

<sup>f</sup> A minus sign denotes a surplus (see Table 5.1).

<sup>g</sup> Includes transfer payments from the public (see Table 5.2).

<sup>h</sup> Average balance relative to GDP (see Table 8.1).

From the beginning of the year, the economy was also affected by the uprising in the territories, the direct damage of which is estimated at about 1.5 percent of the business sector product.

The developments of 1988 represent a further stage in the economy's adjustment to the very substantial changes in the economic environment that have taken place since the implementation of the stabilization program in 1985; the implications of these have not yet run their full course. The two major changes in economic policy after the stabilization program were the shift to a stable exchange rate regime, after many years of devaluations, and to fiscal balance, after large and persistent deficits. Fiscal balance was achieved by higher effective taxation rates together with a slashing of public expenditure and cuts in subsidies. The restrictive monetary policy which accompanied the program took the form of a steep rise of real interest rates in its early phases. Additional support for the program came from the U.S. emergency grant.

	1977– 1980	1981– 1984	1985– 1987	1988
1. <i>Inflation rate</i> , annual percent change in CPI	80	193	21 <sup>a</sup>	16
2. <i>Public sector accounts</i> , deficit (–) or surplus (+), percent of GNP	–16.1	–12.9	0.3	–3.6
3. <i>Current account</i> , net, current \$ million, annual average	–0.9	–1.6	0.1 <sup>b</sup>	–0.2
4. <i>Business sector GDP</i> , annual percent change	3.7	2.8	6.0	1.1
5. <i>Total productivity</i> in the business sector, annual percent change	0.7	0.3	3.7	–0.1
6. <i>Unemployment rate</i> , percent of civilian labor force	3.8	5.1	6.6	6.4
<sup>a</sup> From August 1985 only.				
<sup>b</sup> Excluding the U.S. emergency grant of \$1.5 billion.				

The stabilization program brought about a fundamental improvement in the state of the economy: The inflation rate was reduced from a three-digit level to the range of 15–20 percent, the increase in the domestic and foreign debt was checked, and the danger of a balance of payments crisis receded (see Table 1.2). Following a brief phase of contracting demand and product in the second half of 1985, the economy enjoyed two years of rapid rise in business sector product and productivity in 1986–87, and seemed headed for stable growth without an interim period of recession and unemployment. However, in 1988,

recession set in, and there was a steep rise in the number of firms which had run into difficulty. This indicates that the economy has not escaped paying a certain real price for the obvious advantages of stability.

The 1988 recession is closely related to the erosion of the business sector's profitability in the last three years. In the two years preceding 1988, changes in relative prices accumulated and intensified, side by side with the growth of product and productivity. Prominent among these was the increase in unit labor costs, especially in the tradeables sector, with an erosion of the real exchange rate. As 1988 saw no correction to the decline of profitability, structural problems surfaced in many sectors. Although these originated in the period prior to the stabilization program, they became more acute after it, since the behavior of the business sector, especially in the labor market, had not yet sufficiently adapted to the changes in policy and economic environment. The rise in labor productivity in the previous two years apparently contained a non-recurring component due to the curbing of inflation.

	1981-84	1985	1986	1987	1988
	<i>Annual percent change</i>				
1. Relative prices: Compared to U.S.	0	14	-15	-8	-11
Compared to Europe	-8	14	11	4	-8
2. Labor cost per unit of product	1	-1	6	4	1
	<i>Annual average, percent</i>				
3. Gross returns to capital	13	14	10	10	9
4. Taxation rate on nonwage income	25	27	32	32	33
Credit subsidies and capital transfers to business <sup>a</sup>	14	8	7	7	7
5. Real short-term interest rate	17 <sup>b</sup>	16	8	19	14
Real interest rate on overdraft facilities	25	95	35	39	25
6. Real yield to maturity in the bond market <sup>c</sup>	2	6	6	4	4
<sup>a</sup> As a percentage of nonwage income. See also Fig. 5.2.					
<sup>b</sup> Average for 1983 and 1984 only; 6 percent in 1983 and 29 percent in 1984.					
<sup>c</sup> CPI-indexed government bonds with a maturity of five years (see Table 8.2).					
SOURCES: Item 1—Table 7.5; item 2—Table 4.1; items 3 and 4—Table 6.2; item 5—Table 8.2.					

