CHAPTER I

THE ECONOMY: DEVELOPMENT AND POLICIES

In 1981 economic activity picked up and the rise of prices was slowed. The recovery of the economy began around the middle of 1980, and was felt most strongly until the middle of 1981 in several major areas: total uses (excluding direct defense imports) increased 6 percent after shrinking the year before, the gross domestic product[1] rose 4 percent, and industrial production moved ahead 5 percent after sagging in 1980. Employment grew 2 percent, but unemployment ran at around 5 percent, similar to the 1980 rate but higher than its 1979 level of 3 percent.

The acceleration of inflation, which began in 1978 and reached its peak in 1980, was checked in 1981, when the consumer price index rose 101 percent during the year compared with 132 percent in 1980. This was achieved by increasing subsidies and cutting indirect taxes, two steps that swelled the government demand surplus.

The import surplus rose by about $500 million, but excluding direct defense imports, it held steady this year. Unilateral transfers to the private and public sectors, which have been fairly constant since 1979, financed 65 percent of the import surplus, while long- and medium-term capital movements and foreign advances paid to suppliers in previous years for defense items imported in 1981 covered nearly all the balance.

The better tone of the economy in 1981 was reflected, as stated, in uses and the national product. In uses the most striking development was a 10.5 percent growth in private consumption, after it had fallen 3 percent the year before; fixed investment expanded 2 percent following a 10 percent cutback in 1980; and exports continued to gain ground, paced by nondiamond industrial goods.

The volatility of GNP in the last two years mainly reflected the sharp fluctuations in private consumption. This in turn was due primarily to changes in disposable income and the public's expectations regarding the government's policies and their effect on future income; after declining 3 percent in 1980,

[1] In recent years there has been a significant difference between the measurement of GNP according to sectoral origin and a measurement from the uses side, with the former showing a deeper slump in 1980 and hence a faster recovery in 1981. For analytical purposes we have therefore prefered to use an average of the two estimates in recent years. For more details see Chapter II.

Table I-1

MAIN ECONOMIC INDICATORS, 1976-81

(Percent annual increase unless otherwise stated)

	1976	1977	1978	1979	1980	1981
Resources and uses (in constant prices)						
Total uses, excl. direct defense imports	1.7	3.0	5.0	6.2	-2.3	5.8
Gross domestic product	1.4	1.0	4.4	3.7	2.7	4.2
Gross domestic product of the business sector[a]	0.5	0.0	4.5	3.5	3.0	5.3
Real disposable private income[b]	-3.1	7.5	8.1	1.4	-0.8	14.2
Private consumption						
Total	4.3	4.2	7.4	7.1	-3.2	10.5
Per capita	2.0	1.9	5.1	4.5	-5.5	8.5
Public consumption						
Total	-10.4	-13.5	12.1	-8.7	7.6	7.7
Excl. direct defense imports	-5.2	-1.6	2.5	1.9	1.7	2.8
Thereof: Civilian consumption	5.5	2.9	5.4	2.3	0.0	1.3
Gross domestic investment	-11.0	-11.7	5.1	13.9	-9.6	2.1
Public sector liquidity absorption[c] (as a percent of GNP in current prices)	25	22	20	24	23	18
Balance of payments and international reserves (in $ billion)						
Imports	7.9	8.4	10.3	12.5	14.3	15.6
Exports	4.7	5.9	7.1	8.6	10.4	11.2
Import surplus	3.2	2.5	3.3	3.9	3.9	4.4
Foreign currency debt[d]	7.7	8.8	9.5	11.1	12.0	13.1
Change in foreign exchange reserves[e]	0.1	0.2	0.9	0.3	0.2	0.1
Population, employment, and wages						
Average population	2.3	2.3	2.2	2.5	2.4	1.9
Number of Israeli employed	1.3	2.9	4.6	2.3	1.1	2.0
Unemployment rate (as a percent of civilian labor force), absolute figures	3.6	3.9	3.6	2.9	4.8	5.1
Monthly earnings per employee post (in current prices)	33	49	54	90	126	138

[a] Excluding imputed residential rents.

[b] From all sources.

[c] Revenue from taxes and property and entrepreneurial income, less subsidies (excluding the imputed subsidy component of credit) and net transfer payments.

