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The Israeli Economy: Overview and Developments Through 1997

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(name redacted)
Specialist in Trade Relations
Foreign Affairs and National Defense Division

ABSTRACT

The strength of the Israeli economy has important implications for U.S.-Israeli relations and for the U.S. bilateral assistance program. This report profiles the structural attributes of the Israeli economy, describes four historical stages of economic growth, analyzes key macroeconomic policy issues in 1997, and assesses reforms that would allow the economy to achieve its full potential. See also CRS Issue Brief 85066, Israel: U.S. Foreign Assistance, and Issue Brief 82008, Israel-United States Relations. This report may be updated if necessary.

The Israeli Economy: Overview and Developments Through 1997

Summary

The Israeli economy defies simple categorization. Based on a per capita income level of \$16,783, a large services sector, and hundreds of dynamic high-tech companies, it is modern and advanced. Based on the large role the government still plays in the economy, it is interventionist and regulated. And based on the country's high defense requirements, chronic trade deficits, and political economy, it can be described as distinctive or unique.

Since 1948, the economy has experienced three different stages of development. The first (1948-1972) and third stages (1989-1995) were classic boom periods fueled primarily by rapid increases in the stock of labor. The second stage (1973-1988) was characterized by considerable economic instability and turmoil.

The Israeli economy currently may be entering a fourth stage where concerns once again are being raised about stability and performance. The increase and size of the current account deficit (4.8% of GDP in 1996), combined with an overvalued exchange rate, are matters of particular concern because they can be precursors to a financial crisis. This is a situation of special concern to Israel because it already imports a large amount of capital to finance its deficit, and there is no certainty that sources of funding at reasonable cost will continue indefinitely.

These economic problems have been fueled by an expansionary fiscal policy and a relatively restrictive monetary policy. In order to promote economic stability, most economists agree that Israel needs to pursue a less expansionary fiscal policy mainly by cutting non-productive government expenditures. This, in turn, would allow central bank authorities leeway to run a less restrictive monetary policy without jeopardizing other macroeconomic objectives.

A reduction of the high degree of government intervention in economic activity also could help Israel promote economic growth and macroeconomic stability through a more efficient use of the country's resources. Given the likelihood of a slower growing labor force, productivity increases brought about by structural reforms may become even more critical in the future. However, progress has been gradual in reducing the government's role in owning and running enterprises, as well as reforming capital and labor markets. Progress has been more rapid in liberalizing foreign trade and currency barriers and in increasing competition in certain sectors.

Although there appears to be a consensus within Israel on the policy actions that should be taken to avoid serious economic problems, implementation of a coherent economic strategy continues to be politically difficult. A perennial problem is that as Israel's political system produces coalition governments, the majority party in the government is often hampered in implementing its preferred economic policy by competing claims from small coalition partners. A larger unknown is the commitment of the two major political parties, Likud and Labor, to deficit reduction and structural reforms.

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Profile of the Israeli Economy

The Israeli economy defies simple categorization. Based on a per capita income level of \$16,783, a large services sector, and hundreds of dynamic high-tech companies, it is modern and advanced. Based on the large role the government still plays in the economy, it is interventionist and regulated. And based on the country's high defense requirements, chronic trade deficits, and political economy, it can be described as distinctive or unique.

Advanced Economy Attributes

Based on a population of 5.7 million and a Gross Domestic Product of \$95 billion, the per capita income level in Israel in 1996 was \$16,783. The World Bank categorizes countries at this level as high-income economies. Countries with comparable per capita income levels include Ireland, Spain, and New Zealand.

The structure of the Israeli economy is also representative of an advanced industrialized country. Services (public and private, financial, transportation, commerce, and tourism) now account for nearly 70% of the total output of the economy. Industry, including construction, accounts for around 30% of total output, and agriculture, for less than 3%. The dominance of the service sector prompted the International Monetary Fund to reclassify Israel as an economically advanced country in 1977.¹

In addition to its large and modern services sector, Israel today has a large and diversified manufacturing sector. A skilled, highly educated, and innovative labor force is perhaps its most important asset. The economy is export-oriented and well-integrated into the world economy.

The heart of Israel's manufacturing capability is a thriving, rapidly growing, and innovative high-tech sector. This sector consists of an estimated 1,000 start-up companies. Electronics and software companies, with annual sales of \$7 billion, lead the way. All these start-up companies rely on an abundance of highly trained and educated scientists and entrepreneurs, many of whom immigrated from the Soviet Union in the past seven years. Israel now boasts the highest number of scientists and engineers per capita in the world.

¹ Ezrahi, Yaron. "In Israel, Peace Means Prosperity," New York Times, January 21, 1997, p. A 23.

Many of Israel's high-tech companies have utilized technologies developed in the army and defense industries. Recent products providing improvements in Internet security systems, encryption, and real-time video services all emanated from military technologies.²

Approximately 90 of Israel's high-tech companies are traded on NASDAQ, the U.S. exchange devoted to young and aggressive companies here and abroad. This is more than any country other than the United States and Canada. These companies attracted over \$1 billion in financial investment in 1996, compared to \$543 million in 1995 and \$335 million in 1994.³

With a small economy and a relatively limited domestic market, Israel depends increasingly on international trade for its economic growth. In 1996, exports of goods and services accounted for approximately 30% of GDP and imports of goods and services accounted for about 40% of GDP.

The extent to which international trade plays a key role in Israel's growth is highlighted not only by the contribution of exports to final demand, but also by the composition of its imports. In 1996, for example, production inputs and investment goods accounted for 69% of Israel's imports, thereby serving as a major source for bolstering the productive capacity of the economy.⁴

The European Union (EU), assisted by geographical proximity and a 22-year old free trade agreement, is Israel's main trading partner. In 1996, the EU purchased 31 % of all Israel's exports and supplied Israel with 49% of its imports.

The United States is Israel's other main trading partner. In 1996, the United States purchased 28% of Israel's exports and supplied 21% of its imports.⁵

Israel's export base is well-diversified, with metals, machinery and electronics accounting for a growing share of total exports. Israel also remains one of the leading centers for diamond cutting and polishing, with diamond exports accounting traditionally for one-fourth of total exports. In addition, Israel exports substantial amounts of chemicals.⁶

² Sugarman, Margo Lipschitz, "High-Tech, Highstakes," *Jerusalem Report*, February 6, 1997, p. 37.

³ Rosenberg, David. "Hard Times for High-Tech?," *Jerusalem Report*, February 6, 1997, p. 41.

⁴ International Monetary Fund. "Israel: Selected Issues and Statistical Appendix," IMF Staff Country Report No. 97/2, February 1997 [hereafter cited as IMF Staff Report], p. 52.

⁵ For more detail, see appendix tables 5 and 6.

⁶ U.S. Department of State. "Background Notes: Israel, October 1996" p. 2. For more detail, see appendix table 7.

Interventionist Attributes

By tradition, circumstances, and ideology, the government of Israel has played a leading role in developing the economy and in influencing economic activity. When Israel was established in 1948, the economy was primarily agrarian with only a small manufacturing sector. The state possessed minimal natural or financial resources, little economic infrastructure, and few public services. Faced with the daunting task of settling a huge influx of immigrants from Europe and the Middle East who generally lacked savings or skills, Israel's political leadership gained control over a large part of the country's investment resources and economic activity to provide food, clothing, housing, and jobs for its new citizens. Government control of the economy was also prompted by the need to deal with these challenges in a hostile external environment.⁷

A significant part of all business came to be controlled by three sectors: private, public, and Histadrut (the General Federation of Laborers in the Land of Israel). Histadrut, whose membership initially encompassed nearly all the labor force, came to own or control a significant portion of Israeli industry as a result of its vast pension fund holdings.

While significant steps have been taken over the years to reduce the government's high level of intervention in the economy, the Israeli economy retains an interventionist character today. Security challenges, social welfare considerations, and the small size of the economy have served as justifications by Israeli authorities for keeping a sizeable portion of economic activity under government regulation or control or for going slow on reducing the level of intervention.

Government expenditures, which in the 1990s have averaged 46% to 48% of GDP, symbolize the large role government still plays in the economy.⁸ Continued ownership or control of approximately 116 companies, with the largest ten companies accounting for over \$20 billion in assets, is a second vivid illustration.⁹ Other notable manifestations include some 600,000 public sector jobs, which account for 30% of all jobs. An estimated 93% of the land is also owned by the government, a condition that has contributed to rising land and housing prices. And the government still controls or supervises a number of retail prices, such as meat, transportation fares, and medicines. These goods constituted 18% of the consumer price index (CPI) as of August 1996¹⁰

The government has played a dominant role in capital markets from the beginning due to its need to finance large budget deficits and its interest in channeling the flow of capital within Israel's economy. High levels of spending on

⁷ Kreinin, Mordechai E. "Israel's Trade Policy Review," In *The World Economy: Global Trade Policy 1996*, Blackwell Publishers, p. 120.