The reduction of high inflation and the change in fiscal policy called for patterns of conduct very different from those that had taken root over many years. An examination of the financial crises which overtook a number of big

firms and institutions shows that in many of them the problems date back to the period of high inflation. Their full severity was not perceived at the time because it could be masked by capital gains. Firms with easy access to relatively cheap credit were able to continue borrowing, without making the necessary adjustments on the production side. When inflation was slowed down, these companies' real position was exposed, and demanded solution.

Any new policy naturally gains credibility only gradually, as economic entities observe the actual conduct of the government and come to realize that it is determined to adhere to its policy. The business sector became aware only gradually of the necessity to adjust to the many changes in the functioning of the economy. In the first place, it had to cope with a new exchange rate regime, under which the price of foreign currency served as the principal anchor of the price system and no longer automatically responded to domestic price and wage increases. The stable exchange rate regime contributed significantly to price stabilization, but it also carried a cost: excessive wage rises during the stage in which the public—workers and employers—still continued to behave according to previous adjustment patterns. These wage increases—in part due to structural factors—were reflected in a decline of the gross returns to capital.

Simultaneously, the business sector had to cope with lasting cuts in various subsidies, a rise in the effective rate of taxation on profits (see Table 1.3), and cuts in the public sector's domestic demand—especially, a long-term reduction of the defense system's domestic procurement. It also became evident that interest rates on short-term unlinked credit remained high, although they declined from the exceptionally high level set at the beginning of the stabilization program, and fell further in 1988. Borrowers thus found it difficult to extricate themselves from their debt burden. The high interest rates set in the early phases of the program helped to stabilize the balance of payments. But when high interest rates are maintained for a long time, the supply of product is also affected: In the short run, the cost of working capital is raised, and in the longer run, these high interest rates have an effect on the accumulation of capital stock. Businesses which had not earlier seen to an appropriate accumulation of equity, and had failed to adapt to the post-stabilization environment, ran into operational difficulties, which mounted as a result of the high interest rates. For all these reasons, a stabilization program is typically followed by a phase of slackening domestic demand and output, rising unemployment and an increase in bankruptcies; frequently, it does not emerge immediately, but with some lag. In the case of Israel, certain structural characteristics and factors

specific to 1986 and 1987 further postponed the adjustment in many corporate entities.

Structurally, the Israeli economy is characterized by sectors whose activities are not motivated exclusively by profit. When such sectors accumulated losses or ran into financial difficulties in the past, they were often given assistance from the public purse. These sectors include many agricultural settlements (moshavim and kibbutzim), the government and Histadrut enterprises, the bus cooperatives, the Histadrut's General Sick Fund (Kupat Holim Clalit), and others. The assistance given to these and other big organizations with problems was apparently perceived as a commitment to rescue them in the future. As long as these entities believe that losses will be covered by public funding, they have no incentive to become more efficient. The result was that some businesses and organizations, where the changed circumstances called for lay-offs and cuts in production, did not cut their output and employment until 1987, with wages per unit of product even rising. The turn from profits to losses may explain part of the expansion of credit, since losing firms had to borrow more despite the higher cost of credit. Since the stabilization program, the government has been much less prepared to bail out such organizations, particularly when their economic viability was in doubt. (The cancellation of the Lavie project in 1987 was a milestone in this respect.) Many organizations became aware only gradually of the government's stricter attitude to the business sector, and only when they were already in crisis.

Another structural feature of Israel's economy is the limited flexibility of wages, caused by the institutional arrangements in the labor market. The cost-of-living allowance compensates only partially for price rises, but many firms have supplementary and restrictive wage agreements (such as linkages between different wage scales), which impede a rapid adjustment of wages to changed labor market conditions. Moreover, in 1987 the minimum wage agreement was supplanted by a minimum wage law which substantially raised wages in the low brackets, and also affected other wage brackets. Under this law, the minimum wage is updated automatically without consideration of the level of economic activity and employment. This increases lay-offs in times of recession (for a detailed discussion of the minimum wage law and its implications see Chapter 4).

