CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

In 1979 there were worrisome developments in three principal areas: inflation grew much worse, topping the 100 percent mark; imported fuel prices rose sharply during the year, gravely impairing the balance of payments; and productivity inched up only a notch, while the real cost of labor increased appreciably, thereby greatly impeding the implementation of a policy aimed at toning down inflation and strengthening the balance of payments.

The exacerbation of inflation, which began at the end of 1978, grew more pronounced during 1979. After prices had moved up at an annual rate of around 40 percent since 1974, the advance doubled at the end of 1978 and reached 110 percent in 1979. Inflation has been running at a high rate since the Yom Kippur War and the oil crisis. The inflationary process is a complicated one and can be understood only in the light of the special factors prevailing in Israel: a large public sector demand surplus which has been financed by injecting liquidity into the economy, a monetary system in which most liquid assets are value-linked, and a labor market free of any overt unemployment despite the slackening of demands. The protracted inflation engendered expectations of further price rises, which were intensified by the failure to adjust the institutional wage and taxation arrangements and the interest rate on directed credit for the higher prices.

The escalation of inflation in 1979 took place against the backdrop of a sizable buildup of liquidity in 1977-78 and a low domestic real interest rate level, the expansion of government demands (including public building) after they had drifted down a bit in 1978 and shrunk appreciably in the two preceding years, a booming housing market, and the expectation (which did not materialize) of a large-scale expenditure in connection with the military redeployment in the Negev.

The policy measures adopted with the liberalization of foreign currency control in October 1977 had an immediate impact on prices and the public's assets portfolio, and intensified inflationary expectations. The Israeli pound, it will be recalled, was devalued appreciably at the time, export incentives and the defense levy on imports were abolished, and the value added tax was hiked. The outcome of these steps was a steep rise in prices and a marked increase in the public's financial assets holdings denominated in foreign currency. The appreciation of the public's wealth goes some way to explain the more buoyant demands in the economy; in particular, it stoked the recovery of the home construction market, where demand had begun to pick up even earlier. Contrary to plans and what was required, these measures were not accompanied by a policy of fiscal restraint, which would have dampened the inflationary influences.

When the foreign currency reform was introduced the public was expecting the protracted inflationary process to continue unabated. The price increases that accompanied the reform and those expected because of the cost-of-living adjustment-exchange rate-price spiral apparently magnified these expectations.

Since the cost-of-living allowance arrangement does not fully compensate for the rise in the consumer price index, and in view of the uncertainty as to the future rate of inflation, workers demanded a high nominal compensation in negotiating the biennial wage agreements for 1978-79. These agreements, which were concluded when the economy was in a full-employment situation, together with the cost-of-living adjustment, sharply pushed up money wages, thereby further fueling the inflation. In 1979 there was another hike in wages. One of the consequences of the prolonged rising rate of inflation has been the undermining of the institutional wage system: not only are employees' earnings increased under the cost-of-living arrangement and the framework agreements, but cost-of-living adjustments are now made more frequently and in excess of the original agreements, all sorts of fringe benefits are granted, and in the business sector special increases are awarded at the individual firm level. It should be noted that the increments in the business sector were given during a period of industrial peace and a much larger recruitment of workers, induced by the expectation of an acceleration of economic activity. In the public sector most of the agreements were signed belately in 1979, and the increases awarded in the course of the year influenced wages in the business sector. The high wage demands are apparently explained not only by the change in inflationary expectations but also by the erosion of disposable income resulting from the fact that the income tax brackets were only partially adjusted for the rise in prices.

The nominal exchange rate was quite volatile in the past two years, but this did not seem to have greatly influenced the public's inflationary expectations.

A contributory factor in the inflationary process is the large amount of money pumped into the economy with its rather unusal financial assets system. The government's domestic demand, on the rise since the Yom Kippur War, has engendered a growing liquidity injection, which has been magnified by the directed export credit granted by the Bank of Israel. The distinguishing feature of Israel's financial system is the large weight of value-linked financial assets: most of the financial assets owned by the public are linked to the consumer price index or the exchange rate, and are not eroded by inflation. Their share in total liquid assets has grown as a result of the prolonged inflation and to some extent also because of the foreign currency liberalization, which increased the possibility of holding liquid assets linked to foreign currency. The public's large indebtedness, however, is not linked, and any increase in the rate of inflation augments its wealth.

