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Israel to 1991

REFORM OR RELAPSE?

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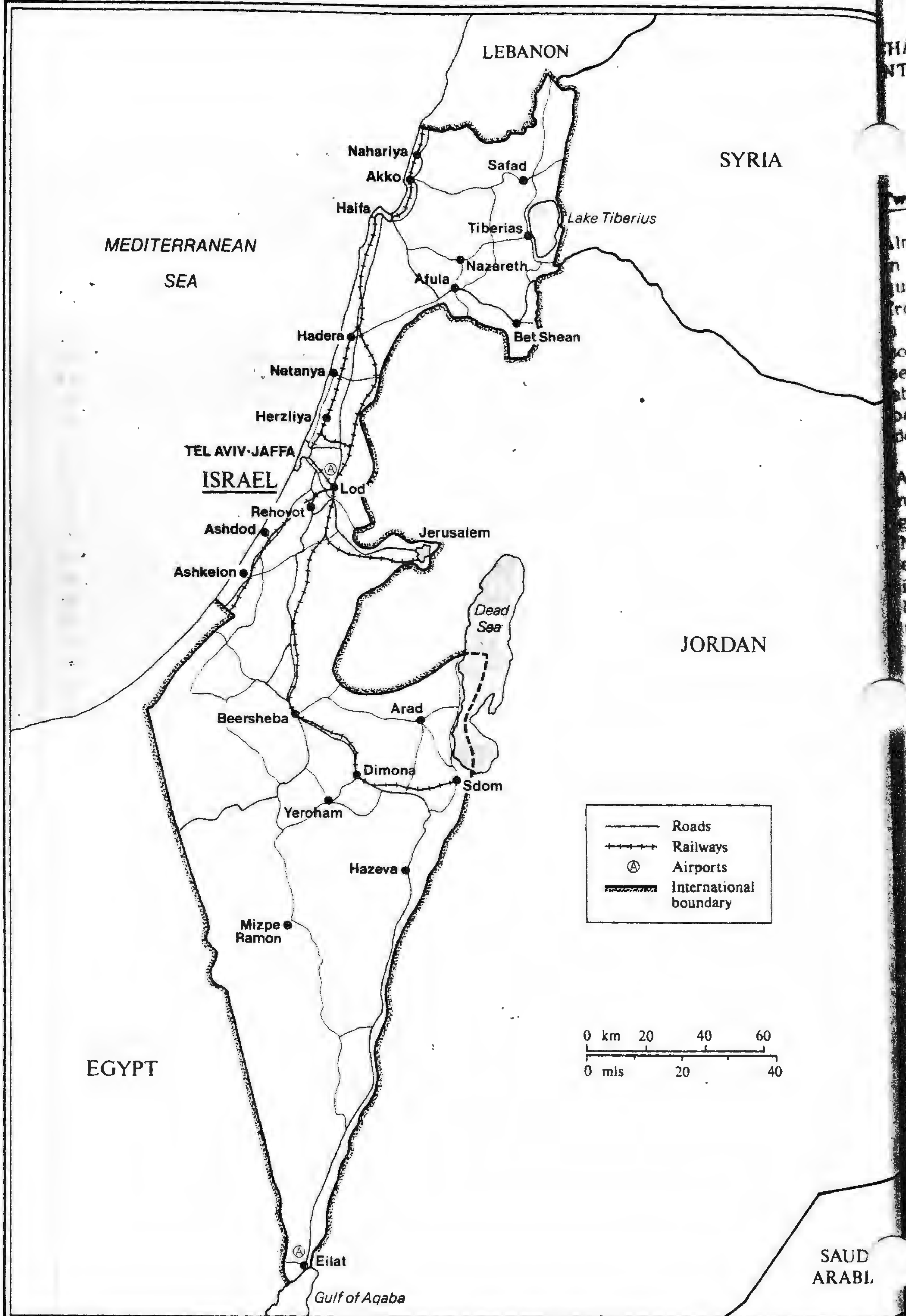

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CHAPTER 1
INTRODUCTION AND SUMMARY

Twenty five years of headlong growth -

Almost four decades have passed since Israel's creation; its economic development in that time may be divided into two distinct periods. The first comprised the quarter century following May 1948, in which the chaos and upheaval stemming from the War of Independence gave way to rapid growth. This was orchestrated by a centralised system of government based on the Labour Party and its affiliated socioeconomic organisations, grouped round the Histadrut, which imposed a clear set of economic and social priorities. This structure facilitated the successful absorption and integration of several waves of Jewish immigration of widely diverse backgrounds, especially of Holocaust survivors and Jews from Arab countries, which doubled the population from 1948 to 1951 and quintupled it by 1970.

Against a background of unrelenting external tension and the refusal of Israel's neighbours to accept its existence, it was inevitable that the first aim of every government, especially the early ones, was the achievement of military security. Nevertheless, using foreign capital to make good the dearth of savings in the economy, the Labour led governments of the 1950s and 1960s invested heavily in infrastructure and education. They allowed industry and services to grow behind high protectionist barriers, before gradually opening up the economy to foreign trade and pushing it from labour intensive import substitution industries to up market export oriented sectors. The combination of clear sighted leadership, foreign capital and an able and eager work force, taking off from a base of negligible proportions, resulted in an "economic miracle" on a scale to match the most dramatic of the post-war period. Until 1972 Israel's average annual growth rate was in excess of 9 per cent per annum, and above 5 per cent in per caput terms. Other measures, such as private consumption, government expenditure and gross domestic capital formation registered similarly spectacular gains.

