Chapter 1

The Economy: Developments and Policies

The huge influx of immigrants from the Soviet Union was the outstanding feature of 1990. The number of immigrants—and with them forecasts for the future—rose throughout the year. So far 200,000 have come, and the most conservative forecasts are for at least double this number in the next two or three years. This immigration may well alter Israel's path of economic development, both because of its magnitude and because of the high educational (primarily technological) level of the newcomers. Once they are integrated into the country's business sector their contribution to productivity and economic growth will be considerable. But the process of integration is beset by difficulties, especially in the short run, presenting both the business sector and the government with an important challenge. It is in this context that the year's economic developments must be viewed.

The picture of 1990 which emerges from a variety of indicators is that the economy has taken a favorable turn. Economic activity is reviving after two years of recession; the business sector has responded to the upswing in domestic demand which focused on investment, and gross business product has risen by 6 percent, accompanied by a substantial productivity increase. In spite of this, inflation did not rise, and the balance of payments has maintained its surplus; in fact, the rate of price increase moderated somewhat (especially at the end of the year), while the external debt continued to decline, with a substantial drop in the debt/GNP ratio.

Table 1.1
Main Economic Indicators, 1986–90

	1986–90	1988	1989	1990
Growth rate[a] (percent change)	4.8	2.5	2.0	6.2
Total productivity[a] (percent change)	2.6	1.3	0.2	4.1
Unemployment rate (percent)	7.6	6.4	8.9	9.6
Balance of payments on current account ($ billion)	0.4	–0.7	1.1	0.7
National saving rate[b] (percent)	17	16	16	18
General government deficit (percent of GNP)	–1	–1	–4	–2
Inflation during year (percent change in CPI)	18	16	21	18
Nominal interest rate on short-term credit (percent p.a.)	33	32	34	23

[a] In business sector product.
[b] The denominator is GNP *plus* unilateral transfers (converted to NIS at the official exchange rate).

With respect to the challenge of immigrant absorption, however, the developments are disappointing. The labor market—the key to the solution of the employment problem which is the crux of the immigrant-absorption process—is inflexible. The market remained slack this year: the unemployment rate rose, but unit labor costs failed to decline. Thus, the rate of return on capital remained too low to induce the amount of investment needed to expand the economy's ability to absorb new manpower. The profitability of exports also failed to rise, and the upswing was not felt in these industries, which grew only moderately compared with previous periods of rapid economic growth. Lastly, housing construction expanded substantially, but still lags behind the requirements arising from the additional population, both those who have already arrived and those who are expected in the next few years.

Table 1.2
GDP and Aggregate Domestic Demand, 1987–90

(real annual change, percent)

	1987	1988	1989	1990
GDP	5.9	2.7	1.6	5.1
Private consumption	9.0	4.2	0.3	5.0
Public consumption[a]	3.1	3.6	0.6	1.9
Gross domestic fixed investment				
Nondwelling	14.9	-1.3	-9.1	17.0
Dwellings	8.3	2.2	7.0	17.5
Domestic use of resources[a]	6.4	3.3	-0.6	7.5
Exports				
Total	11.1	-1.6	3.9	2.2
Excl. diamonds, tourism, and exports to the administered areas	7.7	6.5	7.1	5.9

[a] Excluding direct defense imports.
SOURCE: Tables 2.1 and 2.7.

During the 1988–89 slump the business sector underwent a process whereby it increased its efficiency; together with the lower interest rates which have prevailed since mid-1989, this led to an upswing in domestic demand, particularly for investment. This new trend was reinforced both directly and indirectly by the influx of immigrants. The 200,000 newcomers who arrived in 1990 (most of them in the last four months of the year) increased the population by 1.5 percent (annual average). The immigrants made only a small contribution to the 5 percent increase in private consumption, but accounted for a large part of the 18 percent increase in residential construction. Government demand was also stepped up in order to supply services to the additional population. In addition, actual and forecast immigration created expectations of faster economic growth once the newcomers find employment. All these factors made firms more willing to invest and in fact fixed investment rose by 17 percent (after a decline of 10 percent during the slump). As a result of the over 7 percent rise in domestic demand and the initial results of the reorganization process, economic activity began to recover. GDP rose by 5.5 percent and business-sector gross product by over 6 percent, accelerating in the course of the year. Unlike in the past, exports did not contribute to incremental output, chiefly owing to the decline in tourism. (Exports—other than diamonds and tourism, which were affected by specific factors—rose by some 6 percent, slightly less than total business-sector product, and a very low rate compared with that of other years of recovery.)