The pace at which various producers adapted to the changes that followed the stabilization program was affected by two other factors—expanding domestic demand in 1986 and 1987, and the sharp changes in the exchange rate of the dollar against the European currencies in those two years. The changes

in foreign cross rates increased the profitability of exports to Europe while it sharply reduced the profitability of exports to the dollar bloc. Sectors which benefited from the boom in domestic demand and those which exported mainly to Europe increased their production. They were therefore able to postpone some of the adjustments that were called for after the stabilization. By contrast, sectors exporting mainly to the dollar bloc (which were hurt by a cumulative real appreciation of the currency), or those facing declining domestic demand, could not postpone the necessary changes in production and cost structure. Some enterprises succeeded in making the necessary changes. Others, which failed to do so, found themselves in steadily increasing difficulties. The boom in domestic demand until mid-1987 was to a large extent connected with the slowing of inflation; in part, it was a one-time expansion, which was also related to the large increase in wages. This wage rise, combined with a 10 percent increase, in the last two years, in the business sector's real labor costs per unit of product, suggests that many sectors and enterprises have not yet adequately adapted to the changed circumstances.

The severity of the problems emerged only gradually, and varied among the different sectors, industry branches and sub-branches, and individual firms. The agricultural settlements, heavily reliant on credit, found themselves in financial crisis already in the initial stages of the stabilization program. As a result of the high real interest rates this crisis deepened. Many construction firms encountered financial difficulties as early as 1986, but a general slowdown of production developed only towards the end of 1987, and the full intensity of the recession became apparent only in the course of 1988. In 1988, the various factors described above (see Table 1.3) combined with the slackening of domestic demand growth and the effects of the uprising in the territories on tourism and on exports to the territories. (For a detailed discussion of the overall impact of the unrest in the territories on GNP see Chapter 6.) Throughout the year the government refrained from devaluing the currency—despite the fact that the public expected it and behaved accordingly. In 1988, this contributed to a further erosion of profitability in the tradeables sector, which experienced more difficulties than the services sector. Especially prominent was the contraction in industry, coming after its substantial expansion in the two preceding years, and the crises in a number of big corporations, many of which are publicly owned or belong to the Histadrut.

On the demand side, the stepped-up demand of the public sector contrasted with the slowing of private sector demand. The public sector's domestic demand—civilian and defense consumption, and investment—expanded in

1988 by 3 percent while net tax revenue declined and the domestic and overall deficit both increased substantially. This widening of the deficit to about 4 percent of GNP was partly due to transitory factors—the redemption of compulsory loans and exceptional tax refunds—and in part reflects the cyclical fall in tax revenue in times of recession. When these factors are deducted, the deficit is similar to that of the previous year. Remarkable in the year under review was a 4 percent increase in public sector employment, following two years in which the number of public sector employees had remained unchanged. Another prominent feature was that public borrowing exceeded the requirements of financing the public deficit, due to apprehensions of difficulties in recycling the bank shares under the 'arrangement', which fell due for redemption towards the end of the year. These developments represent a certain retreat from the trends that characterized the public sector's activities since the stabilization program, and are inconsistent with the objective of gradually reducing the government's share in economic activity.

Private consumption, which in the previous two years had expanded by an annual 11 percent, rose this year by 3 percent. At the same time, the private sector's saving rate declined in the last three years to no more than 20 percent of its income, as against an average of 30 percent in the years 1981–84. There is no full explanation for these developments in private consumption and saving; in part, they reflect a long-term trend of lower private saving which is related to the decline in the proportion of age group 20–29 (which typically has a high saving rate) in total population. The changes in private consumption and saving are also partly due to the stabilization policy, and it is possible that the previous period's high saving rate could be exceptional. These previous high rates seem to have been influenced by the general instability in the economy in those years. High inflation, large government deficits, and frequent reversals of economic policy increased individuals' uncertainty about future economic developments in general, and their own expected wealth and income in particular, thus encouraging higher private saving. In this light, the stabilization itself contributed to reducing the saving rate and increasing consumption. Furthermore, following the stabilization, the share of wages and transfer payments in total income increased considerably. This component of income fluctuates less than others, and also serves as a good indicator of household income (better than total disposable income); the propensity to consume out of this income component is therefore relatively high. The other component of income is undistributed profits of firms; the decline of profitability in recent years thus explains part of the fall in the saving rate. Finally, the reduction, compared with

earlier years, in the share of public consumption in GNP enables the private sector to consume a larger portion of the resources available to the economy. The effect of the factors listed above weakened in 1988, and the private saving rate rose by two percentage points.