- gave way to a prolonged and worsening stagnation

The pace at which the economy began changing, in the late 1960s and early 1970s, proved to be too little, too late. Instead of aggressively seeking to promote new industries and greater responsiveness to market forces, the government and Histadrut allowed the existing system to ossify. Meanwhile ever growing resources were channelled into a broad array of social welfare schemes, and into a panoply of incentives aimed at promoting development areas on the country's periphery. Even before the full extent of the emerging structural problems in the economy became clear, the country was struck by the twin traumas of the Yom Kippur War of October 1973, and the oil and commodity price rises that followed it. These caused immediate and continuing losses to the economy, and ushered in a period of gradual loss of momentum, which was severely aggravated by irresponsible government policies in the early 1980s. In this period, which stretches from 1973 to the present, productivity growth was insignificant, investment shrank and, for most of the period, inflation became gradually worse, until threatening to run out of control into hyperinflation in 1984-85.

Only an emergency programme, initiated by a National Unity government comprising the two main parties of Labour and Likud, and backed by large scale additional US aid, succeeded in stabilising the key nominal variables of inflation and devaluation, and significantly reducing the government's budget deficit, in the 18 months from [illegible] 1987. This achievement coincided with the emergence of an extremely favourable external background, as the collapse in the price of oil and other primary products, and the fall of the dollar and international interest rates, produced a sharp improvement in Israel's terms of trade. The stage was thus set for a serious attempt to address the underlying problems that had by now so debilitated the economy that average GNP growth per caput in the 1980-85 period had sunk to zero.

A golden opportunity for reform was missed

However, a far reaching series of economic reforms, prepared by the Treasury and the Central Bank in the latter part of 1986, ran into fierce opposition from an ad hoc coalition of special interest groups, whose benefits and privileged treatment would have been reduced or eliminated. The emergence of interparty strains within the coalition meant that the political leadership needed to overcome this opposition was lacking, resulting in the thrust of the reform strategy being blunted and only a much less ambitious and less cohesive set of proposals being accepted.

At the same time, the improved economic environment sparked a boom on the local market. This, however, was expressed primarily in sharp gains in private consumption, which sucked in huge quantities of imports, while investment and export growth lagged far behind. Given the existence of severe labour market rigidities, this bout of expansion inevitably led to the bidding up of real wages, and further expressed itself in increasing pressure on prices. Together these pressures eventually forced a corrective devaluation in January 1987, so that by early 1987 the tenuous stability reached in 1985/86 was being increasingly undermined.

A strong government could take up the challenge again -

The overriding issue facing the Israeli economy in the coming years is, therefore, whether and when a further attempt can be made to institute the basic structural reforms that are necessary in the tax system, the capital markets, the labour market and regarding the extent of government involvement in every aspect of economic activity. For, without such reforms, stable and prolonged growth is regarded as being impossible to achieve.

The central forecast assumes that this issue will indeed be tackled, but not before the next general election, scheduled for November 1988, but likely to take place six to twelve months earlier. Even then, only the formation of a strong government, based on a stable coalition centred on one or other of the two major parties, will allow the enactment of reforms on the scale necessary. In any event, the pressure for reform, from both internal and external sources, will grow stronger over time, as the economy's performance continues to disappoint.

- spurred on by a sober public and supportive USA

In the background will be a new political reality which will form the cornerstone of any economic policy. This encompasses strongly negative experiences in two main areas in recent years. The first is a widespread and deeply felt revulsion at any prospect of a renewed bout of high inflation, following the success in reducing consumer price rises from 445 per cent in 1984 to 20 per cent in 1986, which ended a run of seven successive years of triple digit inflation. The second, concentrated more in business and academic circles, is the equally strongly felt need to avoid another balance of payments and foreign currency reserves crisis, after the traumatic experience of 1983-85 in these areas.

The chances of the latter threat developing are significantly lessened by the assumption that unilateral transfers, of which US government military and economic aid is the dominant element, will continue at a level ($4-5 bn per annum) high enough to cover both military imports and the civilian balance of payments deficit. The ideological, political, strategic and geostrategic roots of the US-Israeli relationship lead to the conclusion that aid levels are unlikely to be reduced in quantitative terms in the forecast period. Indeed, they may well be enhanced in qualitative terms, for example by the granting to Israel of the status of "non-Nato ally", as was announced in February 1987.

Renewed austerity would then follow the excesses of 1986-87 -

The twin concerns of avoiding inflation and maintaining the balance of payments in rough balance are expected to reassert themselves in the course of 1987, as the deleterious effects of the economic expansion combine with growing political instability to produce rising inflation and a widening budget deficit. They will eventually force the adoption of a new round of austerity measures, either in late 1987 or early 1988, and the period of "go" that characterised 1986-87 and that is expected to bring the strongest rate of growth so far this decade, will give way to another "stop" that will send the economy into recession in 1988-89.

- leading to fundamental reforms

In this period and against a generally favourable international backdrop which will, at the least, not impose new pressures, there will be an opportunity for the next government to prepare, legislate and implement the needed reforms. If this second opportunity is taken, the subsequent round of recovery may be expected to be more soundly based and hence longer lasting than previous ones. In other words the ground should be laid for a fundamental redistribution of resources in both consumption and investment, from the public sector to the private.