The disquieting trends of the past few years in labor productivity and wages grew more acute in 1979. In the business sector productivity edged up a mere 1 percent, while real labor costs rose 10 percent. These developments generated inflationary pressure on the one hand and had a moderating influence on employment on the other. This slump in productivity has been going on for some time, but it became especially grave in 1978-79, when aggregate demand expanded strongly against the backdrop of a rapid growth in the past few years in the amount of capital per manhour. We cannot satisfactorily explain the tailing off of the productivity curve in the past five years; it seems that it was partly due to distortions arising from the protracted inflation, especially with respect to the planning of domestic investments.

The rise in real wages per manhour was much more modest than that in real labor costs per unit of output, but was still high in the prevailing economic conditions. Considering the worsening of the country's terms of trade, the niggardly gain in labor productivity, and the desire to preserve the economy's competitiveness in world markets, prevent any aggravation of the employment situation, and cool inflation, what was needed was a real decline in wages from the workers' viewpoint (which did in fact happen in many economies in similar circumstances), and not an increase, as took place in Israel.

The deterioration in Israel's balance of payments, which began in 1978 with the renewal of economic growth, became more acute in 1979, and this after the deficit had shrunk for two consecutive years. The import surplus (less direct defense imports) rose appreciably, and the economy again had to resort to short-term capital imports to cover it. The turn for the worse this year can be attributed to imports: these expanded quantitatively by more than resource uses, a development aggravated by the steep jump in the prices of imported fuel in the course of 1979. The latter explain close to half the growth of the import surplus, but its full impact will be felt only in 1980.

The real increase in civilian imports (other than diamonds) was concentrated mostly in capital and consumer goods and to a lesser extent in raw materials. To some degree this development was of a temporary cyclical nature, and was not indicative of any long-run trend. This does not apply, however, to fuel prices: past experience shows that a downswing in the price of fuel relative to that of other imports is very slight, and no significant easing of the balance of payments strain is to be expected from this direction. The extra real foreign currency expenditure due to higher fuel prices in effect constitutes an external tax, which in 1980 will amount to some 8 percent of the economy's real income. This has important implications for the required demands and incomes (wages and profit) policies: the attempt to preserve the public's real income while forestalling the growth of unemployment, despite the impairing of real national income, is liable to nullify the efforts to resolve the balance of payments problem.

Exports forged ahead 4 percent in 1979 in real terms, about the same rate as the year before; excluding diamonds, the gain was 9 percent, only a shade below the long-run trend. Considering the conditions that prevailed in the world markets and the loss of the Iranian market, it can be said that exports more or less stayed in line with the long-term trend. But it should be stressed that because of the real increase in the import surplus a more vigorous export advance was needed.

The performance of exports was helped this year by the moderation of domestic demands (which caused producers to seek alternative markets abroad) and by the increase in the subsidy component of credit granted to exporters on concessionary terms. Various indicators show that in 1979 export profitability rose a notch relative to domestic marketing. Especially noteworthy is the fact that, in view of the hidden subsidy in directed credit, the exporting sector recorded a real decrease in per unit labor costs. The directed credit arrangements are designed to ensure sufficient financing for exports, and the large increase in the subsidy element was due to the sharp escalation of domestic inflation and the rise in world interest rates. The method of subsidizing export credit has several shortcomings: the size of the subsidy is a function of the rate of inflation and of monetary policy, which influences the alternative interest rates and hence is marked by a considerable degree of uncertainty. In addition, the allocation of credit is not related to export value added. Moreover, the expansion of credit proportionally to the nominal expansion of exports sharply pushes up its weight in total bank credit and thus leaves the Bank of Israel with less latitude in the conduct of an appropriate monetary policy.

GNP was up 5 percent in 1979, about the same as in the previous year. Economic activity accelerated at the beginning of the year but subsequently leveled off. Toward the end of the year there were even signs of some weakening, which intensified in early 1980. The year reviewed opened with expectations of a strong increase in economic activity. These expectations were fed by the boom in the housing market and by the anticipated start of the military redeployment in the Negev. Added to these expectations were the large amount of liquidity and the low real interest rates prevailing in the economy; these led to a sizable growth of employment and wages, private investment (especially in equipment and heavy transport vehicles), imports, and economic activity in general.