It therefore seems that as long as the government deficit is kept within modest bounds and inflation remains relatively stable, the private saving rate is not expected to return to the level of the decade before the stabilization. Nevertheless, the rate may rise moderately as a result of a decline in the share of wage income, and a rise in the share of business profits, in total private sector income, as well as a renewed increase in the proportion of the 20–29 age group in the population.

The fall in the private saving rate since 1985 was accompanied by a very substantial increase in the public sector's saving rate (which had earlier been negative—an expression of the large public deficits). The national saving rate—the sum of private and public sector saving—increased considerably in 1985, and subsequently declined again to its 1981–84 rate (see Table 2.3). Simultaneously, the external current account improved substantially over the pre-1985 period, due, among other things, to the fall in investment. Most of the decline in gross investment was due to a long-term trend of lower investment in housing, although this recovered somewhat in the last two years. Developments in this investment component mainly reflect demand-side factors, principally demographic trends.

Nondwelling investment has also been on a downward trend over several years. After a 15 percent expansion in 1987, contracted again in 1988, the fall occurring particularly in private sector investment. The decline of investment in 1988 was affected by the general slowdown in the economy and the steady fall in business sector profitability which was accompanied by financial crises in many sectors. The low level of nondwelling investment since 1985 is related to the steady decline in returns to capital in the business sector, due to the large rise in labor costs per unit of product, the increase in the taxation rate on profits, the cut in credit subsidies and investment grants, and the surge in short- and long-term interest rates compared to the period before the stabilization. In these circumstances, the large expansion of nondwelling investment in the previous year was exceptional. This expansion seems to have been due primarily to the 1986–87 economic boom, and to expectations of continued rapid growth of demand and product, and rising profitability. When the trend of GNP growth was reversed and the problem of profitability became more pressing, investment contracted again.

Domestic use of resources increased in 1988 by a mere 2 percent, but the economy's production capacity was not utilized to expand exports. After a substantial increase in the two previous years, exports declined in 1988 by 2 percent. After deducting the effects of the uprising in the territories on exports to them and on tourism, exports are seen to have expanded by some two percent. The scantiness of this rise cannot be attributed to a fall in demand abroad, since international trade has been expanding for several years, and grew even faster in the year under review. This year's developments in exports are therefore primarily related to the supply-side factors discussed in detail earlier in this chapter. Most of the factors that contributed to the economic slump in 1988 and to the 1987 expansion of activity are not unique to exports, but are common to the tradeables sector as a whole. There were particularly great difficulties in exports, such as the movement of wages relative to the exchange rate and the changes in the cross rates of foreign currencies. But there were also supportive factors, such as the growth of world trade and easier credit conditions. Thus the share of exports in total industrial production did not decline. The various factors had an uneven effect on the different components of exports, depending on cost structure, demand and prices in each of the various export markets, and the financing conditions and organizational setup in each branch and enterprise. All these factors determined the degree to which the various sectors succeeded in adjusting to the many changes confronting them, and led to differential rates of growth of production and exports in the various sub-sectors.

The 1986–87 boom in domestic demand was accompanied by a considerable rise in all import components; the economic slack of 1988 resulted in an unchanged volume of imports. The year's terms of trade improved and the import surplus declined in dollar terms. The import components which rose in 1988 were consumer goods, fuel, raw diamonds and the various services; imports of other intermediates and capital goods fell in volume. When the effects of the contraction in imports from the territories (mostly labor services) are deducted from the total, the volume of imports is seen to have risen by 2 percent. The current account deficit ('adjusted', see Table 78) remained at a level similar to that of last year—some \$200 million—despite the changes in its composition.

