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Israel: Poised For Take-Off?

by Augusto Lopez-Claros

- The Israeli economy is at a critical crossroads. Having made impressive progress in the past decade in laying the foundations of a stable macroeconomy, with a diversified productive structure and a growing presence in international markets, it is now necessary for the government to move forward with a range of measures and policy reforms that will allow Israel to enter a period of sustained economic expansion.
- The renewed impetus to the peace process given by the new government could well result in the negotiation of credible security arrangements in the region. If successfully carried out, this is likely to have lasting beneficial effects on the economy. A key source of uncertainty for long-term investment will have been removed and this should boost growth prospects. With a lasting peace settlement in place, the scope for a gradual reduction of the burden of defense expenditures on the budget should increase, creating opportunities for well-targeted public investments.
- Having announced a cautious inflation target for the 2000-01 period, the government and the Bank of Israel now need to seek to bring inflation down to average EU/OECD levels by 2002 at the latest and, along the way, move forward with the implementation of difficult but necessary structural reforms that will secure the financial viability of the pension system, deepen the capital markets and, more generally, improve resource allocation. To strengthen policy coherence it would be desirable to revise the Bank of Israel Law, along the lines proposed by the Levine Committee.
- The recovery of output must take place within a cautious medium term financial framework involving further narrowing of the budget deficit but the government must also proceed with tax and expenditure reforms aimed at correcting some distortions in the tax system and, more importantly, improving the structure and composition of budgetary expenditures.
- Progress in each of these areas is likely to strengthen the pace of economic recovery underway and, in combination with a broadly favorable external environment, could well foreshadow the beginning of a period of rapid economic growth, in keeping with Israel's long-term potential.

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Israel: Poised For Take-Off?

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- **The renewed impetus to the peace process given by the new government could well result in the negotiation of credible security arrangements in the region. If successfully carried out, this is likely to have lasting beneficial effects on the economy. A key source of uncertainty for long-term investment will have been removed and this should boost growth prospects. With a lasting peace settlement in place, the scope for a gradual reduction of the burden of defense expenditures on the budget should increase, creating opportunities for well-targeted public investments.**
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Introduction

Israel has made important strides in recent years in laying out a foundation of macroeconomic stability. Not only has inflation fallen sharply from the runaway levels seen in the mid-1980s,[1] but a wide range of reforms have been put in place aimed at reducing the scale of the public sector and the role of the state in the allocation of resources, and, more generally, supporting a process of modernization of the economy. The approach has been broad-based and has left no major areas unaffected and has included reforms in the capital markets and the tax system, exchange and trade liberalization, the functioning of the labor market, a significant curtailment in the level of government intervention through subsidies and price regulation, and progress in privatization.

In the sections below we present a brief overview of the progress made in some of these areas. Important as these reforms have been, in terms of enhancing the flexibility of the Israeli economy and contributing to fairly sustained increases in output and per capita income during the past decade, much remains to be done in the period ahead. We identify some of the key policy issues facing the authorities and examine the options open to them. Particular attention is given to monetary policy and the related issue of central bank independence; the role of the budget and its place as the main intermediator of resources in the economy; external adjustment; and the likely impact of an acceleration of the peace process on Israeli growth prospects. We are of the view that clearing up of the uncertainties associated with an unsettled security situation is likely to have far reaching repercussions for the economy. It is, therefore, entirely appropriate that the government of newly-elected Prime Minister Barak should have made peace the center of his policy priorities.

[1] *Average annual CPI inflation during the two-year period 1984-85 exceeded 300%; it was over 200% in the five-year period ending 1985.*

Selected Economic Indicators 1/

	1992	1993	1994	1995	1996	1997	1998	1999
Nominal GDP *(NIS bn)*	161.7	186.6	224.8	260.7	303.6	340.7	372.0	398.0
(US$bn)	65.8	65.9	74.7	86.6	95.1	98.8	99.3	95.0
Real GDP	6.8	3.4	6.9	6.8	4.7	2.7	2.0	2.0
Industrial production	8.2	6.8	7.4	8.4	5.4	1.7	2.8	--
Construction output	6.9	-5.0	6.2	17.3	8.0	-1.6	-3.9	--
Consumer prices								
Annual average	11.9	10.9	12.4	10.0	11.3	9.0	5.4	5.3
End of period	9.4	11.2	14.5	8.1	10.6	7.0	8.6	2.5
Real average monthly wage	1.1	0.6	2.6	2.2	1.6	2.4	2.2	--
Working-age population	4.3	3.0	2.9	3.0	3.0	2.7	2.7	2.0
Unemployment								
(% of labour force)	11.2	10.0	7.8	6.9	6.7	7.7	8.6	8.6
Current account *(US$bn)*	-1.4	-3.1	-4.1	-6.4	-6.6	-3.4	-0.7	-1.1
(% of GDP)	-2.1	-4.7	-5.5	-7.4	-6.9	-3.4	-0.7	-1.2
Exchange rate *(NIS/$, eop)*	2.76	2.99	3.02	3.14	3.25	3.54	4.16	--
Gross reserves *(US$bn, eop)*	5.1	6.5	6.9	8.3	11.6	20.3	22.7	22.0
M1 2/	31.4	28.4	7.6	16.6	19.1	11.1	14.1	11.0
M2 2/	20.8	41.3	34.5	37.7	32.2	24.6	19.0	22.6
M3 2/	25.7	31.6	29.4	29.3	31.2	22.3	22.1	23.2
Fiscal deficit *(% of GDP)*	-4.0	-2.7	-1.1	-2.7	-3.9	-2.5	-2.5	-3.0
Revenues	53.1	53.0	52.5	52.9	51	51.2	51.4	--
Expenditures	57.1	55.7	53.6	55.6	54.9	53.7	53.9	--
Interest rates								
Discount loan rate, %	11.8	11.3	13.4	15.5	16.1	14.3	12.0	12.4
Spread on local currency, % 3/	10.6	7.6	7.4	8.1	8.1	7.7	7.3	--
Yield to maturity on TBs, %	12.2	11.4	13.0	15.4	15.6	14.1	12.3	12.4

Source: Central Bureau of Statistics, Bank of Israel,.and Datastream. Unless otherwise noted, figures for 1999 are Lehman Brothers forecasts.
1/ Percent change, y-o-y, unless otherwise specified.
2/ For 1999, mid-August
3/ The difference between rates on overdraft credits and savings deposits.

Low Inflation and Weak Growth: A False Dichotomy?