A V shaped cycle will produce average GDP growth of 2.6 per cent -

This pattern of developments will give rise to a "V" shaped cycle in the key economic variables of GDP, labour productivity, private consumption, public consumption net of defence imports, fixed investment, exports and civilian imports, although not all at the same pace. Unemployment, meanwhile, is expected to rise to a plateau of around 9 per cent, with total employment increasing slowly. Inflation is forecast to rise to around 40 per cent in 1987 before falling to a low of 10 per cent in 1989, with a gradual increase thereafter, spurred by internal expansion and external price rises.

- as lower public consumption releases reserves for export growth

Within this general picture, the most significant trend is expected to take the form of a gradual fall in the share of GDP taken by net public consumption. Growth in this item is expected to be flat overall, registering falls in 1988-89, and a very slow rate of increase even in 1990-91. The resources thus released will flow primarily to export sectors, so that exports will achieve an average growth rate in excess of 5 per cent per annum. This will be fed by a steady, if undramatic, increase in investment in plant and equipment, although residential and other construction investment will remain in its long term downtrend, resulting in total fixed investment showing an average annual growth rate of less than 1 per cent.

Other factors helping the expansion of export sectors will be the policies regarding devaluation and wage rates. The rate of devaluation is expected to be kept in close proximity to local price rises, and a small real devaluation is possible against the background of a weak economy in 1988-89. This, and the sluggish home market

CHAPTER 2
HISTORICAL BACKGROUND

THE INGATHERING OF THE EXILES

A country of immigrants, built in haste -

Israel is a land of immigrants of widely diverse geographical, social and cultural backgrounds, brought together within a short span of time and under conditions of intense pressure. The development of the country's political and economic structures, as well as its society, must be viewed in the light of this basic fact. This also explains why so many of Israel's institutions are at once both complex and yet incomplete, since they were put together under duress to provide quick solutions to numerous and often conflicting needs.

- by a long dispersed people returning to its ancient home -

The process of recreating an independent Jewish state, 1,900 years after the destruction of the Second Commonwealth by the Roman Empire and the ensuing exile of the Jewish population, has no parallel in other modern national movements. The realisation of the aims of political Zionism, a movement which began in the late nineteenth century, involved bringing together in Palestine members of a nation linked through shared religious and cultural roots, but disparate in most other respects.

The foundations for the future Jewish state were laid during the half century between the First Zionist Congress in Basle in 1897 and the United Nations resolution of November 1947 favouring the division of Palestine into separate Arab and Jewish states.

Palestine in the late nineteenth century was a section of the Ottoman Empire. Of the total population of some 450,000, Jews numbered around 25,000 and their general economic position was similar to that of the other inhabitants. Successive waves of emigration, beginning in the 1880s and continuing through both the latter part of the period of Turkish sovereignty, which ended with the British conquest in 1917 and the period of the British Mandate from 1918 to 1948, boosted the Jewish population of Palestine from 24,000 in 1882 to 85,000 by 1914 and to some 600,000 on the eve of the creation of Israel in 1948.

- in the face of growing opposition

The Jewish influx spearheaded modernisation, which spread to other sectors of the population as well, but also led to increasing political opposition from Palestinian Arabs, whose numbers also grew apace in this period. Successive bouts of intercommunal violence, beginning in 1920, led the British to curb Jewish immigration and also marked the early stages of the Arab-Israeli conflict that remains the dominant feature of Israel's external position to this day. This state of conflict has given rise to an increasingly onerous defence burden, an issue which is examined more closely in Chapter 5.

The socialist ethos of the pioneers -

The early immigrants were predominantly European, mostly socialist and overwhelmingly secular. In all these respects they differed sharply from the indigenous Jewish community that they found in Palestine, which had both European and Oriental roots, was religiously oriented and, in its economic activity, was mainly urban, with the limited agricultural sector fitting into the traditional system of landlords and labourers. Although many of the newcomers gave up the struggle against the harsh conditions in the countryside, moving to the towns or emigrating entirely, it was the agricultural settlers that set the tone for the early stages of the Zionist enterprise, and the leadership of the future state was drawn from the collective settlements to an overwhelming degree. The ideas and ideals of socialist Zionism dominated the pre-independence and post-independence periods, only beginning to fade in recent decades, and their influence is still deeply embedded in every aspect of the national life, especially the economy.

One of the key features of this formative period was the degree to which most areas of activity were imbued with ideology. Since most of the population were consciously engaged in promoting a specific brand of ideology, and were determined to impose their ideas on the state in the making, fierce rivalry marked the relations between the different Jewish groups and this extended far beyond purely political debate.

- gave rise to a broad spectrum of achievement -

Thus, for example, the establishment in 1921 of the Histadrut, the General Federation of Labour, was not a simple matter of unionisation against employer exploitation. The Histadrut was envisaged as a vehicle to build a socialist economy, and its subsequent contribution to the industrialisation of the country is without match, over and above its narrower role in unionising the labour force and protecting workers' interests.