[d] Gross foreign currency liabilities, less net foreign exchange reserves in the Bank of Israel and liquid assets in other financial institutions.

[e] Net reserves at the Bank of Israel, including investment of the appreciated value of foreign currencies in relation to the dollar.

Table I-1 (cont.)

	1976	1977	1978	1979	1980	1981
Prices						
Implicit price deflator for GNP (at market prices)	27	43	57	83	129	126
Index of private consumption prices	28	36	54	79	129	118
Consumer price index (December levels)	38	43	48	111	133	101
Monetary (in current prices)						
Money supply	27	39	45	31	102	78
Total liquid assets of the public	26	69	59	83	151	101
Bank credit to the public[f]	37	74	80	101	110	83
Productivity and labor costs (in constant prices)[g]						
Productivity (product per manhour)	2	1	2	0	2	3
Real unit labor costs	10.3	6.1	2.6	7.0	8.2	-0.8

[f] The change in 1979-81 according to a revised definition (excluding credit for oil imports).
[g] Business sector. (The product was calculated using an average of two estimates: by sectoral origin and a measurement from the costs side.)

disposable income per capita rose 12 percent in the year reviewed. This pattern is largely explained by the shifts in taxation and subsidization policy in the last two years. The policy introduced at the end of 1979 hastened the slide into recession at the beginning of 1980 and drove unemployment up to 5 percent. This policy, designed to halt the erosion in the balance of payments, included both fiscal and monetary measures: the total or partial desubsidization of basic items (food, transport, fuel, and electricity), the reduction of public sector personnel, and a tight credit squeeze. The rise in the prices of subsidized items depressed disposable income, and the public gained the impression that the government was determined to persist in its policy of restraint. This exacerbated the public's pessimistic expectations regarding future income and employment opportunities, and goes a long way to explain the noticeable sagging of private consumption and employment in the early months of 1980. Private consumption fell even more than was warranted by the decline in disposable income. In the event, the recession was short-lived, and in the course of the year private consumption and economic activity gradually turned up, but this did not lead to any reduction in unemployment. A telling factor in the recovery was apparently the fading of expectations that the government would continue its stringent fiscal policy.

At the beginning of 1981 there was an abrupt change in policy: In order to cool inflation, the government lowered inordinately high indirect taxes levied on numerous consumer goods, especially durables, and increased the subsidy on basic items. To stimulate economic activity and redress somewhat the erosion of income tax brackets since the tax reform of 1975, it reduced income tax rates. These measures, along with a real increase in public sector wages and salaries (after their decline in 1980), caused disposable income to rise 6 percent faster than GNP. The precipitate upturn in disposable income, together with the compensatory response of private consumption to its over-contraction in 1980, led to an unprecedented swelling of private consumption. The steepest increase was recorded in consumer durables, which are highly sensitive to shifts in income, and their relative price fell.

Total employment in the economy grew 2 percent in 1981, compared with less than 1 percent the year before. In public services the increase came to 3.5 percent, as against 1.5 percent in 1980, while in the business sector the level rose 1.5 percent, after edging up a mere 0.5 percent in the previous year. In 1980 employment expanded more slowly than the labor force, with the consequence that the unemployment rate rose from 3 percent to 5 percent. In 1981 employment grew to the same extent as the labor force; the labor market therefore continued to be weak and unemployment was not reduced. Real wages and salaries shot up 10 percent this year in purchasing power terms, while employers' real unit labor costs in the business sector drifted down 1 percent, as the price of the consumption basket went up more sluggishly than the business sector product at factor cost. The slight drop in labor costs explains why the unemployment rate remained stationary this year despite the sharply higher real earnings per employee.

The import surplus increased $500 million in nominal terms, with all the increment being in defense imports, which display sharp year-to-year changes. Most of these imports were financed with U.S. aid funds, and hence they were not influenced by current economic developments.

After doubling between 1977 and 1980, net capital imports shrank $100 million in the year reviewed due to the jump of interest rates in the world money markets. The higher interest rates earned Israel a larger income from the investment of its international reserves, but had only a marginal effect on interest expenditure on foreign currency liabilities, since most of the outstanding loans were given on concessionary terms and at a time when the going interest rate was lower than at present.