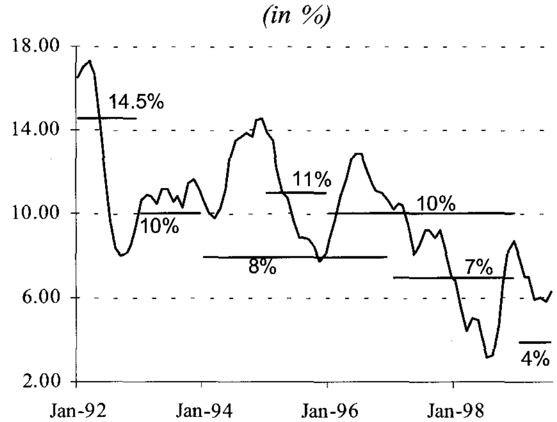
Although inflation targeting was introduced in late 1991, it was only by the mid-1990s, as the band for the exchange rate was widened, that attaining the annual inflation target became a central objective of monetary policy. Indeed, both targets were missed in 1993 and 1994, the latter by a large margin. In contrast, the only inflation target missed in the period 1995-98 was in 1996 and this only marginally so. Because of a weakening of output and rising unemployment during the latter period, there has been an intense debate in Israel in the recent past on the issue of the appropriateness of the monetary policy stance and its implications for GDP growth in the period ahead. There are essentially two schools of thought and their positions may be broadly characterized as follows:

- **The "Price Stability" School.** The primary goal of monetary policy should be the achievement of the annual inflation target. Interest rates should be raised as needed to prevent price disturbances from being translated into rising inflation and the Bank of Israel should refrain from intervening in the foreign exchange market. The monetary authorities should leave to structural and fiscal policies the task of dealing with rigidities and supply constraints that might be dampening the economy's growth potential. Indeed, the optimal strategy for the monetary authorities may be not to yield to the temptation of accelerating money growth in the hope of temporarily stimulating output.

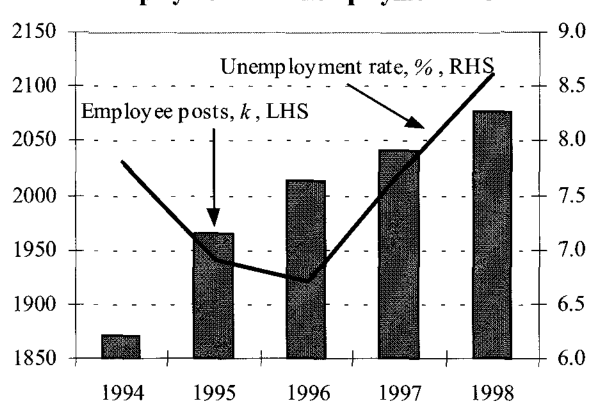
- **The "Strong Growth" School.** The Bank of Israel is unduly focussed on inflation control and is not particularly sensitive to the weakening of output seen in recent years and the concomitant rise in the rate of unemployment. Inflation cannot be brought down to average EU/OECD levels because nearly half of the labor force is unionized and collective wage settlements tend not to pay too much attention to inflation targets. The tight money policy followed since 1997 (combined with the effects of the crisis in emerging markets) have contributed to unusually high real interest rates which have depressed demand and, for the first time in many years in 1998, led to an actual contraction of real per capita income. Given Israel's high population growth, the most urgent priority is to bring interest rates down, even if this will lead to a weakening of the exchange rate and the overshooting of the inflation target.

Inflation targets and y-o-y rises in the CPI

(in %)



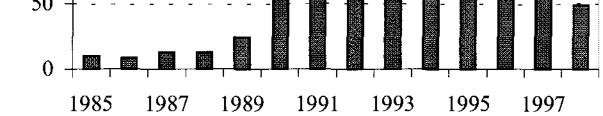
Employment and unemployment rate



With some qualifications, we are of the view that the above is largely a false dichotomy. Israel's policy-makers need not see their policy choices over the medium-term as involving necessarily a tradeoff between growth and inflation, with the price to be paid for higher GDP being an acceleration of the CPI. A number of points need to be made in this respect:

- Some of the slowdown of output seen in the period 1997-98 may well have been desirable; the inevitable winding down of the domestic demand pressures seen in the first half of the decade linked to the need to accommodate the large immigrant inflow and which were accompanied by an expansionary fiscal policy and a widening of the current account deficit. While average annual real GDP growth during 1994-96 exceeded 6%, the budget deficit target for 1996 (2.5% of GDP) was exceeded by more than two percentage points and the current account deficit reached 7% of GDP, a level similar to the previous year's and larger than that of any other OECD member.[2] At an unimpressive 11%, inflation remained at over four times the average seen in the Euro area and well above the rates seen in countries with similar per capita income, whether in Europe or the Middle East. Thus, at least some of the criticisms directed at the Bank of Israel for its tight money policies during the last two years have to be seen against the background of rates of economic growth in the preceding period that may well have been inconsistent with broad macroeconomic stability.

Immigration to Israel, 1985-98, 000s



- Some external (and unforeseeable) factors were also at play during the recent GDP slowdown, including the onset of terrorist attacks in the course of 1996, which sharply reversed a trend recovery of the tourist sector and were further aggravated by a general slowdown in the peace process. A drastic contraction of the Asian markets from 1997 onward and a concomitant slowdown in the growth of world trade in 1998 partly linked to the crisis in emerging markets, were additional exogenous contributing factors. Had these events been anticipated, the Bank of Israel would presumably have run a looser monetary stance.

[2] *Other than the Czech Republic, which had a deficit only slightly larger than Israel's and which saw a formal abandonment of the exchange rate band in the course of the year, amidst a deep financial crisis.*

- Beyond the above factors, all of which to some degree have had an adverse impact on the pace of economic expansion, it needs to be said that Israel's recent inflation performance has been lackluster. At 8.6% y-o-y in December 1998, Israeli inflation was equal to the average rate for the Czech Republic, Hungary, and Poland and actually more than twice as high as the corresponding average rate for the three Baltic countries. What is significant about this comparison is that all six countries had rates of inflation in the early 1990s that were several orders of magnitude higher than Israel's, reflecting significant processes of price liberalization associated with their respective transitions from central planning and the underlying adjustments in relative prices.[3] The present debate about the virtues of a more accommodating monetary policy has to be framed against the background of Israel's relatively poor inflation performance during much of the recent past and what this has implied for exchange rate stability and investor perceptions of Israel's relative place in relation to "emerging markets."