⁸ A comparable figure for the United States in recent years is round 20%

⁹ See appendix table 8 for more detail.

¹⁰ See appendix table 9 for more detail.

civilian services (health, education, and welfare), bolstered by a strong domestic consensus in favor of the “welfare state,” and defense have driven the domestic budget deficits historically. By controlling bank and other credit lines and by establishing tax incentives, the government has exercised major influence on the scale and pattern of investment throughout the economy. A high concentration of capital among a handful of large conglomerates continues to stifle competition.¹¹

Israel’s labor market is affected by structural rigidities and restrictive government regulations. The labor market is dominated by Histadrut, which now represents about 60% of all Israeli workers, including the vast majority of workers employed in the public sector or government-owned enterprises.¹²

Cartels and monopolies, many of which are legal, affect a significant portion of the Israeli economy. The resulting lack of competition in certain sectors is often preserved by a considerable, albeit declining, level of import protection.

Despite having negotiated free trade agreements with the European Union and the United States, the Israeli economy remains relatively protected from imports from generally lower-wage, Asian countries. The protection mainly takes the form of a variety of user taxes and high duties.

Due to these myriad governmental interventions in the marketplace, Israel often is ranked relatively low on various surveys of international competitiveness or economic freedom. Most of these surveys attempt to develop one overall measure of governmental interference in economic activity based on analysis of the state’s tax, trade, budget, regulatory, and monetary policies.

Distinctive Attributes

The Israeli economy has several distinctive features. Three of the more prominent ones are associated with high defense requirements, chronic balance of payments problems, and a political system that make economic policymaking more difficult or uncertain.

Since its establishment, Israel has been subject to almost constant hostility from neighboring states. As a result, defense has almost always come first in terms of the overall allocation of resources. Annual defense expenditures have been high compared to other countries both in per capita terms and relative to the size of the economy. In recent years, defense expenditures have declined, but still average around 10% of GDP.¹³

Israel’s defense burden can be measured by the budgeted resources diverted to defense that could have been used for other civilian purposes. The defense burden also includes the opportunity cost of labor working for the defense sector that is unavailable to work in the private sector, thereby reducing the economy’s potential

¹¹ Rivlin, Paul. *The Israeli Economy*, Westview Press, 1992, p.115.

¹² See appendix table 10 for more detail.

¹³ IMF Staff Report, p.81.

output. In addition, defense spending has been an important factor behind the size of the state budget and persistent budget deficits.¹⁴

Israel's precarious security environment has also insured that foreign policy or geo-political considerations are given priority over purely economic policy issues. As a result, sound economic policy decisions (e.g.) to cut government expenditures in order to promote macroeconomic stability) are often given short shrift when the security environment is tense.

Chronic balance of payments deficits are a second distinctive feature of the Israeli economy. Driven by its need to import most all of its energy requirements, most of its raw materials, and considerable weaponry, Israel historically has run merchandise trade deficits. To finance the deficits, Israel has long had to rely on foreign capital transfers via loans, grants, foreign investment, and borrowing. A perennial concern is that rising trade deficits and capital imports together can lead to a precipitous decline in the value of the Israeli currency. This concern, in the past, however, has also been the catalyst for economic policy changes that would avoid a sell-off of foreign currency reserves and a financial crisis.

A third distinctive feature relates to Israel's political system where seats in the 120-member Knesset are allocated according to proportional representation. Any political party that receives 1.5% of the national vote is allocated seats in the Knesset. The effect of this system is to produce coalition governments where the power of small, mostly single issue parties is greatly enhanced. Currently, nine such parties ranging from the ultra-religious to the left-wing peace parties hold almost half the seats in the Knesset while the two main parties (Labor and Likud) combined control a slim majority.¹⁵

The need for the Prime Minister to consult leaders representing nearly every faction of the governing coalition on most major decisions serves as a formidable constraint on pushing ahead with fundamental economic or structural reform initiatives. A 1996 political reform that provided for the direct election of the Prime Minister arguably has served to reinforce this tendency by encouraging the formation of small parties and by forcing the Prime Minister to cater to the whims of the support groups that elected him.

Within the Israeli government, the Bank of Israel remains the main force supporting macroeconomic stability, particularly low inflation, and liberalization of the economy. Acting as a independent central bank only since the last decade, its willingness to raise interest rates to combat inflation is considered critical. However, a number of political and business leaders have advanced proposals to dilute the

¹⁴ Pelzman, Joseph. "Israel's Economy," In *Israel: A Country Study*. U.S. Library of Congress, 1988. pp. 141-176.

¹⁵ Hunt, Albert R. "The Wonders of Israel...Politics and All," *New York Times*, August 28, 1997, p. A15.

independence of the central bank. If passed by the Knesset, most economists fear that stability of the Israeli economy could be jeopardized¹⁶

Stages of Economic Growth

Since the establishment of the state of Israel in 1948, the economy has experienced three different stages of economic growth and related macroeconomic developments. The first (1948-1972) and third stages (1989-1995) were classic boom periods fueled primarily by rapid increases in immigration that boosted the stock of labor. The third stage (1973-1988) was a period of considerable economic instability and turmoil. The Israeli economy currently may be entering a fourth stage where a combination of problems are raising concerns once again about the stability and future performance of the Israeli economy.

First Two Stages (1948-1972 and 1973-1988)

From 1948-1972, the first 24 years of the state of Israel, the economy grew at a very rapid rate. During this period, real GNP increased at an annual rate of 10.4 percent, one of the highest rates in the world. This high rate of growth allowed for a steady rise in per capita incomes. At the same time, inflation averaged less than 10% on an annual basis.

Rapid increases in both the stock of labor and capital were largely responsible for the rapid growth of the economy. Between 1948 and 1973, the population of Israel increased nearly four-fold, rising from 870,000 to 3.3 million. The growth in the capital stock was even greater, increasing eight-fold from 1950 to 1967.¹⁷

Between 1973 and 1986, by contrast, the Israeli economy performed very poorly and unevenly. The economic growth rate slowed to an annual average of about 2% per year with no increase in per capita incomes. The rate of inflation skyrocketed, reaching a high of 445% in 1984. And the economy experienced balance of payments crises in 1975, 1983 and 1984/1985¹⁸

Three factors — a major increase in defense expenditures following the 1973-74 Yom Kippur War, a world energy crisis, and a sharp increase in expenditures on social welfare — help explain the deterioration in economic performance during this period. In the aftermath of the June 1967 War, defense expenditures between 1970 and 1982 escalated to over 25% of GDP, up from a 10% to 16% of GDP range prior to the war. Sharp increases in oil prices in 1973 and again in 1979 imposed a huge cost on the Israeli economy, estimated at \$12 billion or the equivalent of one year's

¹⁶Marcus, Dockser and David Wessel. "Israel's Central Banker Stirs Controversy, New York Times. September 26, 1997, p. A18.

¹⁷ Rivlin, Paul. pp. 6-7.

¹⁸ Pelzman, Joseph. "Israel: The Economy," p. 141

GDP at the time. In addition, to deal with rising social unrest, government spending on education, housing, and welfare increased substantially during this period.¹⁹

The deterioration of the Israeli economy continued in 1985 with hyperinflation and a precipitous fall in foreign exchange reserves. To stabilize the economy, the government in July 1985 introduced an Economic Stabilization Program. The program involved an immediate 18.8% devaluation of the shekel, a freeze on price and wage increases, deep cuts in government expenditures, and monetary restraint.