The deterioration in the country's terms of trade caused by the second oil price shock of 1979-80 was reversed this year. Together with the strengthening of the dollar against European currencies, this lowered import and export prices in dollar terms and reduced the import surplus (also in dollar terms).

Overseas commodity sales excluding diamonds moved ahead 12 percent this year, an impressive performance considering the deepening slump in international trade and the fall in the prices received by the exporter in European markets (in dollar terms). The rising export trend is explained by the growing maturation of investments, notably in science-based industries, as well as the increased export of noncivilian goods, most of which are produced by the metal and electronics industries.

Imports expanded 7 percent in 1981, owing primarily to the decline in their relative price and a sharp upturn in domestic uses, especially private consumption. However, the volume of imports was still smaller than warranted by the level of economic activity and the demand mix, as there was a continued heavy running down of stocks, especially diamonds.

The civilian import surplus remained at its 1980 level in current dollar terms; however, discounting the price effect described above (i.e. in constant price terms), it grew by about 25 percent, but was still 55 percent below its 1979 level. A quantitative growth of the import surplus implies that domestic uses expanded faster than the national product. Consumption accounted for the overwhelming share of incremental uses this year, whereas domestic investment did not vary significantly. In other words, the change in the import surplus was associated with a decline in national saving.

Inflation was leashed somewhat in 1981, as already pointed out. This can be mainly credited to the direct action taken by the government to brake the advance of prices, but it was also influenced by the growth of GNP, the relative decline in import prices, and the credit squeeze policy. To slow the spiraling of prices and alter the public's inflationary expectations, the government decided at the beginning of 1981 to subsidize controlled goods and services more heavily and to lower indirect taxes on numerous products. These steps dampened the rise of some prices in the first half of the year. In addition, the resulting growth of the government's demand surplus did not find expression during this period, for two reasons: the lagged disbursement of the subsidies, and a larger collection of indirect taxes on those consumer durables whose price was reduced and whose purchase was advanced because of the announcements that the tax cuts were only temporary. Another reason for the cooling of inflation was the continuation of the tight credit policy introduced in 1980. These factors combined to slow the rise of the consumer price index from a 143 annual rate in the second half of 1980 to 94 percent in the first half of 1981.

In the last six months of the year reviewed the absorptive effect of the indirect tax reductions ran its course and the government began its disbursements on account of the basic product price supports. As a result, the liquidity injection stemming from the public sector demand surplus soared 130 percent in real terms over its level in the first half of the year. The real demand surplus for the year as a whole was double the 1980 figure. The upturn in the public sector's demand surplus in the middle of 1981 and the renewed slashing of subsidies on controlled items in September caused inflation to speed up in the second half of the year: the consumer price index gradually picked up momentum, reaching a 109 percent annual rate during this period, in contrast to 94 percent in the first half (however, as stated, this was still lower than in the same period in 1980).

Over the year as a whole, the various price indexes point to the arresting of the escalation of inflation that had been evident since 1978. But this change of trend was relatively short-lived, and in the second half of the year, as stated, prices again began to move up at a faster rate. A large part of the demand surplus was financed through the public's purchase of financial assets; this increased its net financial wealth by 15 percent in real terms, after a formidable growth in the previous year as well. The expansion of the public's financial assets portfolio in the last two years exceeded the long-run trend, and is liable to inhibit the effort to curb inflation in the future and to mend the balance of payments.

The government cannot continue to bear such a heavy subsidy burden if it is to avoid a distorted allocation of resources, and also because of the expansionary effect it has on the demand surplus. A domestic demand surplus of this year's magnitude prevents the continued harnessing of inflation and its convergence to a lower level. A sustained reduction of the inflation rate therefore hinges on a significant contraction of the public sector's domestic demand surplus.

The sizable increase of this surplus and the resulting liquidity injection made it necessary to persist in the stringent monetary policy. For the third year running the Bank of Israel concentrated on restricting the expansion of bank credit, nondirected (free market) and directed alike, in line with the inflation and economic growth targets. As a result, the volume of credit shrank further this year, although much more slowly than in 1980.