We are of the view that there is no credible alternative in Israel in the short-term to inflation targeting, even though, in an uncertain environment, the Bank of Israel (as other central banks similarly engaged) is bound to err occasionally. As will be argued below, in such a setting, the government should instead concentrate on structural reforms aimed at improving the system of incentives in the economy.

Recent inflation performance
(% change, end-year)

Country 1/	1992	1994	1998	1999
Israel	9.4	14.5	8.6	6.3
Czech Republic	12.7	9.7	6.8	1.4
Hungary	21.6	21.2	10.3	10.9
Poland	44.3	29.5	8.6	7.2
Average	26.2	20.1	8.6	6.5
Estonia	954	41.6	6.5	2.6
Latvia	959	26.0	2.8	2.1
Lithuania	1161	45.0	2.4	0.2
Average	1025	39.5	3.9	1.6

1/ For 1999, rates are for August, year on year.

Interest Rate Volatility

With the gradual widening of the exchange rate band in the second half of the 1990s the chief focus of monetary policy shifted to meeting the government-approved inflation target. While the Bank of Israel has been largely successful in meeting these targets from 1995 onwards, interest rates have remained highly volatile, both in absolute terms and in relation to measures of volatility in other inflation-targeting countries. As the table below shows, official interest rates in Israel during the period January 1994 to April 1999 have been adjusted a total of 39 times, more frequently than in the other countries shown. Volatility in the discount rate has, predictably, resulted in volatility in other interest rates in the economy, such as key market lending rates, and has been accompanied by high variability in monthly inflation rates as well. In this section we identify some of the reasons behind this phenomenon and present some arguments in favor of measures aimed at smoothing interest rate fluctuations. On the reasons:

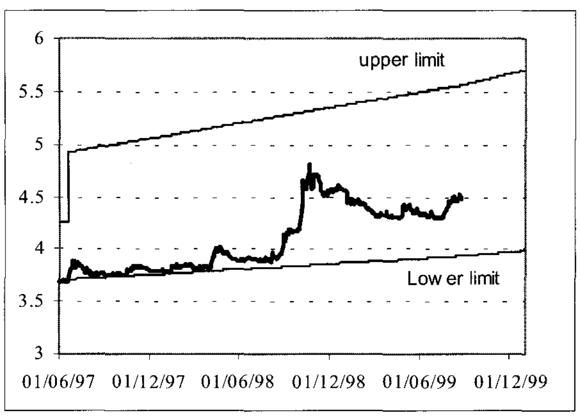
- The highly volatile nature of the inflation measure is perhaps the primary reason. Fruit and vegetable prices and, more importantly, the cost of housing account for some 25% of the CPI basket. Until January 1999 the latter component was particularly significant since the index captured the price of the housing asset (instead of the underlying rent) and, to make matters worse, was measured in dollars, making the index vulnerable to fluctuations in the exchange rate. Furthermore, housing prices have been under intense upward pressure during much of the 1990s because of large migratory flows, particularly from Russia and other former Soviet Union states. Since these flows are projected to continue in the next several years and the Israeli government has little control over their time profile, this component of the CPI is expected to continue to show considerable variance over time.
- Another key factor has been fairly wide swings over time in the stance of fiscal policy, which, against the background of an inflation target, have put the Bank of Israel in the position of having to counteract the impact on domestic demand of the associated fiscal expansion (contraction). Higher interest rates brought about to offset the effects of a fiscal expansion (e.g., 1996) have added to debt servicing costs and, as noted by the IMF, "may have created expectations for future inflation which

[3] *Relative price adjustments in the transition from central planning to a market economy are a key factor that has contributed to the persistence of higher inflation in these countries. The prices of previously heavily subsidized goods and services (e.g., food, fuel, housing, health care, among others) with a large weight in the consumer price index have all increased sharply and such increases have not been offset by decreases in the prices of other goods, leading to upward adjustments in the price level. A measure of the extent to which this process of convergence in the structure of relative prices to that prevailing in the rest of the world was expected to continue following the onset of the transition is provided, for instance, by estimates which suggest that consumer prices in 1994 in Latvia and Lithuania stood at levels equivalent to 30-35% of 1994 prices in Sweden and Austria. (See IMF, Occasional Paper 173,* The Baltic Countries: From Economic Stabilization to EU Accession, *1998.)*

over time raised the risk premium incorporated into the interest rate on government debt as well as the expected inflation rate built into medium-term wage contracts, placing additional burdens on monetary policy to meet the inflation target." [4]

- Perhaps less indigenous to Israel itself, the central bank at times has had to deal with the effects of large and volatile capital flows which have reduced the scope of monetary policy and run up against balance of payments and exchange rate constraints. For example, large capital inflows in 1997 pushed the exchange rate to the lower limit of the band and forced the central bank initially to intervene to maintain the shekel within the band and then to sterilize the associated liquidity to protect the inflation target. Extensive sterilization operations exerted pressures on interest rates and added to underlying volatility.
- Calls on the central bank to "bear in mind" the government's real growth targets have at times created the impression of undue (and ultimately ineffective) pressures being applied to reconcile possibly conflicting inflation, exchange rate and growth objectives, the achievement of which has tended to be associated with interest rate volatility.

NIS/Currency basket exchange rate



The above raises a number of issues as to what might be the appropriate policy response. Here, the prescriptions can be grouped into roughly three categories.

- **Inflation measure.** At the outset, a case can be made in our view to shift the operational focus from the overall rate of inflation to a somewhat narrower subset of prices that might exclude the more volatile components. Other things being equal, high overall CPI volatility should add to interest rate volatility as the central bank attempts to support a price path consistent with the annual inflation target. This recommendation does not mean that the *announced* target could not continue to be the overall rate of inflation (which is the relevant indicator for the elaboration of the budget, for instance); rather it means that the central bank's operational focus would be on a more narrowly defined, less volatile measure of price growth. [5] The point here is that the central bank should not shift rates in response to supply shocks (eg, a poor harvest), but should do so is response to demand shocks (eg, an unexpected increase in immigration resulting in an increase in the price of housing).
- **Time horizon.** An additional innovation worth considering is the possible lengthening of the interval over which the inflation target is announced. The practice thus far has been to announce an annual target; this has meant that the central bank's implementation horizon has been fairly tight. Deviations with respect to the desirable price trajectory (given long lags between changing rates and ultimately influencing activity and inflation) have created the need for interest rate action lest market perceptions of possible failure to meet the target give rise to questions of central bank credibility. A three-year inflation target, for instance, would give the Bank of Israel considerably greater flexibility in operational implementation and would release it from the need to act in response to purely temporary price deviations, often of an exogenous character. A tentative first step in this direction appears to have been adopted recently by the announcement of a 3-4% inflation target for the 2-year period to end-2001. This is a welcome move, although it should be followed, in our view, by a further lengthening of the time period and an official commitment to bring inflation down to international levels by end-2002 at the latest.
- **Expectations.** The Bank of Israel's monetary policy interventions are guided by a measure of inflation expectations in the private sector put together from data on the difference in yields between 1-year indexed and non-indexed government bonds. As noted by the IMF, however, this measure may be vulnerable to a range of influences not directly linked to inflationary expectations per se and may thus introduce biases in the stance of monetary policy. [6] These factors include: changes in the demand and supply of indexed and non-indexed bonds prompted by shifts in their relative rates of return associated with changes in their tax treatment; and