The stabilization program was dramatically successful. It not only reduced inflation from over 400% in 1985 to around 20% by the end of 1986, but it also laid the foundation for the consideration of additional reforms affecting taxation foreign currency and privatization in the years ahead.²⁰

Stage Three (1989-1995)

Beginning in 1989, Israel experienced a huge influx of immigrants, mostly from the former Soviet Union. From 1989-1995, approximately 760,000 new immigrants increased Israel's population from 4.52 million to 5.54 million, a 13% increase. These mostly young immigrants represented according to one analyst "the greatest migration of highly skilled human capital in the twentieth century."²¹

The Israeli government's strategy for immigrant absorption placed primary responsibility on the promotion of private sector employment without direct labor market intervention. Government expenditures for absorption, which averaged approximately 6% annually of the domestic budget, were directed substantially to the construction of public housing. In addition, the government provided Hebrew language and vocational training, as well as loans to new immigrants to start up their own businesses.²²

The rising supply of labor spearheaded a very rapid economic growth that averaged over 6% in real terms from 1990-95. Real per capita incomes experienced healthy rates of increase during this period as well, rising from an average of \$13,977 in 1986-1989 to \$16,783 in 1996.²³

The economic expansion was led primarily by investment that grew at an annual average rate of 16.2 % from 1990-1995, compared to around one-tenth of 1% in the

¹⁹Ibid., 143-144.

²⁰ For an overview of the Israeli economy from 1985-1990, see Wertnan, Patricia A. "The Israeli Economy and Its External Relations: An Overview," *Congressional Research Service*, Report 92-276E, February 28, 1992, 48p.

²¹Rosen, Howard. "Policy Parameters," In Reich, Bernard. *Securing the Covenant: United States-Israel Relations After the Cold War*. Praeger Press, 1995. Pp. 109-128.

²² White House. Report Pursuant to Section 226 (k) of the Foreign Assistance Act of 1961, as amended, and Section 1205 of the International Security and Development Cooperation Act of 1985 [hereafter cited as the 1996 Loan Guarantee Report]. December 31, 1996, pp. 1-3.

²³ Bank of Israel 1996 Annual Report, Chapter 1, p. 4.

1980s. Initially the investment demand was channeled into construction for new houses, but it later spread to increases in plants and equipment. The new immigrants also stimulated private consumption (expenditures on consumer durables), which increased on average by 7.1% in the 1990s, compared to 5% annual growth in the 1980s.²⁴

The impressive growth record was accompanied by favorable developments on the inflation and unemployment fronts. Unemployment fell from a 10.1% average in 1990-91 to 9.0% in 1995, and the numbers of employed increased from less than 1.5 million in 1989 to over 1.8 million in 1995. Inflation, measured by the consumer price index (CPI), dropped from 17.8% in 1990-91 to 10.8% in 1995.

Table 1. Basic Economic Data^a, 1986-95

	1986-89	1990-91	1992-95
Mean population	4,405	4,803	5,327
Population growth rate (percent)	1.6	4.7	2.8
Israeli persons employed ('000s)	1,422	1,535	1,808
GDP (NIS million, 1996 prices)	196,340	223,827	265,683
GDP (\$million, 1996 prices)	61,587	70,209	83,339
Per capita GDP (\$, 1996 prices)	13,977	14,617	15,630
Growth rate of GDP (percent)	3.7	6.2	6.0
Unemployment rate (percent)	7.1	10.1	9.0
Inflation rate (percent)	18.2	17.8	10.8

^aAnnual averages.

Source: Bank of Israel 1996. Annual Report, p.4

The Middle East Peace process contributed positively to Israel's rapid economic growth during this period as well. Since the Madrid conference in 1991, agreements reached between Israel and the Palestinians and with Jordan allowed the expansion of contacts with countries and companies which once boycotted Israel. The peace process also stimulated tourism, a sector which provides roughly 10% of Israel's gross foreign exchange earnings.²⁵

The most important new markets opened to Israel have been in the Far East. Facilitated by the weakening of the Arab boycott, Israeli exports to all of Asia, which now constitute about one-fifth of total Israeli exports, leapt 86% from 1992 to 1995, as compared to an overall growth rate of 45% during that period. The Israeli Finance Ministry calculated that over 60% of the increase in exports in 1994 and 1995 was

²⁴ IMF Staff Report, p .40.

²⁵ U.S. Department of Commerce. "Israel: Commercial Guide," July 1996, p.3.

due to the opening of new markets previously closed to Israeli goods, principally located in Asia.²⁶

The fruits of the peace process are also reflected by increases in foreign direct investment flows, with a record \$2.2 billion entering the economy in 1995.²⁷ A growing number of multinational companies, such as Intel, Motorola, and IBM, have established plants and R&D sites, mostly to tap the economy's skill base in science, medicine, and technology.²⁸

Stage Four (1996-Present)

Beginning in 1996, the Israeli economy has experienced a slowdown in growth compared to the early 1990s, a rise in the unemployment rate, inflationary pressures, and a growing current account deficit. This combination of problems, which has occurred simultaneously with a slowdown in the immigration rate, has raised some concerns about the stability and the future performance of the Israeli economy.

Growth. Israel's GDP growth rate declined in 1996 to 4.4% from the 7.1% rate in 1995. The drop was mainly due to a sharp decrease in export sector growth and a slowdown in construction (both residential and nonresidential).²⁹

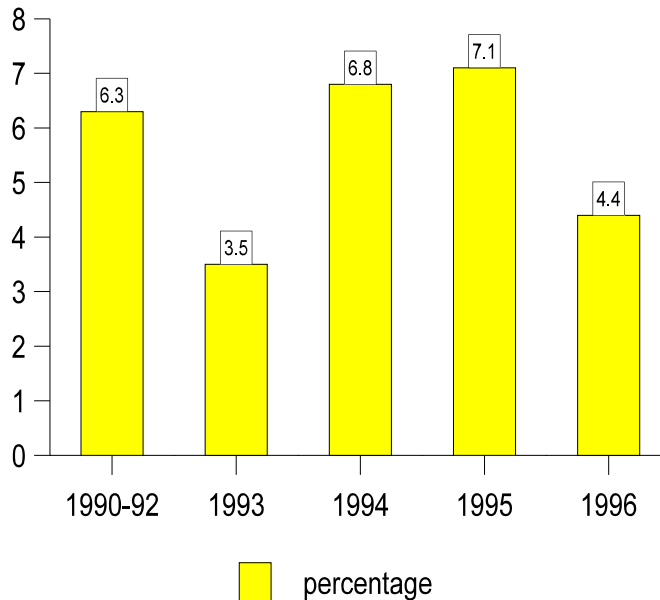
²⁶ LINK Magazine. "Link's Tour of the New Israeli Economy," found at <http://www.link.co.il/privatization/index.htm> (as of October 2, 1977).

²⁷ For the first nine months of 1996, foreign investment totaled \$1.9 billion, composed of \$1.1 billion of investments in Israeli securities and \$875 million of direct investments in Israeli corporations and securities. Cited in Economist Intelligence Unit, 1st Quarter 1997 Country Report on Israel, p. 26.

²⁸ Passell, Peter. "Despite Welfare State Origins, Israeli Enterprise Blossoms," *New York Times*, June 5, 1997, p. D 2.

²⁹ Bank of Israel 1996 Annual Report, p.6.

Figure 1. GDP Growth Rate, 1990-96



Source: Bank of Israel 1996. Annual Report.

The slowdown in the export growth rate was concentrated in services. While exports of goods rose by 7.9% in 1996, a rate similar to 1995, services exports fell by about 1% in 1996, compared to a 14.5% rise in 1995. Most of the rapid expansion of goods exports was in high-tech industries such as software and biomedical equipment, while traditional goods exports such as footwear and clothing continued to shrink. A steep decline in tourism, following the terrorist attacks in March 1996, accounted for a large share of the decline in services exports.³⁰

The economy has continued to slow down in 1997. During the first six months, it grew at only 1.8% — a rate well below the 4.4% growth in 1996. Slower growth can be expected to have both positive and negative consequences for the economy. On the one hand, it is likely to help moderate inflationary pressures and to reduce the current account deficit through reduced demand for imports. On the other hand, it is likely to lead to reduced government revenues, creating more pressure for significant cuts in government expenditures in order to meet budget deficit targets. In addition, slower growth, combined with a population rising at about 2.5%, means there will be little or no increase in per capita incomes. Such increases are an Israeli government goal in order to attract new immigrants, particularly from Eastern Europe.³¹

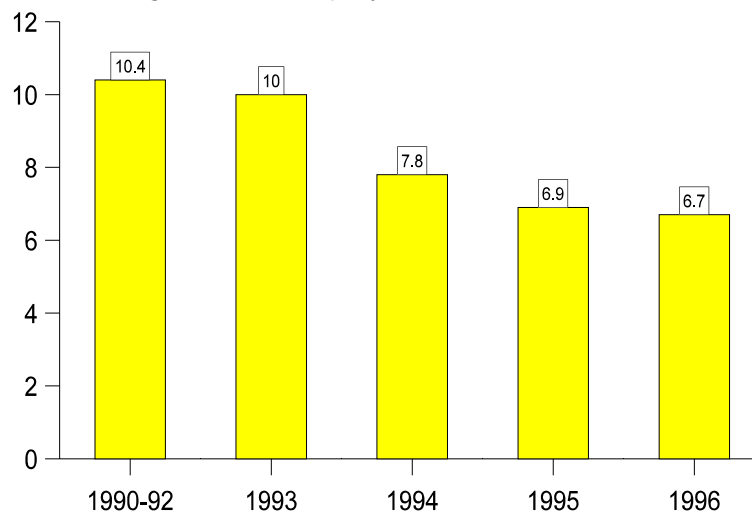
³⁰ Ibid., p. 7.