The Histadrut founded many heavy industrial plants, built whole towns and, in alliance with the various collective agricultural settlement movements, pushed agriculture forward in both quantitative and qualitative terms. To do this, it mobilised capital through its own financial system, and was especially instrumental in developing the pension system and deploying the funds thus amassed to further economic growth. But its influence went far beyond the workplace. It established a comprehensive health insurance system, and its recreation facilities for workers evolved into a national sports organisation, Hapoel. In all of these endeavours, the Histadrut sought to represent everyone but, given its social, political and religious stance, many people rejected its embrace.

Other political creeds, notably the Revisionists - a right wing Zionist group that demanded a Jewish state throughout Palestine, including TransJordan - and the Liberals, as well as the various religious groupings, set up their own rival organisations to serve their own followers and prevent their coming under the sway of the Histadrut.

- but sowed the seeds of later problems

Thus while the Jewish community as a whole succeeded during the Mandate period in building up most of the apparatus that would be needed by an independent state, the internal rivalry within the Jewish camp caused duplication of effort and waste of resources. This was complemented by the creation of a tradition of politicisation in every branch of social and economic activity, itself facilitated by the centralisation of political and economic power in the same hands, namely those of the Labour Party/Histadrut complex which later became the party of government for the first three decades of Israel's independence. These features continue to exist in large measure even today.

Recent years have witnessed some debate as to whether any feasible alternative existed to that of central direction and control in order to achieve industrialisation and successfully absorb the massive immigrations of the Mandate and early post-independence periods. This must remain essentially academic speculation; what is certain is that the achievements in these fields were spectacular and would have been difficult to surpass under the circumstances of those times. On the other hand, the negative features that were part of that system's legacy have developed into major problems in the last 15 years, as will be seen.

Victory against Arab forces -

The new state was born out of the UN partition resolution of November 1947 but the war that accompanied its birth brought a much larger area under Jewish control than had originally been envisioned. The war proceeded in several stages from late 1947 until early 1949 and was marked by successive Jewish victories against both regular and irregular Arab forces, who were far more numerous than the Jewish forces then emerging from the underground.

- led to a period of mass immigration -

The establishment of the Jewish state was followed by a period of massive Jewish immigration from two main sources - Europe and the Arab countries. The former comprised Holocaust survivors and the latter was made up of entire Jewish communities made refugees as part of the Arab reaction to Israel's creation, and the Palestinian refugee problem that stemmed from it.

Between May 15, 1948, and the end of 1951, the fledgling state doubled its population as almost 600,000 immigrants poured in. Although in later years there were subsequent waves of immigration, such as that from North Africa in the late 1950s and early 1960s and the Russian-Jewish immigration of the early 1970s (see Table 1), none approached the scale of the immediate post-independence years. Furthermore, no other immigration wave arrived in so destitute a condition, and to a country only just emerging from a desperate struggle and thus devoid of the resources needed to meet the enormous challenges it faced.

Table 1

Immigrants and Potential Immigrants by Last Continent of Residence, 1948-85 ('000)

	Asia	Africa	Europe	USA & elsewhere	Total[a]
1948[b]	4.7	8.2	76.6	12.4	101.8
1949	71.6	39.2	122.0	6.7	239.6
1950	57.6	26.2	81.2	5.2	170.2
1951	103.4	20.4	47.1	4.3	175.1
1952	6.9	10.3	6.2	1.0	24.4
1953	3.0	5.1	2.1	1.0	11.3
1954	3.3	12.5	1.4	1.1	18.4
1955	1.4	32.8	2.1	1.2	37.5
1956	3.1	45.3	6.7	1.1	56.2
1957	4.2	25.7	39.8	1.4	71.2
1958	7.9	4.1	13.7	1.3	27.1
1959	3.5	4.4	14.7	1.1	23.9
1960	1.8	5.4	16.2	1.2	24.5
1961	4.1	18.0	23.4	2.1	47.6
1962	5.4	41.8	11.8	2.3	61.3
1963	5.0	38.7	14.2	6.5	64.4

(continued)

Table 1

Immigrants and Potential Immigrants by Last Continent of Residence, 1948-85
('000)

	Asia	Africa	Europe	USA & elsewhere	Total[a]
1964	5.1	17.3	28.1	4.2	54.7
1965	5.2	8.5	13.9	3.1	30.7
1966	3.1	3.0	7.4	2.1	15.7
1967	2.0	6.3	4.3	1.8	14.3
1968	4.7	7.6	6.0	2.3	20.5
1969	7.0	5.9	15.2	9.6	37.8
1970	6.9	3.8	14.4	11.6	36.8
1971	5.8	2.4	20.9	12.9	41.9
1972	3.1	2.8	39.1	10.8	55.9
1973	2.0	2.8	40.5	9.5	54.9
1974	1.2	1.2	23.1	6.4	32.0
1975	0.9	0.7	13.4	5.0	20.0
1976	1.1	0.7	12.1	5.8	19.8
1977	0.9	1.6	12.7	6.2	21.4
1978	1.7	1.6	16.5	6.3	26.4
1979	7.1	1.3	22.4	6.0	37.2
1980	3.2	1.0	11.8	4.4	20.4
1981	1.2	1.2	5.9	4.2	12.6
1982	1.0	1.6	6.2	5.0	13.7
1983	0.8	3.1	6.2	6.8	16.9
1984	0.7	8.9	5.5	4.9	20.0
1985	...	...	...	...	11.3

a Totals may not add due to rounding. b May 15, 1948, to December 31, 1948.