[4] *IMF Staff Country Report No. 98/28, International Monetary Fund, Washington, D.C. This effect may have been partly mitigated by an increase in the share of indexed debt.*
[5] *In this regard, the move in early 1999 to a price index that is based on new rent contracts is a welcome development.*
[6] *A more detailed discussion is contained in the 1998 IMF Staff Country Report on Israel.*

Indicators of monetary policy volatility *(01/94-04/99)*

Country	Discount rate No. of changes	No. of changes in direction	Standard deviation*	Inflation rate Average rate %	Standard deviation*
Israel	39	12	0.82	9.5	0.8
European inflation-targeting countries					
UK	19	4	0.21	2.9	0.27
Sweden	13	2	0.37	1.1	0.70
Finland	10	0	0.12	1.0	0.27
Spain	30	2	0.24	3.3	0.22
Other countries					
US	9	1	0.14	2.4	0.17
Greece	15	1	0.37	7.4	0.42

** Standard deviation of the monthly first difference in the discount rate and the 12-month inflation rate. An earlier version of this table appears in the 1998 IMF Country Report.*

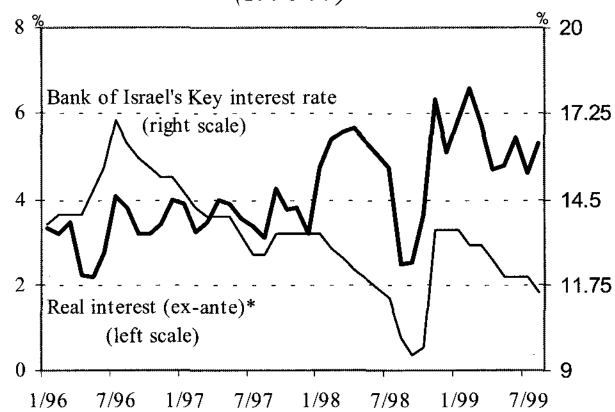
increases in inflation volatility which boost the risk premium on non-indexed bonds. Furthermore, there may be a possible circularity in the process that leads the central bank to determine the appropriate stance of monetary policy. Since the private sector knows that differences in the relative rates of return on indexed and non-indexed securities will prompt changes in monetary policy, the authorities may no longer be reacting to changes in inflationary expectations per se, as measured by the relevant bond yield indicators, but also to the private sector's shifting perceptions of possible changes in monetary policy. This bi-directional feedback is likely to result in higher interest rate volatility and could lead the Bank of Israel to adopt a tighter (looser) stance than purely warranted by an unbiased measure of inflationary expectations. An alternative approach might be for the Bank to use as operational guidance an inflation forecast based on variables which experience has shown to be its determinants and use surveys of inflation expectations to backup the analysis (as is now done in the United Kingdom and Sweden, for example.)

Central Bank Independence

Much of the recent discussion on the role of monetary policy in contributing to a recovery of output growth is taking place against the background of two fairly different visions of central bank independence. Late in 1997 the government appointed a panel—the Levine Committee—with the task of reviewing the Bank of Israel Law (originally adopted in 1954) and issuing possible recommendations aimed at strengthening it. The Committee's key recommendations, presented in a report to the Netanyahu government late in 1998, seek to buttress central bank independence by formally incorporating price stability as the primary goal of the Bank of Israel. While this may not differ substantively from present practice, whereby the central bank aims to achieve the yearly inflation target set by the government, the report sought to improve and clarify a number of aspects of the law. Among the report's main recommendations were those aimed at safeguarding the independence of the bank in the choice of monetary policy instruments to achieve price stability and others intended to broaden the responsibility for the implementation of monetary policy which presently rests solely with the governor, a somewhat unusual arrangement as compared to that prevailing in other countries that have adopted inflation targeting.

A five-member Monetary Committee would be set up, three of whose members would be appointed by the government in consultation with the governor and who would serve for five-year terms. The Committee would be chaired by the governor (who would also serve a five-year term), together with the deputy governor (a position to be created). The minutes of its meetings would be published, and the present role of the governor, as chief economic adviser to the government, would be significantly curtailed, to underscore the desirability of an arms' length relationship between both institutions. Other recommendations address issues such as the distribution of central bank profits and the bank's operational budget. Largely due to the priorities dictated by the recent general election, there has been thus far no formal consultation on the Levine report.

Nominal and Real Interest Rates
(1996-99)



* *Derived from measures of inflation expectations.*

Moving on a parallel track, and at the initiative of the opposition, a draft law to amend the Bank of Israel Law was approved by the Knesset Finance Committee in December 1998 and was passed on first reading by the full Knesset in early 1999. The draft does not unambiguously identify price stability as the primary goal of the Bank and calls for the creation of a Board, akin to a governing council, that would have overall responsibility for interest rate policy and whose members could include academics, Bank of Israel staff, and others, including possibly politicians and/or private sector representatives. The fact that this bill had originally been introduced at the initiative of the present finance minister led initially to market perceptions of possible tensions within the economic policy team of Prime Minister Barak.

We are of the view that, whatever tensions may have surfaced at the outset, these are likely to continue to ease in the period ahead, partly on account of growing evidence of an incipient recovery in activity (which should reduce some of the pressures on the Bank for a quick easing of interest rates); the recent setting of an inflation target for 2000-2001 of 3-4%, seen to be broadly consistent with the Bank's goal of ensuring price stability; and the setting of a budget deficit target for 2000—2 ½% of GDP—also seen to be better than might have been expected for a government that had campaigned actively for a more active demand management policy.