³¹ Dempsey, Judy. "Netanyahu Pledges Cuts and Extra Cash," *Financial Times*, July 12, 1997, p. 4.

Employment. Israel's labor force grew rapidly in the 1990s with the influx of new immigrants. From 1990-1992, the civilian labor force (including foreign workers and workers from the occupied areas) grew by 5.8%. Following a 3.1% rise in 1993, the labor force grew by 5.2% and 6.6% rates in 1994 and 1995, respectively. In 1996 the expansion slowed to 3.4%. Over 2.157 million workers were in the labor force in 1996, up from 2.109 million in 1995.

Despite the increase in the supply of labor, the growth of demand during the 1990s outstripped the supply. This is reflected in declines in the unemployment rate from an average of 10.1% in 1990-91, to 9.0% in 1992-95, and to 6.7% in 1996. During 1997, unemployment is projected to reverse this downward trend by rising to 7.9%³²

Figure 2. Unemployment Rate, 1990-96



Source: Annual Report.

Regarding the composition of business sector employment, the trend of the previous three years continued in 1996: rising numbers of Israeli and foreign workers and declining numbers of workers from the territories such as Gaza and the West Bank. Israeli workers expanded by 2.8% and documented foreign workers by 40%, but employment of workers from the territories declined by 33%. (The number of registered foreign workers rose from 58,000 in 1995 to 83,000 in 1996, elevating their share to roughly 4% of total employment). This development is related to security events and the closure of the territories early in 1996.³³

The entry of a rising number of foreign workers has led to downward wage pressures as well as a reduction of jobs in many traditional industries. This development, which has been reinforced by the on-going liberalization of foreign trade barriers, has occurred at the same time that demand for highly skilled labor has

³² Bank of Israel 1996 Annual Report, p.4.

³³ Government of Israel website found at: <http://www.mof.gov.il/beinle/nutbug1.htm#1.MainTrends> (as of October 2, 1997).

soared, causing their real wages and employment to rise. As a result, Israel, is seeing the gap between rich and poor widen in recent years.³⁴

Inflation. In 1996, price increases as represented by the CPI rose by 10.6%, slightly surpassing the upper limit of the Bank of Israel's inflation target of 8-10%. This slight inflationary upturn was driven by increases in the price of fruits and vegetables and housing (25% and 14% respectively). Other contributing factors included an expansionary budget policy and low unemployment.³⁵

In 1997, inflation has continued to run near the upper limit of the central bank's 7%-10% target zone. As a result, the Bank of Israel announced in August 1997 an increase in the key lending rate it charges commercial banks. This interest rate hike, by 0.7 percentage points to an annualized 13.4%, was the first since July 1996. A continuation of a tight monetary policy, combined with slower growth in 1997, is expected to keep inflation in check.³⁶

Given that a large percentage of Israeli wages, contracts, and mortgages are indexed or linked to changes in the consumer price index, lowering the inflation rate to single digits through monetary restraint is quite difficult. The government, however, has tried to lessen this "structural" component of inflation by decreasing the extent to which prices are indexed.

Balance of Payments. Israel traditionally has run a large external trade deficit that largely has been offset by cash grants from foreign governments and individuals. In recent years, the deficit on goods and services has outpaced the inflow of these unilateral transfers, resulting in a significant increase in Israel's current account deficit. In 1995, this deficit reached \$3.9 billion, or 4.7% of GDP. In 1996, the deficit widened to \$4.4 billion — which represented about 4.8% of GDP. The deficit is large relative to past levels and by comparison with other countries.³⁷

³⁴ Bank of Israel 1996 Annual Report, pp. 8-9.

³⁵ The Government of Israel website at <http://www.mof.gov.il/beinle/nutbug1.htm#1.MainTrends>.

³⁶ Dempsey, Judy. "Israel Eyes Broader Economic Horizons," *Financial Times*, August 25, 1997, p. 4.

³⁷ Bank of Israel 1996 Annual Report, pp. 10-11.

Table 2. Savings, Investment, and the Current Account, 1990-96
(Percent of income, annual rates)

	1990-92	1993	1994	1995	1996
Gross national saving rate	20.5	20.3	18.6	17.8	17.1
Public	-0.6	0.6	0.8	-0.7	-1.7
Private	21.1	19.7	17.8	18.5	18.8
Gross investment	20.8	21.7	21.6	22.1	22.0
<i>Of which</i> Principal industries	12.4	14.7	15.5	14.9	14.5
Transfers on capital account	0.4	0.3	0.3	0.3	0.3
Net balance of payments on current account	0.1	-1.1	-2.7	-4.0	-4.6

Source: Bank of Israel. 1996 Annual Report.

Most of the growth in the deficit was caused by a decline in Israel's savings rate. This rate dropped from an annual average of 20.5% in 1990-92 to an annual average of 17.5% in 1995-96. Low and even negative public savings, reflecting a budget deficit, occurred in 1995 and 1996. At the same time, the investment rate has remained strong in recent years, due largely to a surge in housing and infrastructure outlays.³⁸

Israel has faced no problem in financing this deficit, thanks to an upsurge in foreign direct investment, expansion of the number of long-term loans, and to its borrowings under the five-year, \$10 billion U.S. loan guarantee program that runs through 1998. Implied capital imports averaged an \$6.8 billion in 1995-96, an amount well in excess of the current account deficit.³⁹

Nonetheless, the current account deficit is a matter of concern, particularly over time. A rising deficit, combined with an overvalued currency, are often leading indicators of a possible balance of payments or financial crisis. This is a situation that Israel needs to be especially concerned about because it already is heavily dependent on foreign capital to finance its deficit and there is no guarantee that these sources of funding will continue at a reasonable cost forever.⁴⁰

The rise in Israel's current account deficit has caused Israel's net external debt to rise in absolute terms from \$16.5 billion in 1990-92 to \$20.0 billion in 1996. But due to strong GDP growth, Israel's net external debt has declined from 27.6% of GDP in 1990-1991 to 20.5% of GDP in 1996. The manageability of Israel's debt is

³⁸ Ibid.

³⁹ Bank of Israel 1996 Annual Report, p. 11.

⁴⁰ Bank of Israel 1996 Annual Report, p. 11, and IMF Staff Report, p. 48.

also manifested by a falling debt service/total export ratio of 13% of GDP in 1996, as compared to 16.9% in 1991.⁴¹

During 1997, the slowdown in economic growth has helped reduce the current account deficit.⁴² This has occurred as home demand for imports has slackened and world demand for Israeli exports has increased due to a continuing depreciation of shekel. A strong export performance is also a key to keeping Israel's debt service payments at manageable levels.

Current Macroeconomic Policy Issues

Israel's current economic problems are fueled in large part by a widening gap between fiscal and monetary policies. While fiscal policy has been expansionary in recent years, monetary policy has been restrictive. This has imposed an economic cost on the country, primarily in terms of a high interest rates. Most experts agree that a major fiscal consolidation or tightening is necessary before monetary policy can be eased. The slowdown in economic growth, however, is placing added pressures on monetary authorities to lower interest rates in order to avoid a domestic recession. The problem is that too large a drop in interest rates could lead to an large outflow of capital, precipitating an abrupt depreciation of the shekel.

Fiscal Policy

Until 1995, the burden of absorbing a large influx of immigrants was accomplished without an expansionary fiscal stance. Although the domestic budget deficit increased from 3.2% of GDP in 1989 to 5.3% in 1991, tight controls on expenditures helped drop the domestic budget deficit steadily to 2.0% of GDP by 1994. But with an election approaching in the fall of 1994, large increases in public sector wages and tax cuts, as well as by receipt of less revenues than estimated, turned fiscal policy expansionary. The result was that, in 1995, the domestic budget deficit reached 3.3% of GDP, well above the 2.75% target established by the 1992 Budget Deficit Reduction Act.⁴³

Fiscal policy became more lax in 1996 with the domestic deficit rising to 4.7% of GDP. This deficit also significantly exceeded the deficit reduction target prescribed by law.⁴⁴

⁴¹ IMF Staff Report, p. 48, and 1997 Loan Guarantee Report, p. 12.