Two principal features marked the year's price movements—the rise of the various price indexes was only slightly slower than last year, despite a smaller rise in cost components, and prices of nontradeables continued to rise faster

than those of tradeables. A relative rise in the prices of nontradeables—i.e., a real appreciation—after stabilization programs of the type adopted in July 1985, in which the exchange rate serves as the principal anchor of the price system, is a well-known phenomenon. The boom in domestic demand, which in 1986 and 1987 exceeded the growth of the economy's production capacity, contributed greatly to the real appreciation in these two years. The tradeable sector's ability to raise prices in the domestic market is restricted by competition from abroad, since higher demand for tradeable goods can also be satisfied through imports. By contrast, in the nontradeables sector, where the ability to expand capacity is limited in the short run, a rise in demand translates to a larger extent into price rises.

The real appreciation of 1986 and 1987 also reflects a considerable rise in real wages and labor costs per unit of product in the business sector. It seems that when inflation comes down from a high level, relative prices are highly affected by the public's expectations as regards the exchange rate and future prices. In the initial stage of the stabilization program, in 1986, the public still expected devaluations and price rises higher than those which actually occurred—as suggested by the readiness of employers to grant substantial wage increases. In the nontradeables sector (which mostly consists of the various services) prices were raised in line with these wage increases, and despite higher real compensation per worker, real labor costs to the employer did not rise. On the other hand, employers in the tradeables sector (which is mainly made up of industrial products and their like) could not react to excessive wage increases by raising prices; labor costs in this sector thus rose in excess of productivity growth, thereby eroding the sector's profitability. The institutional arrangements in the labor market mentioned earlier apparently contributed to this wage increase. An 11 percent devaluation against the currency basket at the beginning of 1987 brought about no more than a temporary correction in profitability, despite the accompanying partial suspension of the cost-of-living allowance and a reduction of wage taxes paid by employers. On average for the business sector, real wages per worker (relative to the CPI) rose in 1987. Their rise was supported by a substantial expansion of employment and labor input. As in the previous year, in the nontradeables sector prices rose in line with wages as unit wage costs there did not increase. Wages in the tradeables sector were influenced by the wage rises in nontradeables, and although more moderate in the former, they rose faster than prices of tradeables. Labor costs thus continued to rise in these industries, and their profitability declined further (see Table 4.4 and Figure 4.5).

The government's eventual adjustment of the exchange rate was only partially in line with the movements of wages and domestic prices, and it adhered more firmly to its exchange rate policy than the public had expected. When the stabilization program was launched, the government announced that over time, the stability of the exchange rate would depend on wage stability, but actually it allowed a substantial erosion of the real exchange rate to take place. However, the exchange rate against the currency basket was not frozen: pegging the currency to the dollar in the program's first year, when the dollar weakened against the European currencies, together with the devaluation at the beginning of 1987, amounted to a cumulative depreciation of about 25 percent against the currency basket between mid-1985 and the end of 1987. This partial accommodation to the public's expectations seems to have been unavoidable: greater rigidity was not desirable, and on the other hand, full accommodation would have contradicted the objective of curbing inflation. Yet, such a policy raised a difficulty: the government's signal to the public was ambiguous, and in the learning process and adjustment to the new regime a real appreciation was hard to prevent. One of its manifestations was that real wages increased faster than objective conditions in the economy warranted.

In 1988 government policy sought to achieve a further reduction of inflation, while the public expected a further devaluation of the one-again eroded sheqel already by the end of 1987. At the time the government refrained from devaluation and expectations of it waned. Still, the public, with expectations shaped by the policy which prevailed until 1988, was not convinced that the government could maintain a stable exchange rate regime. Expectations of a devaluation in the second half of the year thus arose again, and peaked towards year's end. The concentration of these expectations in the last quarter of the year is explained by the November date of the elections and the redemption of the dollar-linked 'arrangement' bank shares in October. At some point it appeared that a devaluation unlikely to be carried out before the end of the year. At the same time, profitability problems in the business sector became more severe, particularly in the tradeables sector. In many firms the accumulated losses allowed no further postponement of the required changes, including lay-offs. The rise in business sector wages began to slow appreciably only more than two years after the stabilization, with an unchanged average labor input (the labor input from the territories fell by 25 percent and the number of Israeli workers increased). This stabilization of the labor input of the business sector as a whole is comprised of an expansion of employment and labor input in the nontradeable sectors, in which demand continued to rise, and a decline

in the tradeables sector (see Table 4.4). This turn-around, however, was not sufficient to prevent the recession and the increase in unemployment this year.