Indeed, we would expect that, as Israel continues on the path of modernization, strengthening further its political and economic ties with the developed world—particularly the US and the EU, which now account for some 65% of total trade flows—the model offered by the Levine report, with its fairly tough defense of central bank independence, is the one most likely to prevail. Clarifying the role of the central bank in the conduct of monetary policy and safeguarding its independence should also have another potentially important benefit. It will allow greater focus to be placed on structural reforms and the removal of supply bottlenecks in the economy. The debate then might therefore be less on whether economic recovery is being held hostage to central bank intransigence (not a very credible line of argumentation, in any event, during the last few years, given Israel's relatively poor inflation performance) and more on the kinds of policy reforms necessary to make the economy more adaptable to external shocks, better able to cope with the challenges of international competition in a globalized environment—ie., to policies that raise the economy's long-run (potential) growth rate. This shift in focus, in our view, would, on the whole, be quite salutary.

Per capita GDP
(000s of US$)

Country	1998
Israel	16.4
Spain	14.2
Kuwait	13.3
Greece	11.3
Portugal	10.9
Saudi Arabia	5.9
Czech Republic	5.3
Lebanon	4.8
Hungary	4.7
Poland	4.1
Iran	1.8
Jordan	1.6
Egypt	1.2
Syria	0.9

Fiscal Policy

The conduct of fiscal policy in Israel during much of the 1990s has taken place within the framework of the 1992 Deficit Reduction Law and subsequent amendments made to it. The purpose of this law was to lay out a timetable for medium-term fiscal adjustment through targeting of the domestic component of the budget deficit and, after 1996, in the aftermath of a significant overrun with respect to the government's target, through tight monitoring of the overall deficit. At the time that the focus was shifted to the overall deficit, the government established a target of 2.8% of GDP for 1997. Thereafter, the deficit was gradually projected to fall to 1.5% of GDP by 2001. Both the 1997 and 1998 targets were met, suggesting that the attempts to rein in the deficit under the previous government met with a measure of success.

General government balance, NISbn

	1993	1994	1995	1996	1997	1998
Total receipts	98.9	118.0	137.8	154.9	174.3	191.1
% of GDP	53.0	52.5	52.9	51.0	51.2	51.4
Domestic	86.0	105.9	125.6	140.3	157.4	170.7
o/w: taxes	71.7	88.6	104.7	118.5	136.9	147.9
Foreign	12.9	12.1	12.2	14.6	16.9	20.4
Total expenditure	103.9	120.5	144.9	166.6	182.8	200.6
% of GDP	55.7	53.6	55.6	54.9	53.7	53.9
Domestic	93.5	111.0	135.6	155.4	170.3	186.7
o/w: civilian	30.1	39.2	51.9	60.7	66.8	72.4
defense	14.8	17.6	19.9	22.6	24.5	26.9
transfer payments	21.0	25.0	30.5	36.9	42.3	52.2
Foreign	10.4	9.5	9.3	11.2	12.5	13.9
Overall balance	-5.0	-2.5	-7.1	-11.7	-8.4	-9.5
% of GDP	-2.7	-1.1	-2.7	-3.9	-2.5	-2.6

Source: Central Bureau of Statistics and Bank of Israel.

The fiscal target for 1999 (2% of GDP) is likely to be missed, perhaps by as much as a full percentage point of GDP, mainly on account of revenue shortfalls, resulting from an underestimation of the likely impact of the emerging market crisis on budgetary revenues and the adverse effects of the sharp depreciation of the shekel in late 1998 on enterprise profitability. (An overestimation of likely gains in revenue collection due to improvements in tax administration may have been an additional factor.) After some debate within the new economic policy team (including the Bank of Israel), the new government of Prime Minister Barak announced a deficit target of 2.5% of GDP for 2000. While this will involve a shift in the original 1.5% of GDP target for 2001 to, most likely, 2003, the outcome of the discussions was relatively well received by the market, which seemed to have anticipated that some adjustment to the profile set out in 1997 was warranted, in light of the somewhat turbulent external environment seen during the last two years and the weaker than anticipated evolution of Israeli output. Equally reassuring was the announcement of an inflation target for next year that did not involve a relaxation with respect to this year's target, long advocated by key figures, both within parliament and in the private sector.

As the government moves forward with its plans to improve budget monitoring and control it will have to turn increasing attention to a number of revenue and expenditure issues, requiring important reforms. Important as meeting the deficit targets is from a macroeconomic perspective, more needs to be done to improve the efficiency of the tax system and the structure of expenditure. We highlight some of the key necessary changes.

On the revenue side

As is the case in many countries, there is ample scope in Israel to redistribute the burden of individual taxes. Total state tax revenue has remained broadly stable at 32% of GDP in recent years, with VAT and the personal income tax amounting for some 11% of GDP each. The VAT rate in Israel is set at 17% and is applied on a very wide basis, with no low rate in place and virtually no exemptions; thus the total tax take is considerably higher than in other countries (for instance, EU members collect an average of 7 ½ % of GDP). Capital income, on the other hand, is hardly taxed, with more than 90% of total personal income taxes accounted for by taxes on labor income. A number of tax reform proposals have been floated in the past, intended to improve various aspects of the tax system. Among the more promising ideas we would support are those aimed at:

- Reducing the rate on the PIT, for instance by lowering the top bracket to 40% and increasing the threshold at which it is reached.
- Streamlining the system of tax incentives, which is quite complex and consists of various forms of cash grants, reduced corporate income tax rates, tax holidays and other forms of relief. Total investments grants and subsidies actually budgeted for exceed 1% of GDP. Tax expenditures (including foregone revenue on capital income) are estimated to have exceeded 4% of GDP in 1998.
- Improving certain aspects of tax administration, particularly the creation of a system of penalties and fines, instead of the present setup, which largely relies on redress through the legal system and the courts and is thus lengthy, costly, and inefficient.

On the expenditure side

Important as the above measures would be to improve the efficiency of Israel's tax system, the major challenges lie on the expenditure side. Essentially, the main problem with the budget is that expenditure allocations in the form of transfers and other welfare payments (some 20% of GDP in 1998) dwarf in magnitude those directed to capital projects and other forms of infrastructure spending—about 2% of GDP in 1998. While much of the social spending is no doubt necessary and well targeted, much of it is not. Among key priorities in the spending area one can point to:

- The need to upgrade the country's physical infrastructure, which remains well behind that of EU member countries and which is most likely acting as a structural bottleneck. Traffic jams in Israel have few peers in the region, but there is also evident need for improvements in a range of areas that play the role of support services to the tourist industry (including some environmental cleanup; pollution levels in Israel have increased sharply in recent years).