Source: Central Bureau of Statistics.

- that made outside assistance necessary

To obtain these resources, the Israeli government located three sources of external help. One was the Jewish communities in the West, which had always contributed to the Zionist cause and which were now asked to give and lend much larger sums, to match the scale of the needs. The second was the US government, whose sympathy to the plight of the displaced persons in Europe, coupled with its refusal to let them into the USA, had been vital in the struggle leading up to the withdrawal of the British and the establishment and subsequent recognition of the state.

The third source was at once the most significant at this stage and the most surprising. This was the West German government, with whom an agreement was reached in 1953 for the payment of "reparations" for at least the property stolen from European Jews by the Hitler regime. Individual survivors were allowed to file claims on a personal basis, and the flow of money to them has continued until the present, albeit at an ever slackening pace as the number of people receiving reparations dwindles. For the millions who perished and were unable to make any claims, the Israeli government received direct government to government grants. These, and later other, major infusions of capital (analysed in the next chapter) were of vital importance in financing the growth that Israel needed to help it absorb its immigrants. The human capital they provided themselves.

Ben-Gurion's charismatic leadership -

The decision to make a rapprochement with the "new Germany" was a painful one, coming so soon after the Holocaust, and was violently denounced by the right wing opposition parties. It represented a typically pragmatic approach by the country's dominant political figure, David Ben-Gurion, prime minister from 1948-53 and from 1955-63, and leader of the Jewish National Council in the pre-state period. Ben-Gurion's leadership was marked by a mixture of idealism and hardheaded pragmatism, probably the perfect qualities needed to weld the hoards of refugees who flooded into the country after independence into a cohesive nation. His famous remark, that "to be a realist here, one has to believe in miracles", captures the atmosphere of the country's formative years, when extraordinary achievements in the military, social and economic spheres were compressed into a remarkably short time span.

- concentrated on solving the most pressing problems -

Ben-Gurion, more than anyone else, realised that the final format of the state could not be fixed in these hectic years of scrambled response to the most urgent tasks facing the country - security, employment and infrastructure. Thus issues such as a written constitution, the relationship between the state and the Jewish religious authorities, and even the desirable form of electoral system, were left on an ad hoc basis until the population, and society as a whole, had become more cohesive. However, all of these temporary arrangements have taken on a life of their own and become permanent, even hallowed, features of national life. The electoral system provides an excellent example of this process.

- leaving an unsatisfactory electoral system to catch up later -

Elections to the first Knesset were held in January 1949, in the midst of war, and were intended to create a temporary assembly pending the arrival of more settled times. The voting system adopted was that of direct proportional representation, since that had been used by the pre-state National Council and was simple to apply. The intention was, however, to replace it in due course. In the event, the temporary assembly declared itself a duly elected legislature and the proportional representation system, in which each party puts forward a list of candidates, became the accepted democratic process, used for local council and workplace elections, as well as national ones, although direct elections for mayorships have proved successful since their introduction several years ago.

- which it has yet to do

The result has been that no party has ever won an outright majority and all Israel's governments have been coalitions. This, in turn, has given inordinate strength to the smaller parties that hold the balance of power between the main blocs of right and left, especially to the religious lists. Even in the 1950s and 1960s when the Labour bloc was dominant, coalitions were the rule, since factional disputes within the Labour camp made coalitions with the religious parties easier than forming an outright left of centre government.

Political instability, and the constant threat of crisis, have become the stock in trade of Israeli governments, and have caused the majority of them to come to a premature end. Furthermore, it is widely felt that the party secretariats that determine the lists of Knesset candidates have grown detached from their voters and that the personal qualities of the average Knesset member have declined as a result of this estrangement. Calls for electoral reform are therefore being heard with increasing frequency and from a growing spectrum of opinion. A recent private member's bill seeking to introduce a modified constituency system won the majority of votes cast on its first reading, but this did not represent the required abso majority. In short, reform is on the agenda, but does not seem imminent.

POLITICAL DEVELOPMENT

The major parties evolved gradually -

Both of the current major parties, the Labour "Alignment" and the Likud (litera "combination" or "unity"), evolved over a long period, gradually coalescing f factional groupings on the right and left of the political spectrum. However, t terms "right" and "left" themselves require careful use in the Israeli context. issues of security, defence, relations with the Arab states and the USSR, t right/left divide conforms roughly with the rival camps of "hawks" and "doves" "hardliners" and "moderates", to use accepted jargon. It is on ideological issue such as the desire to achieve a "Greater Israel" and the determination to settle many Jews as possible in the areas occupied in 1967, such as the West Bank, Ga Strip and Golan Heights, that the right/left split is most accurate, and explai why most, although not all, of the religious parties are on the right.

- and their economic policies no longer match their labels

In socioeconomic terms, the parliamentary right/left calculation is increasingl misleading. Originally, the Labour Party was demonstrably socialist in its leanings drawing much of its support from blue collar workers, and conversely the influenc of the Liberals and their middle class supporters was paramount on the right, s that the political spectrum was "orthodox" in structure with respect to th economy. This has, however, undergone significant change in the last two decades.