Despite the slack in economic activity and the slower rise of production costs in the year under review, there was no matching fall in the inflation rate, which remained at a level similar to that of the previous two years. We have no full explanation for the persistence of inflation at this level. Price increases of the different consumption items this year showed more uniformity than in earlier years, and wage increases among industries were also more even than before. This greater uniformity of prices and wages can be attributed to the settling down of the public's inflationary expectations and to its assessment that a devaluation would eventually be carried out. Beyond a certain basic level of inflation, the following developments stand out (Table 3.2): prices of tradeables this year again rose more moderately than the prices of nontradeables, and they also rose at a slower pace than in the year before; the rise in prices of private services was also significantly less than in the preceding year (Table 3.A-2). Higher price increases, compared with last year, were recorded in farm products (due to natural factors), in the subsidized products and part of the public services (as a result of subsidy cuts), and in housing. Overall, prices of those consumer goods that were set administratively, or which were subject to short-run supply fluctuations, rose faster than the year before, whereas prices of other goods and services increased more moderately than last year.

A new cost-of-living allowance agreement was concluded in February 1989, according to which an 85 percent compensation will be paid every six months for price increases exceeding 0.5 percent per month (3 percent in half a year). At the present level of inflation this arrangement has several advantages. On the one hand, the automatic wage increase it guarantees is at least 6 percent less than the rate of inflation, leaving a margin for differential wage increases at the enterprise level in accordance with the state of business. On the other hand, the new agreement ensures that the erosion of real wages—in case of an unexpected acceleration of price rises—will be limited. An immediate compensation of 3 percent, payable with the February 1989 wages, and a further 3 percent to be paid at later dates, were agreed upon for the period from the last compensation until February 1989.

The public's expectations of devaluation which, as said earlier, mounted towards the end of 1988, are part of a speculative cycle. In the cycle's first stage, following the January 1987 devaluation, the public sold substantial amounts of foreign currency; at its peak, in the last quarter of 1988, the public

purchased approximately \$2 billion of foreign currency. The sharp fall in the foreign reserves towards the end of the year led to a 5 percent devaluation at the end of December and a further devaluation of 8 percent at the beginning of January 1989, as part of a more comprehensive package of policy measures for 1989. Devaluation expectations then abated, and in the first quarter of 1989 the public again sold \$1.8 billion of foreign currency to the Bank of Israel.

The speculative cycle of foreign currency acquisitions and the recession that set in during 1988 were the background of monetary developments in the year under review. For most of the year monetary policy acted to reduce interest rates. The fall of real short-term interest rates was indeed substantial, and was accompanied by a narrowing of the gap between borrowing and lending rates in the unlinked short-term sheqel segment.

The decline in interest rates was due to an expansion of the money supply (M3) at a time when the demand for money declined as a result of the rise in expectations of devaluation. Monetary policy expanded the money supply by increasing its lending to the banks and reducing the reserve requirements on sheqel deposits—measures that increase the banking system's ability to extend credit. In the first nine months of the year, the increase in the money supply was accompanied by pressure on the banks to reduce their interest rates on short-term sheqel credit and to reduce their financial margins in this segment. The reduction in the reserve requirements, which tends to raise the banks' profits, supported this policy.

Overall, the real interest rate on overdraft facilities fell from an average 39 percent in 1987 to an average of 25 percent in 1988. The average real interest rate on short-term bank credit declined in this period from 19 to 14 percent, and the difference between the interest rate on overdraft facilities and Treasury bills came down from 36 to 28 percent. The M3 aggregate increased by an average 2 percent in real terms. These annual averages reflect differences between the first three quarters of the year and the last. In the first three quarters nominal interest rates declined gradually; in contrast, from October, when expectations of devaluation rose sharply and the liquid resources of the banks dwindled, the M3 aggregate contracted and the interest rate set in the monetary auctions rose steeply. This translated into a moderate rise in interest on credit, which continued to fall in real terms in the last quarter of the year: the interest on overdraft facilities dropped to about 19 percent.