- At over 9% of GDP, defense spending is high. Moving forward with the peace process—an area in which the government has moved with admirable speed—should release resources over the medium term that can be allocated to other, more productive ends, including deficit reduction.
- Government employee pensions are financed out of current expenditures, an arrangement involving potentially large future claims against the budget. While a 1996 agreement with the main trade union provides for the inclusion of "new" government workers into a funded pension plan, provisions will have to be made for the funding of pensions as the present cohort of government employees gradually retires. In this respect, it would be desirable to introduce an employee contribution, as is the norm in other countries.
- Tightening of eligibility requirements for a broad range of transfer payments, particularly for those opting out of the labor force well before the age of retirement. As in other countries, there is much scope for improved targeting of benefits to the truly needy. Also desirable would be a reduction in the duplication of duties carried out and benefits provided by state hospitals and the Sickness Fund; the present system of incentives may encourage long hospital stays.

A Decade of Structural Reforms

As noted above, considerable progress had been made in recent years in moving forward with a broad range of structural reforms. Without aiming to be comprehensive, the focus below is on privatization, reforms in the capital markets, exchange and trade liberalization, and the labor market.

- **Privatization.** By the late 1980s, the government maintained some form of ownership in well over 100 companies, spread over a broad range of sectors and producing some 10% of GDP. A process of divestiture of state assets was set in motion in the early part of this decade and has been implemented with gathering momentum. Overall revenues from privatization amounted to some $2bn through 1996 and then more than doubled in 1997, when an additional $2.5bn were collected, largely on account of the sale of the government's majority participation in the largest bank, as well as a number of other sales of bank shares, both through direct sales to groups of investors and public offerings through the stock exchange. The government still maintains majority ownership in the second and third largest banks but the momentum for the continued privatization of banks remains strong; the government had no problems meeting its 1998 targets for revenues from privatization.

  While progress in the divestiture of state assets in the non-bank sector has been rather more limited in scope, some progress has nevertheless been made, with plans underway (announced by the previous government) to include the main enterprises in the areas of telecommunications, electricity generation, chemicals, utilities and aircraft. For instance, in late 1998 the government sold a 31.5% stake in Israel Chemical in what turned out to be the largest single offering in the Tel Aviv stock exchange.

  More important than the revenue actually generated through these privatizations, is perhaps the change in the perceived role of the public sector, with economic agents seeing it less in its traditional role as provider/producer of goods and services, and increasingly more in terms of its role as chief regulator and manager of the macroeconomic environment. The renewed impetus to the privatization process has had a favorable impact on foreign direct investment inflows, which reached $2.1bn in 1998, the largest figure to date and equivalent to some 2% of GDP. While these amounts remain below the levels seen in recent years in some of the more well adjusted transition economies (which have ranged over 5-10% of GDP), they suggest the potential upside over the medium-term, once the peace process is well underway.

- **Capital markets.** The reforms have mainly involved deregulation of the financial markets and the elimination of a host of administrative restrictions and interventions. Reserve requirements, which had ranged well over 30% in 1987, had fallen by end-1998 to 4% on average; this in turn contributed to a marked narrowing of interest rate spreads. Undue segmentation of the credit markets was sharply reduced; for instance, the share of mortgage credit allocated by the government fell from 70% in the mid-1980s to some 25% by end-1998. Even sharper drops took place with respect to other forms of credit. The reforms also saw a sharp reduction in the share of obligatory investments in government bonds to be made by pension and provident funds. Provident funds, the largest institutional investor in the Israeli economy, may now invest up to 50% of their holdings in equities and other financial assets. In parallel to these efforts at deregulation, there has also been significant streamlining and modernization of the stock market, which has emerged as one of the most technologically advanced in the world, with continuous trading and short clearing periods, against the background of fairly sound securities legislation. These achievements notwithstanding, more will need to be done over the medium term to broaden the range of financial instruments offered to the public and to remedy remaining inefficiencies stemming from unequal tax treatment of different classes of investors and/or savings instruments, and to encourage more long-term savings.

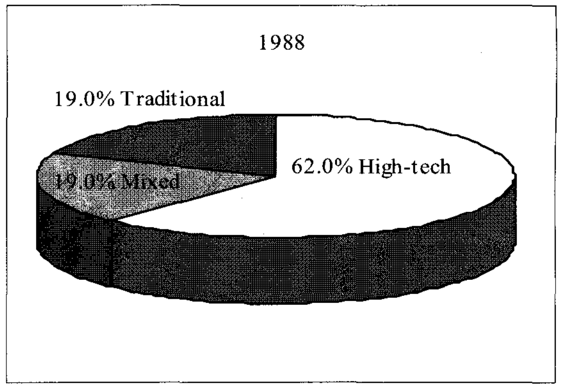
- **Exchange and trade liberalization.** Israel was a signatory to the 1947 GATT and is a founding member of the WTO. It has a liberal trade regime, with more than 70% of imports under free trade regimes. Indeed, it is the only WTO member to have concluded free trade agreements with both the United States and the EU. With respect to third countries with which no free trade agreements are in place, the government recently concluded a five-year trade liberalization programme which significantly reduced tariffs on industrial products and eliminated or streamlined licensing requirements and non-tariff barriers. With the liberalization of the financial sector, foreign exchange controls have been largely phased out, as have most other restrictions on the capital account, such as limits on outbound foreign direct investment by Israeli residents.

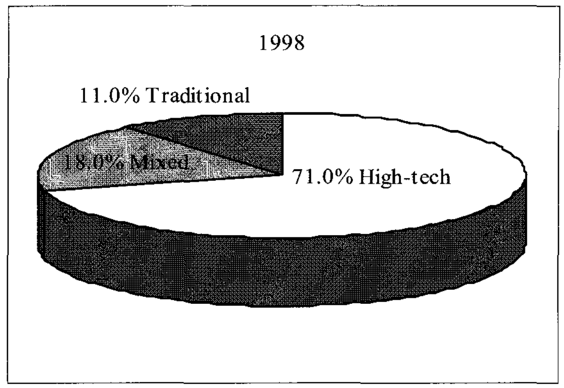
Exports 1992-1998, % y-o-y, volume change 1/

	1992-95	1996	1997	1998
Total	12.2	7.1	6.7	6.4
Total 2/	12.4	7.2	10.4	10.9
Industrial	11.9	7.5	13.9	11.5
o/w: Traditional industries	6.3	-4.9	-4.1	1.8
High-tech industries	14.3	10.7	20.8	16.0
Agriculture	7.7	17.5	8.5	6.9
Diamonds	12.4	4.0	-0.6	-13.5

Source: Central Bureau of Statistics and Bank of Israel.
1/ For 1992-95, average annual average.
2/ Excluding diamonds and exports to the Palestinian Autonomy.