Labour has moved increasingly to the centre, and perhaps even beyond, as th middle class has abandoned the Liberals, whose identity has been swallowed up in the Likud. This latter has drawn its support more and more from the poorer socioeconomic groupings and has adopted policies that may best be described as populist. In very general terms, it may be said that both parties contain a wide spread of socioeconomic views, and that there is little, if any, ideological content to interparty disputes in these areas of policy. The very large degree of state intervention and state ownership in the economy, however, has made government power and patronage the focus of party rivalry, while uniting all the parties' functionaries in instinctive opposition to any moves aimed at reducing the state's role. Their leaders, on the other hand, have become increasingly convinced that that is precisely what must be done. This explains the economic policy successes of the current National Unity government, in particular in 1985/86, as well as its consistent failure so far significantly to dent the size of the government's expenditure or to sell government owned companies, despite repeated commitments on both issues.

The Labour factions coalesced into the Alignment -

The main strand of the Alignment is its forerunner, Mapai, the Israel Labour Party, and the party of Ben-Gurion, Golda Meir and the two men who dominated the economy for the first generation after independence, Levi Eshkol and Pinhas Sapir. To its left on socioeconomic policy was Ahdut Haavoda (Labour Unity) and to the left of that was Mapam, the United Worker's Party. However, in a typical example of the sort of ideological complexity that characterises Israeli politics, it may be noted that Ahdut Haavoda was more hawkish on security and territorial issues than Mapai, whose record of pragmatism stretches back to the original Palestine partition debates of the interwar years. Mapam was, and remains, very dovish.

he Alignment itself was formed in the mid-1960s, after Ben-Gurion resigned in 963 and split Mapai. His supporters - including the late Moshe Dayan and the urrent prime minister, Shimon Peres - formed the Rafi Party and ran on a eparate ticket in the 1965 elections, with only partial success. Mapai and Ahdut Haavoda combined for the first time since 1951 and lost only five seats to Rafi, while Mapam remained independent. In the face of the growing right wing threat, the Labour Party completed its consolidation in 1969, with the bulk of Rafi, as well as Mapam, joining in forging a common platform. The results gave it a bloc of 56 seats in the 120 member chamber, the nearest any party has yet come to an outright majority.

- governing in alliance with the National Religious Party

All the left wing parties, whether they ran together or separately, were the perennial constituents of the coalitions that eventually emerged from the post-election horsetrading. The other party regularly included in the cabinet was the National Religious Party, which maintained a fairly consistent showing from 1951 until 1977, the years in which it maintained its "historic partnership" with the Labour movement. On most policy issues it found common ground with Labour, while its specifically religious concerns were covered by the "status quo" agreement forged between Ben-Gurion and the NRP in the early 1950s and adhered to by all subsequent governments.

Liberals and Nationalists formed Likud to challenge Labour's hegemony -

The 1965 election also witnessed the electoral debut of the joint right wing opposition, Gahal, the forerunner of the Likud. This comprised two separate parties, married rather than merged - a structure that remains in place even now. The Liberal Party itself was created by the merger of the old General Zionist and Progressive parties, that had run separately until the 1961 election. Its leaders represented the traditions of central European liberalism, as the Labour Party leaders represented Eastern European socialism, and its support came from the urban middle class and from the non-collective agricultural sector.

Its new partner, Herut, was the heir to the Revisionist Zionist movement and was led by Menachem Begin. Its main plank was its strong nationalist stand on security and territorial questions, but its growing support came from presenting itself as the alternative to the entrenched establishment of the Labour Alignment. This line was aimed at appealing to the mass of mainly working class Oriental Jews (Sephardim) who had immigrated during the 1950s and who strongly resented what they perceived as the overweening paternalism that characterised the Labour dominated establishment comprised almost exclusively of European Jews (Ashkenazim). Mr Begin, though thoroughly European himself, opened this party to the up and coming leaders of the Sephardi communities - especially the Moroccan-Jewish immigrants, who formed the largest single ethnic grouping - and made Herut the spokesman of the "second Israel". This, more than anything else, led Herut and later the Likud, on the path to populism and hence to greater state intervention in search of fairer shares for those who felt left out or discriminated against.

- but found this difficult to achieve -

The Herut/Liberal marriage was thus one of convenience, with the ageing Liberals contributing financial resources and public respectability and Herut its dynamism and swelling membership rolls. But the new partnership was by no means an instant success, since the 26 seats it garnered in 1965 were less than the sum of its constituent parties' haul in 1961. Only in 1973, in the traumatic aftermath of the

Yom Kippur War, did the right wing coalition, now expanded into the Likud, m significant progress.

In fact, though, the right wing was granted a measure of legitimacy as early 1967 when, in the face of the joint threat posed by Egypt, Syria and Jordan the tense period before the Six Day War, Labour agreed to expand the governm into one of National Unity. Not only did the Rafi breakaway party rejoin, w Moshe Dayan becoming minister of defence, but Gahal came aboard as well to fo a wall to wall coalition of all the Zionist parties in the face of the immedia peril. The coalition constituents ran separately in the 1969 elections, b reconstituted the grand coalition immediately thereafter. Within a year, howeve Gahal withdrew and political life returned to normal.

The extreme right and the extreme left of the political spectrum were occupied until recently, by the ultra religious parties of the Agudat Yisrael movement, a by the Jewish-Arab communist parties, in various guises. Neither of these, nor t various ethnic and other lists that came and went over the years had any role government, much less in policy, at least until the "political upheaval" of 197 Table 2A illustrates the number of Knesset members elected from each party li through 1969, while Table 2B shows the results of the three elections he subsequent to the Yom Kippur War of October 1973.