In the second half of 1979 the housing market began to lose vigor, and the anticipated growth of domestic demands in the wake of the military redeployment failed to materialize. In the course of the year the Bank of Israel took action to curb nondirected credit for the domestic market and to raise the real interest on such finance. In November further measures were introduced, the most important of which were the almost complete abolition of subsidies and the statutory limitation of nondirected bank credit. As a result, the performance of the economy in general and the construction industry in particular fell far short of expectations; in the latter part of the year there were signs of some softening of the labor market and expectations of a slowing of economic activity.

The GNP gain in 1979 can be attributed to the more buoyant domestic demands, part of which were diverted to imports. Resource use (exclusing direct defense imports) was up 7.5 percent, while civilian imports (exclusing rough diamonds) rose 14 percent. The faster growth of uses this year reflected a large inventory investment and the expansion of public residential construction and domestic consumption, while private consumption contributed less to the advance than in 1978.

The public sector helped to stoke domestic demands in 1979. After the government's demands had drifted down for three years running(in 1978 they still acounted for 32 percent of GNP), there was a 6 percent real upswing in 1979. This reversal of trend was chiefly due to a larger domestic defense bill and the expansion of public housing construction after it had sagged in previous years. Another factor was the appreciable 10 percent increase in real wages paid to public sector employees. Net revenue from taxes and property and entrepreneurial income shot up 28 percent in real terms. This can be credited primarily to the much greater consumption of consumer durables, the real increase in wages, the failure to adjust income tax brackets, and the erosion of part of the transfer payments. If we deduct from tax receipts subsidies in the form of the differential between the market rate of interest and the subsidized interest on nonindexed government loans, it turns out that there was hardly any increase in the amount of money siphoned out of the economy this year in real terms.

Gross domestic investment was 16 percent up on 1978, compared with a 3 percent growth the year before. There were hefty increases in imported machinery, earthmoving equipment, and trucks, and an especially steep rise in inventory investment. Residential construction also expanded, but nonresidential building slumped. The larger inventory investment was partly due to the unexpected slackening of economic activity, but the dominant factor was the income tax relief granted on inventories, which was designed to prevent the erosion of equity capital.

The housing market began to loosen up in the middle of the year; this affected private building starts, but was only slightly reflected in the data on total construction activity in 1979. This reversal of trend in explained by the financing difficulties experienced by potential buyers in the face of soaring home prices and by the fact that inflationary taxation squeezed contractors' profits. These developments led to the stabilizing and then a downturn in both the real price of homes and the volume of private starts. Subsequently the rate of financing relative to the total price of the home was raised and repayment terms made more convenient. But in the meantime public housing construction was greatly stepped up, with all its familiar shortcomings.

The interest rate on nonindexed loans was only slightly adjusted for the sharpening of inflation, and so the hidden subisidy in such loans swelled, creating a larger-than-planned differential between the price of investment to the economy and that to the individual investor, and thereby warping investment decisions. In addition, debtors enjoyed large capital gains in 1979 because of the unexpected exacerbation of inflation, and this gave a further stimulus to domestic demands. The government decided this year to value-link its loans and ration subsidized investment credit, but the lion's share of the investment made this year was still financed under the previous system. The changes introduced will undoubtedly lead to a better allocation of domestic investment, provided the Treasury corrects the distorting effect of recognizing indexation differentials as a deductible expense for tax purposes at the time they accrue and not when they are actually paid.

Private consumption was up 6 percent (after rising nearly 9 percent in 1978), while disposable private income edged down 1 percent in real terms and the private saving rate dipped. It is noteworthy that real disposable wage income rose this year and this unquestionably influenced consumption spending, as did the large unexpected capital gains earned by those owing nonindexed debts to the government. Trends in private consumption were mixed: purchases of durables, most of which were imported, rose by a daunting 34 percent this year, but the uptrend in the other items sagged, barely eclipsing the population growth rate.