Industrial and software exports by type of industry
(1988 and 1998)





- **Labor market.** Flexibility in the labor market has increased significantly in recent years as a result of changes in the wage bargaining process which have sought to decentralize wage negotiations in the private sector and to de-link them from those for the public sector. Sharp increases in labor supply, associated with immigration from Russia and other former Soviet Union states, is also thought to have played a significant role in moderating wage growth and boosting labor market flexibility, particularly since the government decided not to use the public sector to absorb excess labor. Finally, cost of living adjustments in the private sector (still set at the national level) do not now fully compensate for inflation and are binding on the public sector. Public sector wages in relation to GDP in the 1999 budget amounted to 8.6%, below the 9.8% of GDP paid out in 1995.

External Adjustment

The current account of the balance of payments, while still projected to remain in deficit in 1999 and beyond, poses no immediate threat to macroeconomic stability. The factors which contributed to the emergence of a deficit in excess of 5% of GDP on average during the period 1992-97 seem to be rapidly on the wane. The massive inflows of immigrants from the Soviet Union, which boosted the population from 4.5m in 1989 to close to 6m by 1998 and provided such an impetus to investment and consumption, have decelerated sharply and are expected to remain on a more sustainable path. The fiscal deficit has, likewise, been on a downward trend and the public sector is not expected to be a source of undue pressure on the external accounts; the growth of public sector consumption during the period 1997-98 averaged 1.6%, less than half the annual average during the previous six year period. While a pickup of growth will boost imports, the impact on the external accounts should be moderated by the existence of spare capacity in the economy.

Trade liberalization and the associated exposure to international competition is thought to have been a more important factor in putting pressure on the current account earlier in the reform process than now, when 68% of imports arrive under free trade agreements negotiated with the United States and the EU and the majority of the remaining share come in at relatively low rates. While the import/GDP ratio has risen steadily over time, the composition of imports has remained fairly benign, with factor inputs and investment goods accounting for close to 90% of the total import bill. Finally, net external indebtedness remains at a level that gives little cause for concern. The bulk of public sector liabilities are medium-to long-term, while annual principal debt repayments during the period 1996-98 averaged around $3bn—small in relation to the level of gross reserves of the Bank of Israel which, at end-September 1999 stood at $22bn, equivalent to close to nine months of imports. Net debt service payments in 1998 stood at some 14% of exports of goods and nonfactor services.

The current account and its financing, US$bn

	1994	1995	1996	1997	1998	1999
Current account	-4.1	-6.4	-6.6	-3.4	-0.7	-1.1
In % of GDP	-5.5	-7.4	-6.9	-3.4	-0.7	-1.2
Trade balance	-5.6	-7.6	-7.2	-5.2	-3.2	-3.8
Exports	17.2	19.2	21.2	22.6	23.0	23.7
Imports	-22.8	-26.8	-28.4	-27.8	-26.2	-27.5
Services balance	-1.7	-1.7	-2.3	-1.0	-0.8	-0.5
Exports	6.5	7.7	8.0	8.4	9.0	9.5
Imports	-8.2	-9.4	-10.3	-9.4	-9.8	-10.0
Interest income (net)	-2.2	-2.7	-3.2	-3.5	-2.8	-3.0
Transfers (net)	5.4	5.6	6.1	6.2	6.1	6.2
Financing:						
Capital transfers	1.8	2.0	2.1	2.2	1.8	
Long- & medium-term capital	3.0	2.8	5.1	5.3	3.4	
Short-term capital	-0.1	0.2	0.1	-0.8	0.1	
Banking system	-1.3	1.1	-0.4	4.1	-0.5	
Errors and omissions	0.8	1.4	3.1	2.0	-2.2	
Rise (-) in forex reserves	-0.1	-1.1	-3.4	-9.4	-1.9	

Source: Central Bureau of Statistics and Bank of Israel.

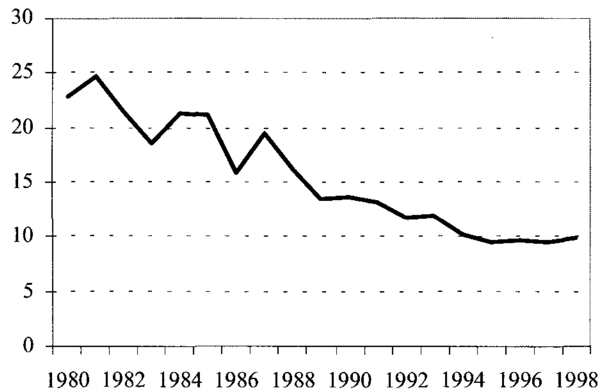
Peace Dividends

Bringing to a successful conclusion negotiations aimed at securing a peace settlement with Syria, Lebanon, and the Palestinians will be crucial to the economic outlook. Israel's new Prime Minister, Mr. Barak, has given the highest priority to the resumption of the peace process, which is intended to establish credible and lasting security arrangements with these neighbors. In our view Israel's future growth prospects are very much linked to the ability of the government to succeed in this area. Among the most obvious benefits of peace one can point out to:

- The scope it would provide for a medium-term restructuring of budgetary expenditures, diminishing over time the burden of defense and the maintenance of the associated military establishment. Annual defense expenditures have amounted to some 10% of GDP over the period 1993-98 (down from 25% of GDP in the early 1980s), compared to 2-3% in the EU and in the United States. Peace should permit further spending cuts over the next several years, releasing resources which could be allocated to other ends, particularly in the area of infrastructure, where Israel suffers from a number of shortcomings with respect to, for instance, EU members with similar levels of per capita income.[7]

[7] *In the initial stages the implementation of peace accords could well involve substantial redeployment costs, to be partly covered by foreign aid.*

Defense Expenditure, 1980-98
(% of GDP)



- The coming on stream of a number of potentially large infrastructure projects (water works, electricity generation, railroads) in the border areas with Syria and Lebanon, with potentially lasting effects on investment demand. Beyond this, peace would also be expected to boost intra-regional trade in the Middle East and cross border direct investment.
- The further expansion of the tourist sector, where activity has tended to closely reflect the underlying security situation (the onset of terrorist attacks, the Intifada, and so on) and where the potential for further development is seen to be vast. Israel is projected to receive some 2m tourists in 1999, a relatively small number when compared to other countries in the region (eg, Cyprus, Greece). Making generous allowances for population size and other such scale factors and with appropriate investments and upgrading in the facilities supporting the sector, there is no reason why tourist arrivals could not easily double within a few years, with beneficial effects on growth and the balance of payments.
- With its highly educated labor force, its close trade links with the EU and the United States and the remarkable expansion of high-tech industries seen in recent years, Israel is singularly well positioned to become a leading center for a broad range of multinational corporations intent on expanding their activities in a post-peace settlement environment.
- Last, but not least, a permanent boost to confidence, as economic agents are able to increasingly view decision making in a medium-term perspective, characterized by less uncertainty about the political environment and greater faith in the stability of the country's policies and institutions.