The cyclical capital movements characteristic of a stable exchange rate regime create difficulties for monetary policy, as exemplified by developments in the latest cycle. After the rise in interest rates that followed the devaluation of

January 1987, the Bank of Israel acted from the second quarter of 1987 to gradually reduce interest rates. In mid-1988, however, the speculative cycle reversed itself, a devaluation was expected, and the public again began to purchase foreign currency. Lending rates were still high while the economy was already in recession, so that monetary policy faced a dilemma: It could allow a steep rise in interest rates in order to reduce the purchases of foreign currency, but thereby aggravate the recession, or it could continue reducing interest rates by increasing liquidity, thereby augmenting capital movements. The policy adopted in the third quarter of 1988 was to prevent a deepening of the recession, and the lowering of interest rates was continued. But when the purchases of foreign currency intensified greatly in the last quarter of the year, the Bank allowed interest rates to rise sharply in order to slow these purchases.

In early 1989, after the devaluation, the reduction of interest rates was resumed at an accelerated pace. The management of the stable exchange rate was also revised: the exchange rate against the currency basket was permitted to fluctuate within a range of 3 percent above and below the stable rate, in response to short-term capital movements and other monetary developments. These two changes will make it easier for monetary policy to influence the size of capital movements in the future. Other policy measures adopted in January 1989 were a cut in subsidies to basic products, which led to a steep rise in their prices, a reduction of the exchange rate insurance by 2 percentage points and several measures of liberalizing foreign currency-linked credit and loans from abroad. The combination of these measures led to a sharp rise of prices in January, but subsequently price rises returned to their 1988 pace.

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The Israeli economy has come a long way since the 1985 stabilization program. Indeed, 1988 was a year of low profitability, recession and crises, but it also showed signs of structural change in the business sector, towards greater efficiency. Many of the difficulties now confronting the business sector are the result of the many changes in the key variables of the economy which took place after the stabilization program. The government's commitment to stability, since 1985, expressed by balancing its budget and maintaining a stable exchange rate, called for corresponding changes in the business sector's patterns of conduct. It seems that in many sectors employers and workers understood the meaning of these changes only after the passage of time, and when already in crisis. The policy measures adopted in early 1989 were intended to correct some of the detrimental effects on profitability and relative prices.

Many of the present problems have their roots in the past—the size of the public sector, its deep involvement in the economy, and insufficient competition in the markets for goods, labor, money and capital. In earlier years high inflation obscured many problems on the production side, and their exposure after the stabilization called for many changes. The 1985 program laid the foundations for these, and measures taken later on addressed problems that arose during the program's implementation. Reforms are necessary in many areas in order to adapt the rules of business conduct to the framework of low inflation and to increase competition. Some of these are already under way: in 1987, a substantial reform of the capital market was initiated, and personal and corporate income tax rates were cut. No further progress in these fields was made in 1988; in particular, public sector employment increased again, and a planned comprehensive income tax reform failed to reach the stage of implementation. In early 1989 several steps were taken to improve the functioning of the various markets: a new cost-of-living agreement, another stage of cuts in customs tariffs and greater exposure to international trade, and measures of liberalizing capital movements.

At the same time there have been signs of a retreat in fiscal policy: Budget cuts that were planned at the beginning of 1989 were eroded even before they were approved by the Knesset, by the addition of many expenditures without cuts in others. The additions to the budget included, inter alia, allocations for specific institutions and entities, investment grants and assistance to a number of ailing sectors. Although aid to sectors in difficulties should not be ruled out altogether, it is necessary to restrict such aid and insist that it be given only in line with comprehensive recovery programs. Support of inefficient undertakings is inconsistent with long-term stability and growth, and transmits negative signals to the private sector. In this context it may be pointed out that part of the 1988 recession can be regarded as the price which the economy paid, in unemployment and loss of output, until the stabilization policy of the government gained credence. A change in policy today would jeopardize the fruits of earlier efforts. It should be kept in mind that structural change is a lengthy process, and in order to embark on a course of sustainable steady growth it is important to fully exhaust the process of raising efficiency. Moreover, consistency of policy reduces uncertainties and as such contributes to an improved functioning of firms. The renewal of growth can be given further assistance mainly by continuing the policy of reducing interest rates and the fuller implementation of the reforms initiated in recent years.