⁴²The current account deficit has declined from \$3.6 billion during the first six months of 1996 to \$2.3 billion during the first six months of 1997.

⁴³ In addition, the methodology used by Israel in calculating the deficits reportedly underestimates the amount compared to the methodologies used by other industrialized countries. See IMF Staff Report, p. 41.

⁴⁴ Bank of Israel 1996 Annual Report, p. 13.

Table 3. Main Indicators of Fiscal Policy, 1990-1996
(percent of GDP, annual rates)

	1990-92	1993	1994	1995	1996
Domestic budget deficit					
Legal limit	6.2	3.2	3.0	2.75	2.5
Actual	4.9	2.4	2.0	3.2	4.7
Total public deficit	4.0	2.3	1.2	3.1	4.2
Domestic public deficit	7.2	4.1	2.4	4.3	5.3
Total net public debt	111.1	100.4	93.7	89.3	89.7
<i>of which</i> Internal public debt	92.5	80.3	74.3	72.8	76.1

For 1992 only.

Source: Bank of Israel. 1996 Annual Report.

The deviation of the actual budget from the deficit target arose again in 1996 on the basis of both an overestimation of domestic tax revenues and failure to cut the rate of spending.⁴⁵ As in the case in 1995, more than half of the deficit overrun was caused by revenue shortfalls rather than overspending.⁴⁶ The shortfall in revenues, in turn, was attributable to a decline in income and other direct tax collections, as well as to the growing role of foreign workers who are paid in cash.⁴⁷ On the expenditure side, large increases in public sector spending occurred prior to the May 1996 election. Particularly noteworthy were rapid increases in both public sector salaries and public sector jobs.⁴⁸

Viewing recent shifts in the composition of expenditures, two developments stand out. The first is that defense spending as a percentage of GDP has declined from around 11.5% in 1992 to just 9.5% in 1996. At the same time, transfer payments to households and nonprofit institutions have increased from 13.5% in 1992 to 15.6% of GDP in 1996. The share in the budget going to non-defense public sector salaries also has risen from 5.1% of GDP in 1992 to 6.3% of GDP in 1996.⁴⁹

To date in 1997, Israeli efforts to reduce the budget deficit to 2.5% of GDP have proven difficult. In December 1996, the government did get its 1997 state budget approved by Knesset. The initial \$56.8 billion budget package included a variety of

⁴⁵ While government expenditures as a % of GDP declined from 48.2% of GDP in 1992 to 46.2% in 1996, revenues also declined from 44.4% of GDP in 1992 to 41.9% of GDP in 1996.

⁴⁶ Loan Guarantee Report, 1997, p. 9.

⁴⁷ Ibid.

⁴⁸ Bank of Israel 1996 Annual Report, p. 13.

⁴⁹ Loan Guarantee Report, 1997, 10; IMF Staff Report, tables p. 80-81.

measures designed to bring the overall deficit back to 2.5% of GDP without raising taxes. But intense opposition to proposed cuts in transfer payments and subsidies, however, forced the Likud-led government to rely on increased taxes to obtain approximately half the proposed reduction in the budget deficit.⁵⁰

Subsequent efforts by the government early in the summer of 1997 to obtain additional expenditure cuts have been thwarted by political pressures to increase spending, particularly for projects favored by minority parties in the coalition. Thus, meeting the budget deficit target could prove difficult again this year as the economy continues to grow more slowly.

The 1997 economic slowdown increases the likelihood that revenues will run below projected levels. As the baseline 1997 budget assumed an economic growth rate of 4%, actual growth at around 2% could translate into a revenue gap of at least \$425 million.⁵¹

The slowdown may also increase political opposition to budget cuts. While economic theory suggests that significant budget cuts could facilitate lower interest rates and a lower exchange rate that, in turn, could generate increases in domestic production, cuts in government spending are traditionally unpopular among influential interest groups.

Monetary And Exchange Rate Policies

Since 1985, the main objective of Israel's monetary and exchange rate policies has been to reduce inflation to levels prevailing in most advanced, industrialized countries. The central bank's principal tools are control over the money supply and interest rates.

As Israel's fiscal policy turned expansionary in 1994, monetary policy turned restrictive. Throughout 1995 and 1996, a tight monetary policy has persisted with the Bank of Israel holding real interest rates at 4 to 5 percentage points above the underlying rate of inflation. Combined with an attempt to maintain a downward, crawling peg exchange-rate mechanism, this policy has had a number of side-effects.

First, high real domestic interest rates in 1995 and 1996 encouraged a surge in short-term capital inflows. By the end of 1996, short-term deposits had boosted M2 (a monetary aggregate that includes short-term deposits) to a level that exceeded foreign reserve holdings threefold. This development raised concerns that if interest rate spreads between Israel and other countries narrowed, a huge supply of shekels could be dumped on the market as domestic agents switched to foreign currency assets.⁵²

⁵⁰ Economist Intelligence Unit, Israel: 1st qtr 1977 Country Report, p. 13.

⁵¹ Schmemmann, Serge. "In Fight Over Privatization, Netanyahu Wins A Round," *New York Times*, July 24, 1997, p. 3.

⁵² Economic Intelligence Unit, Israel: 1st Qtr 1997 report, p. 14.

Second, the large-scale capital inflow has led to a moderate (5% since 1993) real appreciation of the shekel. While a stronger currency helps in the fight against inflation, it is controversial in the business community because it increases the price of Israeli exports.

Third, the tight monetary policy and accompanying high interest rates have encouraged Israeli firms to increase substantially their use of foreign denominated credit. The rising demand for foreign currency borrowing has forced the central bank to engage in activities to soak up the supply of shekels it has pumped into the economy in order to prevent the monetary base from growing and undercutting its inflationary targets. This process, known as sterilization, has imposed a “quasi-fiscal” cost on both the Bank of Israel and the public.⁵³

In June 1997, the Bank of Israel acted to counter the negative pressures from capital inflows and the sterilization requirements. Exchange controls were further liberalized to allow provident and mutual funds more freedom to invest abroad and the exchange rate band was widened to make speculation riskier. The Bank also dropped its main lending rate from 13.9% to 12.7% after the cabinet agreed to cut the deficit by an additional 600 million shekels.⁵⁴

Monetary authorities hope that the interest rate reduction will reduce the demand for shekels in the foreign exchange market and allow some real devaluation of the shekel to take place gradually. Their concern is that a diminution of interest rate spreads between Israeli and foreign markets could prompt a large outflow of foreign capital that, in turn, could lead to a precipitous depreciation of the shekel. Without substantial cuts in budgetary expenditures, however, monetary authorities can be expected to maintain a very cautious policy towards any further interest rate reductions.

Structural Reforms — Recent Developments

Attainment of Israel’s macroeconomic objectives — particularly rapid economic growth — can also be facilitated by a range of structural reforms that would reduce the level of government intervention in the economy. The government of Israel has for a long time pursued these structural reforms not only to improve the government’s finances, but also to promote a more efficient use of the economy’s resources. Given the likelihood of a slower growing labor force, the main spur to the rapid growth in the early 1990s, productivity increases brought about by structural reforms that enhance efficiency may become even more critical in the future.

Since 1985, the government's record on implementing structural reforms has been varied. On the one hand, limited progress has been made in the privatization of state-run enterprises, and the deregulation of markets for capital, labor, and land. On the other hand, more significant progress can be discerned in efforts to liberalize foreign trade barriers and to interject more competition into specific sectors that have

⁵³ Bank of Israel 1996 Annual Report, p.18.

⁵⁴ Dempsey, Judy. "Israel Foreign Exchange to be Reformed," *Financial Times*, June 20, 1997, p. 22.

dominated by a few large conglomerates or state-run enterprises. According to many observers, more rapid, sustainable, and non-inflationary growth.