The upswing in economic activity rested on a substantial rise in factor utilization, and total productivity rose by 4 percent, far beyond anything seen during the 1980s. Nevertheless, there is still unutilized capacity. The labor market continued slack: labor input grew by no more than 2 percent, more slowly than the supply of labor, so that the unemployment rate rose, reaching 9.6 percent. Moreover, most of the new immigrants have not yet joined the labor force, which is expected to grow in the next few years at an almost unprecedented rate.

The relatively slow pace of recovery is in part attributable to the Gulf crisis, which cast a shadow over the economy from the beginning of August. This had an adverse effect on incoming tourism (though merchandise exports also suffered) and also increased uncertainty in the region, deterring firms from investing. Furthermore, the process of adjusting to the new economic environment created by the 1985 economic stabilization program had evidently not yet run its course. Profitability, which had risen during the slump, was still not up to the level of the early 1980s, and there was no appreciable improvement during the year: unit labor costs failed to decline, after an exceptional rise in 1986 and 1987, and the rate of return on capital did not increase (Table 1.5). This is surprising in view of the fact that the unemployment rate has gone up and the labor supply is rising and is expected to continue doing so in the near future. Among other things, this situation reflected labor-market rigidities which have in the past confronted the business sector with severe difficulties and which are liable to hinder immigrant absorption. Another contributory factor was the course of prices, and its interaction with the development of wages.

Inflation, as measured by the Consumer Price Index (CPI), did not rise above the plateau reached in 1986. When housing (which rose disproportionately to other prices) and prices controlled by the government are excluded from the calculation, a slowdown is evident from all the relevant price indexes. Net of these components, the rate of price increase was checked, reaching an average of 11–12 percent (Table 1.3). This trend is primarily the outcome of the decline in the rate of increase of nontradables prices (other than housing), which outstripped the rise in tradables prices in the previous four years. This development is in tune with both the labor-market slack, which tended to curb nominal wage increases, and the absence of excess demand for nontradables (excluding housing). There was no pressure for these prices to rise faster than tradables prices, and both rose at the same rate, 11–12 percent, on average.

The increase in the prices of tradables is directly connected with developments in the

Table 1.3
Prices, 1987–90

(annual rate of change, percent)

	Average 1987–90	1987	1988	1989	1990
Business-sector wages per employee post	21.2	29.6	21.8	18.3	15.4
Consumer prices (CPI)					
All items	18.4	19.9	16.3	20.2	17.2
Excl. housing	16.9	20.4	16.1	17.8	13.4
Excl. housing and controlled commodities	15.8	21.3	16.2	14.4	11.6
of which Tradables	12.6	14.3	11.6	12.6	12.1
Nontradables	20.1	30.4	22.8	17.1	10.8
Business-sector gross product prices	17.0	18.4	18.5	18.4	12.7
Exchange rate[a]	10.2	12.3	2.4	16.1	10.6
Export prices	15.5	15.3	12.5	22.9	11.7
Import prices (excl. direct defense imports)	14.9	18.3	8.1	20.8	12.7

[a] Against the currency basket.
SOURCE: Table 3.2.

exchange rate and world prices of Israel's trade. Prices of tradables rose more slowly this year than in the last few years because world trade prices rose more slowly. The currency was devalued by 11 percent against the currency basket (which reflects the currencies of Israel's principal trading partners), thus continuing the trend of the last few years. (In 1990 the currency was devalued by less than in 1989, when the rate of devaluation compensated for the fixed exchange rate during 1988.) In the context of mass immigration, exchange-rate policy concentrated more than in previous years on the prevention of real appreciation rather than on reducing inflation. *Ex post*, as mentioned, in the business-sector the rate of increase of output prices slowed down, and no real appreciation developed.[1] In the housing market, however, where needs grew appreciably as a result of the increase in population, demand pressure built up and relative prices rose steeply for the second consecutive year. The housing market exhibits wide price swings as a result of its cyclical nature, arising from both the long production time involved and additional speculative demand for dwellings as investment.