Short-Term Outlook And The Challenges Ahead

Outlook

There is some evidence that the economy may have entered a phase of gradual recovery this year. Investment in fixed assets during the first half of 1999 was up by some 9% in real terms, after having contracted sharply in the second half of 1998. Industrial production rose at an annual rate of 2.8% during the same period and tourism receipts have recovered sharply, reflecting a resurgence of "millenium" related visits but also the likely beneficial effects of an improved security situation. Exports have also shown an upward tendency in May and June, reflecting, in part, the sharp recovery of high tech exports to the Asian market. The government's new GDP forecast for annual growth is conservative (1 ½-2%) and below the growth rate assumed in the 1999 budget (2 ½ %). The government and the Bank of Israel should have no problem meeting the 4% inflation target in 1999; indeed we expect a 3% outcome to be entirely feasible.

Weaker-than-expected growth in 1999 will be the key factor in contributing to the underperformance of revenues and the corresponding overshooting of the fiscal deficit target, by possibly as much as 1-1 ¼ percentage point of GDP with respect to the 2% of GDP budget target. Provided that the government sticks to the cautious policy path just announced, and that gradual progress continues to be made on the peace front, we consider the present 3% official GDP forecast for 2000 to be entirely reasonable. Indeed, to the extent that circumstances contribute to accelerate the momentum for peace, growth could be higher. The current account of the balance of payments is projected to widen marginally. This is not a source of concern, however, given Israel's more than adequate level of reserves, continued foreign direct investment inflows, and comfortable debt carrying capacity.

The Period Ahead

The Israeli economy finds itself at a critical crossroads. Having made impressive progress in the past decade in laying the foundation for a stable macroeconomy, with a diversified productive structure and a growing presence in international markets, a number of important challenges remain. The newly elected government of prime minister Barak, recipient of a strong popular mandate during the last general elections, is well placed to push forward with a range of measures and policy reforms that will allow Israel to enter a period of sustained, balanced, economic expansion. Three general areas would appear to us to be of particular crucial importance:

- **The Peace Process.** The prospects for lasting peace in the Middle East have improved measurably since Mr. Barak took office. The successful negotiation of lasting security arrangements—a cornerstone of the new government's policy programme—would have positive, widespread ramifications for the Israeli economy and the region as a whole. On the domestic front, a lasting peace would remove one of the main sources of uncertainty for long-term investment. Free of the anxieties generated by unsettled relations with key neighbors, there is no reason why Israel could not begin to see a substantial acceleration of foreign direct investment inflows directed to a broad range of sectors, including tourism, financial services, and high tech industries. More importantly, securing peace would permit the government to gradually shift the composition of expenditures, increasing the share of non-defense related items, particularly those aimed at modernization of the country's infrastructure. We are cautiously optimistic that the conditions are right for the successful conclusion of a binding treaty with Syria and the resolution of the major outstanding issues with the Palestinians. While the issues are complex and the negotiations may thus be drawn out, growing confidence about the likelihood of a positive outcome is expected to boost growth prospects.

- **Inflation and Growth.** The (at times heated) debates on the costs of the Bank of Israel's tight money policies seem to ignore, in our view, that responsibility for the determination of the target rests largely with the government. Views may differ as to the nature and timing of central bank interventions.[8] But the Bank can hardly be faulted for carrying out what is, in the end, its primary task: to achieve the government's (often not particularly ambitious) inflation target. Over the medium-term (and no later than 2002, say) the government will have to bring inflation down to average EU/OECD levels and, along the way, move forward with the implementation of difficult but necessary structural measures aimed at enhancing the efficiency of budgetary expenditures, securing the financial viability of the pension system, deepening the capital markets, and other reforms the purpose of which will be to remove rigidities and supply constraints in the economy and boost growth performance. The Bank of Israel, through appropriately timed and well designed interventions, can continue to play a key role in supporting this process, but it cannot generate it and it certainly should not be blamed when policy slippages or external factors delay the recovery.

  One way to strengthen policy coherence would be to revise the Bank of Israel Law along the lines proposed by the Levine Committee. We judge that the recommendations made by this independent body are basically sound. If adopted, they will remove a number of ambiguities as regards the central bank's mandate, protect its independence and make it less vulnerable to external pressures and misplaced criticisms, and enhance its operational capacities. In parallel to this, the government and the Bank may wish to formally lengthen the time horizon over which the inflation target is announced—as seems to have been recently done, in a less formal way, with the inflation target for 2000-2001.

  The budget. The claims that security and peace issues are likely to make on the government's administrative capacities are heavy. These pressures notwithstanding, the government has moved to reassure markets that policies will not be loosened and that fiscal adjustment will continue to take place, in a way that supports the newly announced inflation objectives. We are particularly encouraged that, following some initial evidence of tensions within the economic policy team, there seems to be broad consensus that the recovery of output will have to take place within a cautious medium-term framework involving a further narrowing of the deficit. While this is fine, the government will also need to proceed with tax and expenditure reforms which have been, in some cases, "in the works" for several years. Of particular importance would be improvements in the efficiency of transfer payments, which account for a large share of current spending and the removal of distortions in the tax system which, at certain levels of income, may have reduced the incentive to work and discriminated against investment in human capital, as opposed to physical capital.

Progress in each of these areas is likely to contribute to a strengthening of the pace of economic recovery underway. Provided that an appropriate policy environment remains in place, in which structural reforms are implemented in a context of strong commitment to financial stability, we are of the view that there is no reason why Israel could not enter a period of sustained expansion, in keeping with its true long-term potential. The strong popular mandate received during the last general election by the new government of Prime Minister Barak suggests that the conditions are right for securing peace and, hence, for unleashing a period of considerable growth and development. We are cautiously optimistic that the government will rise to this important challenge.■

[8] *Should the Bank of Israel have intervened in a limited way in the foreign exchange market in the aftermath of the Russia crisis to smooth out some of the underlying shekel turbulence? Might it have been somewhat more aggressive in reducing interest rates in the early part of 1999 when inflation was negative for several consecutive months?*