Table 2A

Knesset Elections, 1949-69

	1949	1951	1955	1959	1961	1965	1969
Mapai/Ahdut Haavoda	46	45	50	54	50	45	) 56[a]
Mapam	19	15	9	9	9	8	)
Herut	14	8	15	17	17	) 26[b]	26
Liberals/Progressive	12	24	18	14	17	)	
National Religious	16	10	11	12	12	11	12
Agudat Yisrael	-	5	6	6	6	6	6
Communists	4	5	6	3	5	4	4
Labour affiliates & breakaways	-	-	-	-	-	14	12
Others	9	9	5	5	4	6	4
Total	120	120	120	120	120	120	120

a Alignment. b Gahal.

Source: Jerusalem Post.

- until the impact of the Yom Kippur War -

Although the Six Day War of June 1967 had changed the shape of the country - quite literally - it had no discernible effect on voting patterns. Not so the war of October 1973 in which Israel was caught unprepared by a joint offensive of the Syrian and Egyptian armies and suffered heavy losses as a consequence. The fact that the final outcome was a crushing Israeli victory, especially on the Egyptian front, where only Soviet intervention prevented the annihilation of the Egyptian Third Army, did not prevent the public laying the blame for the early setbacks on the Labour government.

Table 2B

Knesset Elections, 1973-81

	1973	1977	1981
Alignment	51	32	47
Likud	39	45	48
National Religious	10	12	6
Agudat Yisrael	5	5	4
Tehiya	-	-	3
Centre/Left/Reform lists	7	17	5
Communists	4	5	4
Others	4	4	3
Total	120	120	120

Source: Jerusalem Post.

The 1973 elections, postponed because of the war, took place in its immediate aftermath, when sporadic fighting was still taking place on the Syrian front. On the political right, the Likud, as noted, surged strongly, while on the left a number of protest movements sprang forward and captured several seats. These trends intensified in the following years: the "founding fathers" generation in the Labour Party was swept out of office and replaced by a new generation of younger, mostly Israeli born leaders. However, the party split between Shimon Peres and Yitzhak Rabin, based mostly on personality and much less on policy differences, left it in a weakened state, while its opponents to the right and left gained strength.

- brought it to power in the "upheaval" of May 1977 -

The election of May 17, 1977, nevertheless shocked the country by returning the Likud as the largest single party and thereby led to the first handover of power in Israel's history. Nevertheless, it remains true to say that the Likud did not so much win the election as Labour lost it. The emergence of the reformist Democratic Movement for Change (DMC), formed just before the elections, demonstrated the extent of Labour's decline as it swept up 15 seats, primarily from disenchanted Labour voters. Its programme of electoral reform and economic liberalisation have since been largely, if covertly, accepted by Labour, although remaining on paper for the most part.

The other key development was the switch of allegiance of the NRP from Labour to the Likud, dictated by the increasingly nationalist-fundamentalist orientation of that party's rising younger generation. This allowed Mr Begin to form a coalition with the NRP and Agudat Yisrael, which in turn allowed him to outmanoeuvre the neophyte leadership of the DMC in the course of prolonged negotiations, eventually granting it participation in government for very little return in policy commitments.

- which it retained in 1981, despite Labour's recovery

These political changes shook Labour, while the failure of the DMC to "deliver" on major reforms, coupled with the increasing confidence of the Likud in promoting its own policies, drove Labour voters back "home" so that the 15 lost seats from 1977 were regained in the 1981 elections. Likud, however, gained ground as the NRP fell victim to internal dissension and the DMC collapsed entirely. Tehiya emerged on the far right as an ultra nationalist breakaway of Likud hardliners opposed to the Camp David peace process and especially the dismantling of Israeli

settlements in the Gaza Strip under the terms of the Israel-Egypt peace tre
signed in 1979.

Yet neither military nor diplomatic successes win elections

One interesting conclusion that emerges from the record of voting patterns is th neither Israel's greatest military victory, that of the Six Day War, not greatest diplomatic triumph, the peace treaty with Egypt, led to electoral gai for the incumbent governments - of the Alignment and Likud respectively. Th lends some support to the contention of many Israeli psephologists that the mo consistently influential factor on voters' minds when they cast their votes is th current state of the economy.

CHAPTER 3
THE ISRAELI ECONOMIC MIRACLE: WHERE IT CAME FROM, WHERE IT WENT TO

THE GENERATION OF GROWTH

From dramatic growth, through stagnation, to crisis

Israeli economic history divides itself into two distinct periods. In the generation following independence, the economy grew at annual average rates of around 10 per cent, on a par with the most spectacular "economic miracles" of the post-war era, such as those of Japan and South Korea. From 1972/73, however, severe structural problems became evident, and these were soon compounded by the twin blows of the Yom Kippur War and the oil price shock. These ushered in a decade of decline, in which huge defence and welfare programmes were financed by higher taxation and increasing resort to borrowing at home and abroad. This process accelerated sharply in 1981-83 and precipitated a severe crisis, which became apparent in 1983 and reached its climax in the following two years.