The slowdown in the rate of increase of output prices was not utilized to reduce inflation. On the one hand, the government failed to adjust controlled prices to the declining trend (controlled goods rose by 19 percent this year, while public services wages rose by 18 percent). On the other, the demand for dwellings led to a 34 percent increase in their prices. Thus the CPI rose by about 17 percent, similar to its average increase in the last four years.

[1] Note that business sector output does not include imputed housing services. Moreover, an increase in the price of housing (most of which is owner-occupied) should not be interpreted as detracting from business-sector competitiveness abroad.

One might remark here that the CPI does more than merely show the rise in the price of the average consumption basket. Because it is published monthly and has proved reliable over many years, it serves as a benchmark for many economic agents. Since the CPI did not register any slowdown, expectations of inflation persisted, preventing the decline in the rate of inflation from spreading to other sectors. The increase in the CPI for the last quarter of 1990 and the beginning of 1991 does however indicate some moderation of prices, providing favorable conditions for bringing the underlying rate of inflation below that of recent years. A necessary condition for achieving this is keeping the rates of increase of the exchange-rate, government-controlled prices and wages, and business-sector wages low. The expected increase in the labor supply arising from mass immigration should help to increase the flexibility of the labor market, making it possible to reduce inflation without impairing profitability.

Table 1.4
The Labor Market, 1986–90

(annual rate of change, percent)

	1986–90	1988	1989	1990
Israeli employed persons				
Business sector	2.2	3.2	0.0	2.0
Public services	1.7	4.2	1.9	2.3
Unemployment rate	7.6	6.4	8.9	9.6
Real average wage[a]	3.9	6.0	−1.3	−0.9
Of which Business sector	4.0	4.7	−1.6	−1.5
Labor productivity, business sector	3.9	2.2	0.6	3.8
Unit labor cost, business sector[b]	0.3	−2.2	−1.0	0.2

[a] Deflated by the CPI.
[b] Deflated by the implicit price index of gross business-sector product at factor cost.
SOURCE: Tables 4.3 and 2.2.

The rate of increase of nominal wages again moderated this year, especially in the business sector, continuing the trend that started after the 1985 stabilization program. This trend was reinforced by the high level of unemployment, and possibly also by the threat of the potential increase in supply. In 1990, before most of the new immigrants had entered the labor force, the labor supply grew by 3 percent, and will continue to grow significantly in the future. Real wages from the employee's (consumer's) viewpoint fell only slightly, however. The limited responsiveness of salaries to market forces, and to the unemployment level in particular, is due to the unionized and institutional structure of this market in Israel. The strength of the unions, which influence wage-determination while giving scant regard to the job opportunities of the unemployed, and interindustry wage linkages, which prevent the differential development of wages in response to demand, mean that even when wages respond, they do so slowly and not in full.

Despite the decline in real wages there was an increase in real labor costs, since output prices rose by less than the CPI and wages. This may be the result of a mistaken assessment by the parties to wage-bargaining of the rise in the relevant prices, since the calculation was based as usual on the CPI. In any event, a gap of 7 percentage points between the consumer and producer price indexes —as was created this year—heightens the natural tension between employee and employer, leading to wage claims on the one hand, and unwillingness or inability to pay higher wages on the other. One third of this year's gap was due to fiscal policy, which consisted of reducing subsidies and raising taxes.

Table 1.5
Some Determinants of Business-Sector Profitability, 1981–90

(percent)

	1981–84	1986	1987	1988	1989	1990
Annual rate of change						
Wholesale prices						
United States relative to Israel	0	–15	–9	–11	6	–1
Europe relative to Israel	–8	11	4	–8	–3	10
Unit labor costs	1	6	4	–2	–1	0
Annual average						
Gross rate of return on capital	13.5	11.7	10.7	11.9	12.2	12.3
Tax rate on nonwage income[a]	25	32	31	30	26	26.5
Net indirect tax rate	4	11	11	10	11	12
Real interest rate						
Short-term (average)[b]	14	10	17	11	13	9
Overdraft facilities[b]	21	35	39	23	11	15
Real yield to maturity of bonds[c]	2	6	4	4	2	1

[a] Percent of nonwage income.
[b] Deflated by the implicit price index of business-sector product at market prices.
[c] Five-year government bonds indexed to the CPI.
SOURCE: Tables 2.2, 6.7, 7.2.