Privatization

At the request of the Israeli government in 1987, the First Boston Corporation produced a strategic privatization plan. At that time, the government owned a stake in some 160 companies whose output accounted for about 10% of GDP. The plan, which was adopted by the government in 1988, identified 75 commercially oriented companies that could be sold both through direct sales to investor groups and public equity offerings on the Tel Aviv Stock Exchange (TASE). In addition, 30 companies were identified as prime candidates for privatization within the next five years.⁴⁷

Privatization either through direct sales to investor groups or through public offerings is desirable not only because it could enhance the economy's competitiveness, but it could also attract more foreign direct investment. In addition, sales of state assets could help the government meet its deficit reduction targets.⁴⁸

Since the privatization program began, Israel has raised about \$2 billion of an expected \$5 billion from sales of state-owned companies. In addition, sales of shares in government-owned banks have raised about \$2.9 billion compared to an expected \$4.5 billion. As shown below, revenues from privatization has varied greatly from year to year.

Table 4. Revenue From Privatization
(millions of dollars)

1986 through 1990	423
1991-1992	1,025
1993	1,241
1994	207
1995	535
1996	201
1997 (through September)	2,370

Source: Government Companies Authority

A number of factors are often cited for the relatively slow pace of the privatization process. One important factor concerns the question whether the government should restructure industries before privatizing or should privatize enterprises before restructuring. A potential problem is that if pro-competitive structural reform is not implemented prior to privatization, the result could be the substitution of a private monopoly for a public one. Other factors include lack of

political will, resistance from unions and management, and depressed conditions in the Israeli stock market.⁵⁵

At present, the government retains control over some 116 companies. About half of these companies are commercially oriented (such as tourism), and half provide public services (such as airports).

In July 1996, Prime Minister Netanyahu promised to “privatize everything in sight”. As a sign of his intention, he relocated the privatization authority from the Ministry of Finance to the Office of the Prime Minister.⁵⁶ In January 1997, a Ministerial Privatization Committee approved a limited plan that called for 12 government corporations to be sold in 1997. The leading candidates include: Bezeq, the Israeli telephone company; Zim Israel Navigation, a shipping company; El Al, the national airline; and Israel Chemicals.⁵⁷

The government’s efforts to carry out this plan have been met with predictable resistance by the unions and workers. The sale of 12.5% of Bezeq’s stock to Merrill Lynch for \$250 million, for example, prompted a one-day general strike on July 24, 1997. This strike, which involved over 60,000 workers, disrupted telephone services and halted all outgoing flights from Ben-Gurion International airport. Unable to block the sale, Histadrut may have called the strike to negotiate maximum benefits for any workers that might lose their jobs as a result of the privatization.⁵⁸

Despite organized resistance, the government raised over \$2.3 billion in revenues from its privatization efforts in 1997 (through September). In addition to successful offerings on Bezeq and Israeli Chemicals, the government sold the country’s largest bank, Bank Hapoalim.⁵⁹

Capital Markets Reforms

By imposing barriers to investment abroad, mandatory purchases of government securities by institutional investors, and high reserve ratios, the Israeli government historically has played a dominant role in the allocation of credit. The government has also played a dominant role in the banking system — a role that was solidified by a 1983 bank scandal that led the government to take over the country’s three largest banks.

In recent years, Israeli capital markets have been liberalized by reducing the government’s once dominant involvement in capital allocation and the banking

⁵⁵ Dempsey, Judy. “Rough and Smooth on the Israeli Road to Privatization,” *Financial Times*, January 30, 1997, p. 10, and IMF Staff Study, p. 18.

⁵⁶Some observers believe that this change does little, if anything to insulate the privatization process from "politics".

⁵⁷ Rosenberg, David. “With A Whimper,” *The Jerusalem Report*, February 20, 1997, p. 42, and The Economist Intelligence Unit, 1st Qtr. 1997 report, p. 14.

⁵⁸ Schmemann, Serge. “In Fight Over Privatization, Netanyahu Wins A Round,” p. 3.

⁵⁹ Rubin, David. “Growing On Ingenuity,” *Journal of Commerce*, July 28, 1997, p. 9A.

system. Bank reserve ratios and requirements to hold government paper have been reduced, and directed credit schemes have been canceled. A number of restrictions placed on Israeli residents to borrow from abroad have also been lifted.

Despite the progress made, capital markets remain characterized by considerable government intervention and subsidization. A variety of regulations and restrictions affect the portfolio allocations of institutional investors and private savings. These include a complex system of taxation of different assets and the issuance of government bonds with guaranteed real rates of return. In addition, the Israeli capital market lacks a number of financial instruments found in other industrialized countries such as corporate bond issues and simple fixed-income money market certificates. As a result, the flow of funds to the private sector remains distorted.⁶⁰

In July 1996, a committee (chaired again by Mr. Brodet) was established to explore structural reforms of the capital markets. The committee identified five major problems: absence of long-term institutional investors; high degree of concentration; tax discrimination between investors and savers; lack of regulation of financial agents; and a limited supply of stocks. Recommendations centered on ways to encourage long-term private savings, attract more investors into stock and bond markets, and make more funds available for mortgage lending. In the fall of 1996, the Knesset voted to adopt only part of these recommendations, while deferring action on proposals affecting short-term savings and pension fund reform.⁶¹

Labor Market Reforms

Israel's labor market historically has been relatively inflexible due substantially to a wage setting system and a minimum wage law. In regard to wage settlements, Histadrut (the huge and powerful labor federation) negotiates sector and industry wage agreements with the government and the organization of private sector employees. The agreements reached constitute a framework of wage scales for the different sectors of the economy and, with occasional changes of detail, also provide for automatic payment of a cost-of-living allowance as compensation for inflation.⁶²

A minimum wage law, enacted in 1987, further reduced labor market flexibility. The law establishes a minimum wage equivalent to 45% of the average wage, and it is adjusted semi-annually as the average wage changes. Histadrut has vigorously opposed efforts to make adjustments in the law.⁶³

More flexible labor markets, by allowing downward pressure on wage rates and unit labor costs to work their way through the economy, would help create

⁶⁰ IMF Staff Study, p. 21.

⁶¹ Rosenberg, David. "Brodet's Mini-Market Reform," *The Jerusalem Report*, October 17, 1996, p. 44, and IMF Staff Report, pp. 24-25.

⁶² Israeli Ministry of Foreign Affairs. Found at <http://www.Israel-mfa.gov.il/facts/econ/fecon7.html>.

⁶³ U.S. Agency for International Development. Report on Economic Conditions in Israel: 1992-1993, January 5, 1994, p. 13.

employment and would enhance the overall efficiency of the economy. Due to the influx of new immigrants and foreign workers (many of whom take non-union jobs), and to changes in the wage bargaining process, however, the labor markets arguably have become more flexible in recent years.

The impact of a growing labor force can be seen in terms of minuscule real wage increases for non-public sector workers from 1989-1995. During this period, real wages have declined for four of the seven years. And in the years when real wages have risen, the increases have been small (1.8% in 1992, 0.3% in 1993, and 0.2% in 1995).⁶⁴

Structural changes in the wage bargaining process may have contributed to real wage restraint in the business sector as a smaller share of the wage bill is now negotiated at the national level. With more freedom in wage bargaining at the local level, firms may have been able to negotiate wage settlements more in line with their ability to pay.⁶⁵

Significant rigidities in the heavily unionized and regulated labor market, however, persist. The decline in real wages in the business sector has been more pronounced in the less-heavily unionized services sector of the economy, such as construction. And in contrast to the real wage declines in the business sector from 1989-1995, real wages of public sector employees increased on average by 2.5% annually. This gap between public and business sector wages continues to blunt the movement of labor from the public to the private sector. In addition, it is uncertain how a slower growing labor force will affect wage flexibility in the future.

Foreign Trade and Currency Reforms

In an effort to increase domestic competition and to expand exports, Israel has opened its economy increasingly to foreign trade. During the 1970s and 1980s, Israel substantially liberalized its trade barriers to imports from the European Union (EU) and the United States — trading partners that supply Israel with bulk of its imports. Within the context of its free trade agreements (FTA) with the European Union and the United States, Israel eliminated, or will eliminate, tariffs on the bulk of its imports from the EU and the United States. Israel has also signed agreements with a number of Scandinavian and Eastern European countries that are essentially equivalent to its FTA with the EU, as well as an FTA with Canada in January 1997.

Beginning in 1991, Israel began to gradually liberalize trade with “third countries,” namely those in Latin America, Asia, and Eastern Europe, not covered by free trade agreements. Nearly all quantitative restrictions on non-agricultural products were initially replaced with tariffs ranging from 20% to 75%, with higher tariffs for such products as wood and textiles. In 1992, maximum tariffs were reduced to 60% for most products and to 110% for wood and textiles. All tariffs were reduced to maximum rates of 8% for raw materials and 12% for finished and intermediate goods by September 1997. However, tariff reductions on some

⁶⁴ See appendix table 7 for more detail.