The principal monetary policy tool in countries with efficient money and capital markets is open-market operations in government bonds. This helps to determine the composition of the financing of the demand surplus, and in this way the government and central bank directly influence the monetary base and the public's assets portfolio mix. In the absence of such an efficient and flexible tool, the Bank of Israel has focused on bank credit as its chief monetary instrument. It should be stressed, however, that this alone is incapable of countering all the expansionary effect of a sizable government demand surplus such as that in 1981. Moreover, monetary policy cannot serve as a perfect substitute for fiscal policy: it can only complement it in achieving the economic objectives.

The larger government liquidity injection this year, coupled with an improvement in saving terms, led to a much greater accumulation of financial assets by the public: its total holdings expanded, and its net financial wealth swelled even more. The public's financial wealth has been growing for several years, surpassing the growth of physical wealth. In a period of high inflation the existing system of taxation also encourages the purchase of financial assets and financial activities funded by credit, and their preference over productive investment. It is to be hoped that the enactment of the proposed law dealing with taxation under inflationary conditions and its full implementation will protect equity capital against erosion in a period of rising prices and encourage productive investment more than financial investment. Such a reform is also likely to help narrow the existing differentials between the real interest rates (after tax) on credit granted to the various economic units.

The main economic policy target is sustained growth along with the bolstering of the balance of payments. Continued rapid growth requires the stepping up of domestic investment, and this, together with a structural improvement in the balance of payments, can be achieved only if saving is increased. In other words, policy must ensure that consumption (private and public) does not outpace the expansion of GNP, so that the requisite resources can be diverted to increasing capital formation and strengthening the balance of payments. The success of such a policy depends first and foremost on the reduction of government spending and a substantial narrowing of the gap between its expenditures and tax revenue. The government must gradually diminish its reliance on the capital market for financing its outlays, thereby making more capital available for financing business sector investment.

In 1981 the private saving rate rose appreciably, but this was accompanied by the growth of disposable income and private consumption. Because of the government's tax and subsidy policy, especially in the first half of the year, disposable income expanded faster than GNP. It is reasonable to assume that the public looked on the subsidization-related increase in its income as a temporary phenomenon, and so the growth of private saving (which will largely be channeled to the various types of financial assets) should not be regarded as a change in the public's saving behavior.

Total saving did not increase this year, for the government's demand surplus swelled to undesirable proportions. The domestic demand surplus, defined as the difference between the government's domestic expenditures (mainly on consumption) and its tax revenue, doubled in real terms compared with 1980. An expanding government demand surplus implies a mounting negative contribution to national saving: the economy's total saving relative to its income declined this year from 14 to 10 percent in gross terms and from 8 to 3 percent net of discards.

To reach the targets set it is therefore essential to conduct a fiscal policy that will ensure a decline in the weight of the government demand surplus in GNP, or in other words, a growth in public sector saving. Because of the large weight of taxes in GNP it would be undesirable to reduce the demand surplus by stiffening taxes. In fact, thought should be given to lowering direct tax rates, including national insurance contributions, which in effect are a tax on labor. It should be borne in mind that such taxes are a component in the direct and indirect cost of labor to employers; hence their reduction is likely to increase employment while making domestically produced goods more competitive and easing pressure on prices from the costs side. The problem of shrinking the public sector demand surplus should be tackled from the expenditure and not the income side: government spending, including both consumption and transfer payments, must be pruned. It should be reemphasized that the resumption of economic growth and closing of the balance payments gap depend on the expansion of national saving, or to be more precise, on reducing the government's dissaving.

The cooling of inflation while creating the proper conditions for a renewed improvement in productivity, ensuring sustained economic growth, and strengthening the balance of payments are Israel's main economic goals. To achieve these requires a balanced, consistent application of monetary policy measures designed to prevent, as far as possible, shocks and undesirable fluctuations in economic activity. The government's budget policy, with respect to expenditures and tax revenue alike, is the main ingredient in overall economic policy; if the budget deficit is not significantly trimmed, the economy will find it hard to return to a growth path without aggravating the balance of payments problem. In addition, a contraction of the government's demand surplus would make it possible to ease the credit squeeze and bring down real interest rates, thereby stimulating productive activity. The government must increasingly cover its expenditures from tax receipts, and reduce its resort to the capital market as a source of financing. Domestic saving must be used for expanding the economy rather than financing the government's current activities. The withdrawal of the government from the capital market would also enable the Bank of Israel to operate more efficiently in the open market, thereby allowing this instrument to play a central role in monetary policy.