Real labor costs rose by more than labor productivity, checking the rise in profitability which had started in 1988, and preventing a return to the level of the early 1980s. This deterred firms from investing and expanding, and hampered economic growth. The contribution of fiscal and monetary policy to improved profitability was ambiguous in 1990. On the one hand, long- and medium-term real interest continued to decline, helping to make investments more profitable. On the other, although nominal interest remained below the 1989 average, the cost of short-term credit rose because of the unexpected decline in the rate of increase in output prices. Average net indirect taxes and the tax rate on nonwage income rose (Table 1.5), also impairing profitability. The endemic uncertainty increased as a result of events in the region as well as the unpredictability of immigrant absorption, thereby reducing the profitability of investments. The government did not do enough to reduce the uncertainty faced by the business sector, and indeed sometimes increased it by its own inconsistency.

As stated, the failure of business-sector profitability to improve was accompanied by a rise in the profitability of housing construction. The expansion of this sector was hampered by several bottlenecks, principally in labor supply. Many building workers come from the administered areas, and their participation was restricted by the authorities, particularly as a result of events at the end of 1989. Nonetheless, investment in housing grew on average by about 18 percent in 1990, accelerating during the year, and contributing appreciably to the increase in activity. Over and above this, building entrepreneurs appear to have been hesitant, responding slowly to expanding residential needs. This sluggishness was apparently due to the fact that the immigrants were not yet in a position to purchase apartments, and also to the government's involvement policy, which changed several times during the year, generating uncertainty and perhaps expectations of larger incentives in the future. The rise in housing investment was largely initiated by the government, public investment increasing by a steep 184 percent, while that of the private sector hardly rose at all.

Table 1.6
Balance of Payments, 1986–90

($ billion)

	1986	1987	1988	1989	1990
Current account	1.7	–0.9	–0.7	1.1	0.7
Import surplus	3.8	5.8	5.2	3.8	5.1
Unilateral transfers	5.4	4.8	4.5	4.9	5.8
Civilian import surplus	2.6	3.3	3.1	2.5	3.6
Civilian imports	14.8	17.6	19.0	19.9	22.6
Exports					
Total	12.1	14.3	16.0	17.4	19.0
Excluding diamonds and tourism	9.5	10.9	11.9	12.9	14.6

SOURCE: Tables 6.3, 6.11.

In other industries the relative profitability of the local market and exports remained constant. This reflects a wide variation in the profitability of sales to different countries because of changes in cross rates; the profitability of exports to Europe increased greatly, while it fell with regard to the United States. The change in relative profitability does not indicate any trend, however, and was in fact reversed in the first months of 1991. Exports—net of diamonds, which are influenced by changing conditions, and the adverse effect of events in the Gulf—increased by more than the expansion of world trade (6 percent compared with 4 percent). Hence, Israeli exports managed to increase their share of world trade to some extent. But in contrast with previous instances of emergence from a slump, in 1990 exports did not increase beyond their average rate in recent years, despite the unemployment, increased labor supply, and reorganization within manufacturing industry. There was no change in the profitability of production for export, after the improvement of the previous two years resulting from the streamlining process.

Total exports, including tourism—which was badly hit by events in the region—slowed down appreciably this year, leading to an increase in the import surplus. This also reflects the growth in imports, which was a response to the upswing in local demand. Nonetheless, in 1990 the import surplus fell short of unilateral transfers, which rose this year because of increased immigration, so that there was a surplus on current balance of payments account. The increase in demand has not yet been expressed as a current account deficit; the rise in private consumption was accompanied by a drop in private saving, and since the latter was less than the rise in public saving, national saving has grown. Increased investment was funded in part by an increase in national saving, and in part by capital inflow from abroad. Since the current account is now almost balanced, a large increase in investment which does not come from saving will be expressed in the future as a deficit. The huge volume of investments required for the absorption of mass immigration will make large-scale foreign borrowing necessary, thereby increasing the national debt. The continued decline of the debt/GNP ratio to date has created relatively favorable conditions for increasing it, which will be necessary in the future.