The year reviewed witnessed a blunting of the monetary expansion of 1977-78, when there was a huge public sector liquidity injection and total bank credit and the public's portfolio of liquid financial assets swelled. The monetary squeeze in 1979 was the outcome of Bank of Israel policy measures and the mopping up of purchasing power through the balance of payments. At the same time the public sector's liquidity injection through its budgetary operations and the provision of directed export credit had an expansionary effect on the monetary aggregates. Bank of Israel policy placed the focus, as mentioned, on restricting the growth of nondirected bank credit while raising the real interest. The influx of short-term capital in the final months of 1978 was one of the major causes of monetary expansion, and so in April 1979 the Bank imposed a 12 percent interest surcharge on such capital imports. Assuming that the public does not expect an upvaluation of the real exchange rate, apart from random fluctuations, this in effect set the lower bound of the real interest rate on foreign currency credit at 12-14 percent. The interest on Israeli currency credit lagged behind that on foreign currency credit during the year reviewed, but the steps taken by the Bank of Israel made it very expensive for banks to expand credit, thus limiting the growth of nondirected credit in Israeli currency.

It can be said that since April the effective real interest rate on nondirected credit has been very high. The return on financial assets has not been raised proportionally, so that a large gap has been created between the interest on credit (12-14 percent) and that earned on assets (2-4 percent). This had a strong impact on the monetary aggregates during 1979, and especially toward the end of the year: it discouraged the accumulation of assets as a substitute for credit.

Besides the Bank of Israel, two other factors influence monetary developments: the government, through the excess of its domestic expenditure over its domestic income, and the balance of payments. The government did not pump any money into the economy in the first half of 1979, but between August and the end of the first quarter of 1980 it injected a large sum because of a heavier spending and the shrinkage of tax receipts.

The balance of payments had a contractionary effect this year. In the second half, and especially in the final quarter, the public greatly stepped up its purchases of foreign currency from the Bank of Israel, mainly because of the growth of the private sector's current account deficit (the desire to accumulate foreign currency and foreign debt repayment may have been secondary factors); this partially offset the expansionary influence of the public sector's liquidity injection.

In the second half of the year reviewed the economy began to lose momentum. One of the main reasons was apparently the curbing of nondirected credit and the hiking of the interest thereon. In November it was decided to further tighten credit by imposing statutory quotas on both Israeli and foreign currency credit. In view of the large government liquidity injection, these measures led to a sharp real contraction of nondirected credit. The principal fiscal policy measure in this area was the abolition of subsidies on numerous goods; the consequent rise in their prices temporarily eroded real wage income and apparently also depressed private consumption. But this failed to nullify the impact of the large amount of liquidity pumped into the economy as a result of the public sector deficit, which continued in the first months of 1980.

The activation of policy instruments was thus unbalanced: public domestic spending continued to expand in real terms throughout the year, generating a large liquidity injection. Monetary policy cannot by itself counter for any length of time the expansionary effects of the government's fiscal operations without leading to the overrestraining of the business sector in favor of the public sector. In addition, in Israel monetary policy is of only limited efficacy in fighting inflation and dampening demands, because of the linking of directed credit (which today accounts for about half of total bank credit) to the growth of exports: such credit automatically increases with a rise in exports, so that the scope within which monetary policy can operate effectively is limited to nondirected credit alone. What is more, the overwhelming weight of value-linked assets in the public's financial assets portfolio diminishes the Bank of Israel's ability to influence the nominal value of the portfolio as part of an anti-inflationary monetary policy. In order to balance the picture it must be said that were it not for the existence of value-linked assets at a time of rapid inflation, financial saving would fall off. These enable the public to invest its money in a way that provides a hedge against inflation, thereby averting a larger flight to the commodities market and helping to ease demand pressures.

Restoring the balance between the various economic policy instruments—that is, the adoption of a contractionary fiscal policy alongside monetary restraint and a proper incomes policy—is essential for attaining the economic goals: the toning down of inflation and reduction of the balance of payments deficit while avoiding unemployment and the excessive restriction of the business sector. The dimensions of the inflation and size of the current account deficit, together with the worsening of the country's terms of trade, have placed these problems at the top of the list of economic policy priorities.