⁶⁵ Israeli Ministry of Foreign Affairs website op. cit.

traditional manufactures (e.g.) wood products, footwear, textiles and clothing) will not be implemented until later.⁶⁶

While FTA's and unilateral initiatives, as well as membership in the World Trade Organization, have substantially reduced tariff barriers between Israel and its major trading partners, significant non-tariff barriers remain. These include high purchase taxes on luxury goods, artificial customs uplifts, and quotas on agricultural products. As is the case worldwide, a number of these remaining barriers protect local producers.⁶⁷

Since 1985, the Israeli government has substantially liberalized a once rigid system of foreign exchange controls. In particular, reserve requirements on domestic foreign-currency deposits have been significantly lowered in recent years.⁶⁸

The government has also taken a number of steps designed to make the shekel fully convertible. In support of this objective, the government recently lifted several restrictions on Israeli companies' investing abroad. The measures will also eliminate curbs on the foreign activities of Israeli banks and provident funds. Restrictions limiting the amount of foreign currency individuals may purchase for travel abroad (\$1,000) and on pension funds from buying foreign securities, however, remain.⁶⁹

Other Reforms

Since the late 1980s, the Israeli government has tried to increase competition throughout the economy by lifting, streamlining, or reducing burdensome regulations. The objective of the reforms has been not only to enhance the overall efficiency of the economy, but also to reduce prices to consumers. Reforms have cut across a broad spectrum of different sectors, including telecommunications, energy, and transportation. Initial steps have also been taken to make the market for land more efficient and to reduce subsidies to the business sector. In general, steps that have been either proposed or implemented represent modest progress towards realizing Prime Minister Netanyahu's goal of "massively" deregulating the Israeli economy.

In the telecommunications sector, the monopoly status of Bezek is being gradually eroded. The process began in 1994 when a second operator was allowed to compete with Bezek for cellular phone service. In the summer of 1997, two new companies (one backed by Sprint) began providing service on international calls. By the end of 1997, new tenders in the telecommunications field are expected for a third cellular telephone operator and for allowing broadcast satellite TV to compete with

⁶⁶ Loan Guarantee Report, 1997, p.14.

⁶⁷ IMF Staff Study, p. 26.

⁶⁸ IMF Staff Report, p. 25.

⁶⁹ Dempsey, Judy. "Israel Eyes Broader Economic Horizons," p. 4.

cable. Concurrently, Bezek has attracted substantial private sector investors, including Merrill Lynch and a British company.⁷⁰

Regarding the transportation sector, the government recently approved a plan to open several intercity bus routes to competition and to license one additional baggage handling company at Ben-Gurion airport. And in the energy sector, the government is considering a proposal to increase the number of gas stations and to reduce the control of the major fuel chains over individual station operators.⁷¹

In 1994, the Israel Lands Administration (ILA), which administers the usage of nearly all land through leases, initiated a process to deregulate and privatize its activities. Contracts to lease, plan, and develop land for residential purposes are now offered through public tenders, resulting in more than 400 projects being launched outside the ILA. Despite these reforms, a more streamlined approval process for building permits and a greater number of tenders for public lands for housing construction could help bring down high housing costs.⁷²

The government of Israel has also tried to reduce as well as restructure subsidies provided under the 1953 Capital Investment Encouragement Law. The restructuring has focused on directing economic incentives to promote investment in human capital and research and development, as opposed to a previous concentration on subsidies for the building of factories and the purchase of capital equipment.⁷³

Outlook

The potential strength of the Israeli economy has increased in recent years due to a number of factors. These include a skilled and highly educated labor force, a growing and dynamic high-technology sector, and an economy that increasingly is integrated with other major world trading powers. To realize its economic potential in the medium-term, as well as to avoid any possible financial crisis, there appears to be broad agreement among Israel's policy elites about the proper course of action.

First and foremost, a cut in government spending is advocated by many in order to increase domestic savings. This would not only forestall any potential balance of payments problems by curbing any rise in Israel's persistent high reliance of external resources, but it would also help fund investment-led growth. Meeting the domestic deficit reduction target for 1997 and beyond would also reduce the burden on monetary policy in stabilizing the economy, and contain the possibility of an escalation in inflation. In addition, containment of generally non-productive expenditures (some business subsidies and tax preferences, transfer payments) could free up domestic resources for necessary investments on infrastructure.

⁷⁰ Rubin, David. "Growing On Ingenuity," p. 9A.

⁷¹ Economist Intelligence Unit, 1st Qtr 1997 report, p. 21.

⁷² IMF Staff Study, p. 28.

⁷³ Economic Intelligence Unit, 1st Qtr., 1997, p. 13.

The acceleration of significant structural reforms could also complement efforts to promote economic growth by generating a more efficient and productive use of the country's resources. A more rapid program for privatizing state enterprises could free up resources (both capital and labor) that could be employed more efficiently by the private sector, and attract more foreign direct investment. Reforms promoting greater competition could improve productivity growth.

Despite an apparent consensus on the proper policy actions that appear most supportive of macroeconomic stability, implementation is far from certain. Formidable internal and external obstacles could continue to thwart movement in this direction.

Internally, Israel's political system tends to result in coalition governments where the majority party is hampered in implementing its preferred economic policy by competing claims from small coalition partners. As their support is necessary for the government to continue in power, small parties ranging from ultra-religious to left-wing pro-peace parties tend to predicate continued participation in coalition governments on the direction of government funds into their own preferred projects. As a result, announced economic policies and goals continually conflict with political promises.⁷⁴

In the current Likud-led coalition, for example, Prime Minister Netanyahu agreed at a special cabinet meeting held in June 1997 to cut an extra \$168 million from this year's budget to order to meet the deficit reduction target of 2.8% of GDP. Since then, Mr. Netanyahu has renewed his pledge to make the cuts while at the same time promising his coalition partners substantially more funds for their favorite projects. Similarly, Mr. Netanyahu's need to consult leaders representing nearly every faction of his coalition on most major decisions serves as a formidable constraint on pushing more forcefully ahead with a sweeping structural reform initiative.⁷⁵

A larger unknown is the commitment of the two major parties, Likud and Labor, to implementation of budget cuts and more rapid structural reforms. Both parties have sizeable constituencies in favor of maintaining the current system and blocking real reforms. Thus, in the event that Likud and Labor ever formed a national unity coalition, it is debatable how much of a difference this could mean in terms of economic policymaking.⁷⁶

Some observers maintain that any push for serious reform is undermined by the considerable amount of foreign aid Israel receives. This view is that the aid

⁷⁴ Murphy, Emma. "Structural Inhibitions To Economic Liberalization In Israel," *Middle East Journal*, Volume 48, No.1, Winter 1994, p. 80.

⁷⁵ Dempsey, Judy. "Netanyahu Pledges Cuts and Extra Cash." *Financial Times*, July 12-13, 1997. p. 4.

⁷⁶ Miller, Ed. "Sharansky Will Lead Fight for Economic Reform in Israel," *Metro West Jewish News*, Vol. L, No. 23, June 6, 1996, p. 34.

eliminates any real incentives as well as the necessity for the government of Israel to push ahead with politically sensitive and economically painful reforms.⁷⁷

Externally, any serious effort to strengthen the economy through increased international linkages will be affected by the peace process. When the future of the peace process is in doubt, there is greater likelihood that Israel's economy will be adversely affected on the margins by declining investor confidence. If the stability of the region is viewed as problematic, foreign investors are likely to hold off on making any major new investments, and international financial markets are more likely to downgrade Israel's credit rating.

⁷⁷ Rabushka, Alvin. "Scorecard on the Israeli Economy: A Review of 1996," Institute for Advanced Strategic and Political Studies, Jerusalem, and Washington, D.C., March 1997, and Kontorovich, E.V. "Israel Needs Help to Kick the Subsidy Habit," *New York Times*, July 17, 1997, p. A 22.