Table 1.7
The Rate of Saving, Investment, and the Current Account, 1981–90[a]

(percent)

	1981–85	1986–87	1988	1989	1990
Gross saving					
General government	–4.7	3.2	1.5	–1.8	0.4
Private	22.3	14.6	14.2	18.2	17.3
Total	17.6	17.7	15.7	16.4	17.7
Gross investment	19.2	16.6	16.1	14.5	16.5
Current account balance	–1.6	1.2	–0.4	1.9	1.2

[a] The denominator is GNP *plus* unilateral transfers.
SOURCE: Table 2.6.

The gradual relaxation of currency control (employing a wide variety of measures) has accompanied the reduction of the external debt/GNP ratio. Interest in Israel and abroad has been linked more closely, apparently helping to reduce interest rates in Israel and narrow the interest-rate spread. There has been a parallel increase in capital inflow to Israel, especially towards end-year. This inflow, due in part to the increase in imports and the growing private sector deficit, has contributed to the growth in foreign reserves.

Speculative short-term capital movements were also in evidence during the year, though they were smaller than in the past. The policy of permitting the exchange rate to fluctuate within a band appears to have proved effective in restricting capital movements of this kind, which had caused instability in the financial markets in the past. The fluctuation of the exchange rate within the band, which was affected by capital movements, eased the pressure on short-term interest, so that it fluctuated less, together with smaller fluctuations in the money supply. In addition to its movement within the band, the midpoint exchange rate was raised twice during the year,-by 6 percent in March, and by another 10 percent in September. This combination of devaluation and movement within the band amounted to an actual devaluation by 11 percent vis-à-vis the currency basket, and by no more than 5 percent vis-à-vis the dollar (annual average). In March 1991 there was another 6 percent realignment.

At the same time, the object of monetary policy was to maintain average nominal interest at its rate during the second half of 1989, which was significantly lower than that which prevailed after the stabilization program. The aim of this policy was to further the resumption of economic growth while preventing the rate of inflation from increasing. Thus, monetary aggregates and credit were allowed to expand in response to demand; they rose slightly more than the increase in nominal transactions, with an upward deviation in the second half of the year. Part of the expansion of the monetary aggregates was due to the fact that the public deficit was financed to a greater extent by money creation than by domestic borrowing. This deficit financing mix reinforced the decline of long-term interest rates, particularly in the second half of the year, despite the increase in the government deficit. This kind of financing cannot be maintained for long, however, since it pushes monetary aggregates up while expanding the interest-rate spread, and this conflicts with the expected path of the government deficit. The latter will remain relatively high in the immediate future, and neither can nor should be financed largely by money creation.

The public deficit was influenced by the combination of expansionary effects arising from the absorption of immigrants with an increase in tax receipts due to economic expansion and a contractionary fiscal policy. Contractionary influences were dominant, so that the deficit was considerably reduced, reaching the low level of 2 percent of GNP.

The structure of the budget, as regards both expenditure and taxes, reflects a change in government policy. This arises from the concerted effort required to absorb the influx of immigrants, although rather less was done than was called for. The direct budgetary requirements for absorbing large numbers of immigrants necessitate a radical revision of priorities, and this has not yet been done. To date, the change has consisted primarily of an increase in direct expenditure on absorption. This includes the provision of both an absorption grant and such public services as education and medical care for the additional population. At the same time, steps were taken to increase tax rates in order to increase government revenues, with the object of preventing excessive growth of the deficit.