A policy must be adopted that will temporarily slow economic activity for the domestic market by leashing public and private consumption and preventing investments that do not help to master the balance of payments problem. In the short run the cooling of economic activity helps to mend the balance of payments, mainly by curtailing imports and damping down inflationary pressures. In the longer run the braking of domestic economic activity makes it possible to change the structure of the economy so as to divert factors of production to the exporting sector. The required structural changes cannot be made under conditions of galloping inflation and a swelling public sector.

The government's ability to mop up more money from the public through taxes without aggravating inflation is limited because of the various indexation and compensatory devices. It is therefore extremely important to clamp down on the government's domestic spending in order to reduce the share of public services in total uses. Achievement of this objective necessitates a resolute policy of freezing, and even decreasing, public sector employment.

The indexing of long-term credit is an important step in ensuring greater selectivity in investment, but it must be complemented by the amendment of the tax laws and a reexamination of the capital investments law.

Incomes policy has a major part to play in blunting inflation. We have to diminish the role of inflationary expectations in determining money wages by adopting suitable compensatory arrangements. But no compensation should be paid for the

Table I-1

MAIN ECONOMIC INDICATORS, 1975-79

(*Percent annual increase unless otherwise stated*)

	1975	1976	1977	1978	1979
Resources and uses (in constant prices)					
Total domestic uses, excl. direct defense imports	1.2	1.9	3.0	5.3	6.6
Gross domestic product	3.5	1.8	0.8	5.0	5.4
Gross domestic product of the business sector[a]	3.1	1.0	-0.3	5.3	5.9
Real disposable private income[b]	-0.6	-7.5	7.6	8.1	0.9
Private consumption					
Total	0.6	3.9	4.2	8.6	6.1
Per capita	-1.7	1.6	1.9	6.3	3.5
Public consumption					
Total	10.0	-0.1	-13.1	10.9	-8.8
Thereof: Civilian consumption	4.6	5.5	2.9	5.1	3.3
Gross domestic investment	4.1	-12.2	-8.5	3.1	15.8
Public sector liquidity absorption[c] as a percent of GNP (in current prices)					
Balance of payments and international reserves (in $ billion)					
Imports	8.0	7.9	8.4	10.3	12.2
Exports	4.0	4.7	5.9	7.0	8.4
Import surplus	4.0	3.2	2.6	3.3	3.8
Foreign currency debt	7.6	9.4	11.1	12.9	15.0
Change in foreign exchange reserves	0.1	0.1	0.2	0.9	0.4
Population, employment, and wages					
Average population	2.3	2.3	2.3	2.2	2.5
Number of Israeli employed	1.5	1.3	2.9	4.5	2.3
Unemployment rate (as a percent of civilian labor force), absolute figures	3.1	3.6	3.9	3.6	2.9
Monthly earnings per employee post (current prices)	36.5	32.9	48.4	54.0	92.9
Prices					
Implicit price deflator for GNP (market prices)	37.8	26.9	42.5	54.2	78.0
Index of private consumption prices	40.4	28.8	36.2	53.7	78.9
Consumer price index (December levels)	23.5	38.0	42.5	48.1	111.4
Monetary (current prices)					
Money supply	31.0	17.8	39.9	37.6	34.1
Total liquid assets of the public	28.6	18.2	28.0	67.6	74.3
Bank credit to the public	79.1	32.7	54.9	91.9	90.2
Productivity and labor costs					
Productivity (product per manhour)[d]	-0.7	0.9	-0.9	1.3	1.1
Real wages per manhour[d]	-4.8	8.3	6.8	0.0	3.8
Real labor costs per manhour to employers[d,e]	-1.9	12.4	1.8	0.3	11.7

[a] Excluding residential rents.
[b] From domestic sources.
[c] Revenue from taxes and property and enterpreneurial income, less subsidies (excluding the imputed subsidy element in credit) and net transfer payments.
[d] Business sector.
[e] Excludes the subsidy element in export working capital credits. Inclusion of this item in 1979 would change the figure to 8.6.

rise in fuel import prices. Reliance on the harnessing of demands alone is liable to cause the economy to slide into stagflation—i.e. a growth of unemployment without any significant cooling of inflation.

Attainment of the economic goals—economic growth coupled with an improvement in the balance of payments and the slowing of inflation—therefore depends first and foremost on a consistent policy that will lead to the easing of public sector demands, a more stringent selection of investments, and a proper incomes policy.