Statistical Appendix

Table 5. Israel: Destination of Exports, 1989-96
(Percent of total)

	1989	1990	1991	1992	1993	1994	1995	1996
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
European Community	31.8	34.9	34.3	33.6	29.6	28.4	30.5	31.1
Belgium-Luxembourg	4.9	5.7	5.9	5.2	5.5	5.5	5.4	5.4
Denmark	0.2	0.3	0.3	0.3	0.2	0.2	0.3	0.2
France	4.0	4.7	5.1	4.5	3.9	3.5	3.6	3.6
Germany	4.7	5.8	6.3	5.7	5.3	5.0	5.1	5.3
Greece	1.2	0.9	0.9	0.8	0.6	0.6	0.9	0.8
Ireland	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Italy	3.8	4.2	3.8	3.4	2.9	3.0	2.9	2.9
Netherlands	4.4	4.4	3.7	3.7	3.7	3.6	4.2	4.8
Portugal	0.2	0.3	0.3	0.3	0.3	0.2	0.2	0.3
Spain	1.4	1.4	1.6	1.8	1.4	1.4	1.6	1.7
United Kingdom	6.7	7.0	6.3	7.6	5.6	5.1	6.1	5.8
Japan	6.8	7.3	6.1	5.3	5.2	6.0	7.0	6.4
United States	29.8	28.8	29.7	29.7	31.3	31.6	30.2	28.2
Canada	1.0	0.8	0.8	0.6	0.7	0.6	0.6	0.5
EFTA ¹ countries	4.1	4.2	3.9	3.1	3.0	3.4	3.1	2.9
Other countries	26.5	24.0	25.1	27.7	30.1	30.0	28.6	30.9

Sources: International Money Fund. "Israel: selected Issues and Statistical Appendix," IMF Country Report NO 97/2, February 1997. [hereafter cited as IMF Staff Report] p.95

¹ In 1995, Austria, Finland, and Sweden moved from the European Free Trade Area to the European community. In this table they are still classified under EFTA to enable a comparison with previous years.

Table 6. Israel: Origin of Imports, 1989-96

(Percent of total)

	1989	1990	1991	1992	1993	1994	1995	1996 ¹
Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
European Community	47.1	49.3	47.5	48.7	49.2	51.0	47.7	48.6
Belgium-Luxembourg	14.2	13.2	11.1	12.6	12.4	12.7	11.8	10.9
Denmark	0.4	0.4	0.5	0.7	0.7	0.6	0.6	0.6
France	3.8	3.9	4.3	4.1	3.8	4.5	4.0	4.1
Germany	10.1	11.7	11.6	11.8	10.4	10.4	9.1	9.0
Greece	0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.5
Ireland	0.2	0.3	0.3	0.3	0.3	0.4	0.6	0.6
Italy	5.4	6.1	6.5	6.9	7.3	7.8	7.6	8.0
Netherlands	3.2	3.4	3.4	3.2	3.4	3.3	3.3	3.3
Portugal	0.2	0.3	0.3	0.3	0.7	0.5	0.3	0.4
Spain	1.0	1.0	1.0	1.1	1.0	1.7	1.8	2.1
United Kingdom	8.2	8.6	8.3	7.2	8.7	8.7	8.0	9.2
Japan	2.5	3.6	4.4	5.3	5.1	4.0	3.2	3.7
United States	16.7	17.8	19.3	17.0	17.4	17.9	18.1	21.2
Canada	0.6	0.9	0.8	0.6	0.5	0.7	0.8	0.6
EFTA ² countries	10.7	11.4	10.9	9.4	10.2	9.1	8.8	8.4
Other countries	22.4	17.1	17.1	19.0	17.6	17.2	21.4	17.5

Sources: IMF Staff Report, p. 92

¹ May.² In 1995, the European Free Trade Area countries moved to the European Community. In this table, they are still classified under EFTA to enable comparison with previous years.

Table 7. Israel: Commodity Composition of Exports, 1991-96
(In percent)

	1991	1992	1993	1994	1995
Agricultural products	5.8	4.5	4.0	3.7	4.2
Citrus fruit	1.4	0.9	0.9	0.8	1.2
Other fruits and vegetables	1.5	1.1	1.0	0.9	1.0
Other	3.0	2.5	2.0	2.1	2.0
Industrial products (excl. Diamonds)	69.7	70.6	71.8	71.0	69.6
Ores and minerals	2.7	2.4	2.0	2.1	2.2
Food (excl. beverages and tobacco)	4.7	4.4	3.9	3.5	3.5
Textiles (excl. clothing and leather)	7.2	7.4	6.4	6.1	5.9
Other light industry products	8.7	9.4	8.6	8.2	8.9
Chemicals	13.6	13.0	13.8	13.4	13.4
Metals, machinery and electronics	32.2	33.3	36.5	37.1	35.2
Diamonds	24.4	24.9	24.2	25.3	26.2
Total	100.0	100.0	100.0	100.0	100.0

Sources: IMF Staff Report, p. 93

Table 8. The Largest Government Companies as of December 31, 1995
(in millions of U.S. dollars)

	Total Assets	Total Revenues	Percentage Direct and indirect Government Ownership
The Israel Electric Corporation	8,651	2,452	100
Bezeq - The Israel Telecommunication Corporation	4,370	2,283	77
Israel Chemicals	2,614	1,387	48
Mekorot - Water Corporation	1,861	427	100
Israel Aircraft Industries	1,599	1,394	100
Oil Refineries	1,218	1,909	74
El-Al Israel Airlines	1,072	1,235	100
Israel Military Industries	496	440	100

Source: IMF Staff Report, p. 34.

Table 9. Regulated Prices in the Consumer Price Index
(as of August 1996)

	Weight (out of 1000)		Weight (out of 1000)
A. Controlled prices		B. Prices under supervision	
Public bus transportation	14.7	Flour	1.5
Meat	7.8	Margarine	0.8
Municipal taxes	20.0	Yoghurt	5.7
Electricity (for domestic use)	18.4	Bread	9.0
Water (for domestic use)	8.6	Milk	7.6
Education fees	22.7	Cream	1.1
Sick Fund services	8.1	Butter	0.5
Train and domestic flight tickets	0.3	Cheese	9.8
Phone services	20.3	Refrigerators	5.0
Mail services	0.5	School books	4.4
Total	121.4	Medicines	4.2
		Gas (for domestic use)	3.2
		Oil and fuel (for domestic use)	0.4
		Taxi rides	3.4
		Total	56.6

Source: IMF Staff Report, p. 39.

Note: Price controls on most of Israel's dairy products were lifted on June 12, 1997.

Table 10. Israel: Labor Market Indicators, 1977-95

	Average 1995	Average			Percentage change							
		1977-80	1981-85	1986-88	1988	1989	1990	1991	1992	1993	1994	1995
Israeli population of working age	3,903.4	2.3	2.0	1.9	2.0	2.0	3.9	7.1	4.3	3.0	2.9	3.0
Israeli civilian labor force	2,100.4	3.0	2.2	2.4	3.9	3.2	2.9	7.3	4.9	4.8	4.3	3.5
Total Israelis employed	1,968.1	2.7	1.7	2.5	3.5	0.5	2.1	6.1	4.2	6.1	6.9	5.2
Public services	545.0	4.5	2.0	1.4	4.2	1.9	2.3	6.6	3.2	3.5	4.8	4.0
Business sector	1,423.1	1.9	1.7	2.9	3.2	0.0	2.0	5.9	4.7	7.2	7.7	5.6
Workers from Administered areas	60.0	6.1	3.0	9.3	0.4	-4.1	2.7	-9.2	18.1	-27.3	-16.7	-14.3
Foreign workers	58.0											
Total employed	2,086.1	2.7	1.9	2.7	3.3	0.2	2.2	5.1	5.0	4.9	6.4	5.9
Memorandum items:*												
Participation rate	53.8	49.4	50.0	50.8	51.4	52.0	51.5	51.7	52.0	52.9	53.6	53.8
Unemployment rate	6.3	3.8	5.4	6.5	6.4	8.9	9.6	10.6	11.2	10.0	7.8	6.3

Source: IMF Staff Report, p. 59.

Note: Beginning in 1985, the data are based on the 1983 census and correspond to the population aged 15 and over. Prior to 1985, the data correspond to the population aged 14 and over.

*For Israeli population.

Table 11. Israel: Real Wages, Labor Costs, and Productivity, 1988-95
(Percentage change)

	1988	1989	1990	1991	1992	1993	1994	1995
Real wages per employee post ¹								
Total economy	6.0	1.3	-1.0	-3.0	1.2	0.6	2.3	2.1
Business sector								
Real consumption wages	4.7	-1.7	-1.4	-5.2	1.8	0.3	-0.4	0.2
Real production wages	9.0	1.4	0.4	-4.8	-6.1
Public Sector	9.8	0.3	0.1	1.6	-0.4	1.1	9.8	5.6

Sources: IMF Staff Report, p. 61

¹Real wages in the public sector and real construction wages in the business sector are deflated by the consumer price index; real production wages are deflated by the implicit price index of business sector net domestic product at factor cost.

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