Nothing was done in 1990 to improve the infrastructure, which has been seriously neglected during the last decade and whose expansion would contribute greatly to business-sector growth. The proportion of GNP devoted to infrastructure investment has declined, both in government investment (roads) and by public sector corporations. The bottom line of the budget shows that the deficit (2 percent of GNP) was low considering

Table 1.8
Monetary Indicators, 1987-90

(percent)

	1987	1988	1989	1990
Monetary aggregates (average change)				
M1	61	33	26	30
M2	73	29	18	27
M3	37	21	20	24
Short-term bank credit	37	25	24	20
Nominal interest				
SROs (CDs)	13	13	12	13
Short-term bank credit	39	32	34	23
Foreign credit[a]	7	8	9	8
Nominal GDP (average rate of change)	27	23	23	22
CPI (average rate of change)	20	16	20	17

[a] Three-month Eurodollar rate.
SOURCE: Tables 7.1, 7.3.

the absorption of immigrants, which justifies a temporary departure from a level acceptable for long-run stability. (In fact, for the current fiscal year the government has set a limit of about 5 percent of GNP.) Within that budget constraint the economic situation could have been improved, by expanding the infrastructure or reducing tax receipts.

Nonetheless, this year's deficit does not reflect the full extent of involvement decided on by the government, and embodies a commitment to future deficits. This can be inferred from decisions already taken concerning government guarantees, buy-back guarantees, and budget-funded construction begun at the end of the year. These decisions bring out the *ad hoc* nature of annual budgets, clearly indicating the need to draw up budgets covering several years. Moreover, the absorption of immigrants is consistent with a deficit path which rises in the first few years, then gradually falls back (since some of the expenditures are temporary, and tax receipts are expected to increase as economic activity picks up). The temporary increase in the deficit can be justified only if the path is mapped out over time, and it is therefore important to ensure that the government adheres to it. One way of doing this is by legislation of one kind or another, which will increase economic stability and facilitate borrowing abroad.

Part of the deficit incurred by the government in the absorption of immigrants can be regarded as an investment, since once the immigrants are integrated output will grow, the tax base will expand, and budget surpluses will be possible at existing tax rates. The absorption of immigrants is not entirely without risk, however, bearing in mind the uncertainty regarding their number and the suitability of their occupational and educational composition for the country's economic growth. Only if their integration succeeds, and they become productive in a way which utilizes their human capital, will it be justified to regard expenditure on their absorption as an investment. If we fail in this

Table 1.9
General Government Deficit, 1980–90

(percent of GNP)

	1980–84	1986–87	1988	1989	1990
Total deficit (–)	–11	2	–1	–4	–2
Domestic deficit (–)	–11	–1	–2	–6	–5
Domestic revenues	48	51	49	46	46
Direct domestic demand	34	30	30	30	29
Other domestic expenditures[a]	25	23	21	22	21
Deficit financing[b]					
Net money creation[c]	2	1	–6	0	3
Net domestic borrowing	3	–2	1	6	0
Net foreign borrowing	6	–2	5	–4	–1

[a] Includes direct subsidies, credit subsidies, transfers to households, and real interest payments. For details see Table 5.2.
[b] Includes errors and omissions (see Table 5.1).
[c] Net of the profit from the discount-window loan.

undertaking, government deficits and unemployment will persist. The government must do everything it can to maximize the probability of success, while not being too lax in permitting the creation of present and future budget deficits. The financing of increased government spending on the absorption of immigrants requires the reorganization of the budget as regards priorities and expenditures.

Apart from the fiscal aspect of immigrant absorption policy, the government also has an important role to play in generating macro-economic conditions which will enable the business sector to rise to the challenge. What has been done so far is too little and too late. Reports of the impending influx of immigrants began to arrive in mid-1989. Although the initial numbers predicted were far lower than those current today, preparations should have been made in view of the supply-side problems and the rigidity of the labor market, both of which impede the occupational integration of immigrants. Despite public awareness of these problems, they were tackled only after delays, and it was not until September 1990 that the government adopted a program designed to meet the challenge. This comprised elements which were conducive to increasing the flexibility of the labor market, liberalizing foreign trade and capital movements, and introducing some tax reform. Not enough has yet been done to gain the Knesset's approval and to implement these steps, so that new initiatives keep coming up, generating uncertainty as to government policy. This lack of consistency is partly responsible for the slow response of the business sector. The pace of employment is sluggish, lagging far behind the growing supply. The rate of growth of investments is also insufficient to meet the needs of absorbing immigrants in employment. There is no substitute for a comprehensive program which is carried through coherently and consistently, thus sending an unambiguous message to the private sector.