The economy was forced to start from scratch -

The problems facing Israel in the period immediately after 1948 were daunting. The new state had no resources, either natural or financial, no reserves, little infrastructure and few or no public services. The system of civil administration built up by the British had collapsed with their withdrawal and with the huge population movements that accompanied and followed the war itself. Large parts of the former Arab population had fled, leaving some areas of the country partially deserted, while the main Jewish population centres along the coastal plain and in Jerusalem (now a divided city), were being swamped with refugees pouring in from Europe, and later from the Arab countries as well. These people lacked the most basic requirements of shelter, employment and, of course, services such as health and education. Because of the cultures they came from, many suffered from the sudden leap into a modern society. All of these issues required the urgent attention of the government.

- and adopted a path of rapid industrialisation -

The extent of the government's success in tackling these issues can be ascertained, in crude outline, from Table 3, which shows the differing rates of economic development in the main sub-periods covered by this chapter.

Table 3

Key Economic Indicators, 1950-82
(annual average % increase)

	Population	GNP	GNP per caput	Capital stock	Consumption per caput
1950-51	20.0	29.7	10.0	...	...
1952-64	4.0	9.1	4.9	12.3	5.1
1962-72	3.0	8.9	5.5	8.4	3.6
1973-82	2.1	3.2	0.8	6.7	3.2

Sources: Central Bureau of Statistics; Bank of Israel.

The tremendous boom of 1950-51 reflected the recovery from the dislocation of war. Inevitably, however, it ran into bottlenecks and resulted in rising infla and a balance of payments crisis. This caused a recession in 1952-53, after wh growth took off again at a very rapid rate and continued for two decades, mar only by the deliberately engineered slowdown of 1965-67.

This boom represented a classic case of successful industrialisation, based import substitution and high trade barriers at first, gradually being eased facilitate a move to a more open economy. The overall policy strategy was concentrate on building up basic industry and services and providing infrastructure that they required. Within this framework, education was given very high priority, and the average educational levels of the population ro consistently.

- achieved through centralised planning -

The fact that the main strands of political, economic and social power we concentrated in the same hands - those of the Labour-Histadrut complex - ma the formulation and implementation of policy much simpler. The compactness of t country, the small population (even if it was growing rapidly) and the intimacy the group that held the top positions in every sector, made centralisation control the logical and probably the only feasible method of administration Another major factor that facilitated the achievement of rapid economic grow was the quality of administration. The best products of the rapidly growi university system went, almost as a matter of course, into the government servic and made their mark there. Only at a later stage, with the development of a mor sizeable private sector, did an alternative career path emerge.

- and the use of foreign aid from several sources -

The government went about resolving the dearth of financial resources by seeking aid from overseas. This came from four sources, whose relative importance varied over time, as shown in Table 4. Personal restitutions from West Germany began in the 1950s, in the wake of the Reparations Treaty signed in 1953. "Other private remittances" includes individual investments, other transfers of immigrants, temporary residents and corporations, less transfers abroad by individuals and corporations. Institutional remittances represent those funds collected by the main Jewish fund raising organisations in the Diaspora, including those on behalf of academic and other non-profit making institutions, which were forwarded to Israel. Government remittances stem from aid from West Germany in particular, in the 1950s and 1960s, and from the USA from 1973.

The rise in personal restitution payments was due, in the first place, to the number of claims lodged and the amounts paid by the West German government, and later to the rapid appreciation of the Deutschemark against the dollar in the 1970s. The underlying trend has been one of decline in the amounts paid, as the generation of eligible recipients passes on, but this is distorted by the effects of currency swings in the last decade. The figure for "other private remittances, net" is affected by numerous factors, such as the rate of immigration, foreign exchange controls in force at various times, and the availability of attractive investments, especially in securities.

Table 4

Transfer Payments to Israel, 1952-85
($ mn)

	Personal restitutions from West Germany	Other private remittances	Institutional remittances	Government remittances	Total
1952-55	27	76	336	395	834
1956-60	310	180	390	435	1,315
1961-65	630	396	425	227	1,678
1966-70	718	643	1,050	-59	2,352
1971-75	1,461	1,705	2,177	2,480	7,823
1976-80	1,979	2,035	2,341	6,148	12,503
1981-85	1,894	1,938	2,802	10,189	16,823

Sources: Central Bureau of Statistics; Bank of Israel.

- of which Diaspora Jewry has been the most stable -

Institutional remittances, on the other hand, show a clear pattern. After relative stability until 1967, there followed a very sharp rise in the wake of the massive fund raising that accompanied and followed the Six Day War, after which the underlying level was much higher than before the war, although not as high as in 1967 itself. Exactly the same pattern was followed during and after the Yom Kippur War in 1973, and the average amount from this source in this decade has been some $550 mn each year. The importance of this inflow remains very high, especially in periods of emergency, and its reliability is higher than that of any other.

- while US aid has become dominant

Government to government remittances have, since the beginning of US aid in 1973, become by far the dominant element in total transfer payments. The flow of funds from the West German government tapered off in the early 1960s, and between 1967 and 1971 the Israeli government was actually a net donor of aid - mainly in agricultural and other assistance to African countries - rather than a recipient. This is a rather curious reflection on the period between 1967 and 1973 when Israel regarded itself, and was regarded, as a local "great power", an idea that came to an abrupt end, along with many other illusions, with the Yom Kippur War. From that time, economic and military assistance has flowed in ever increasing sums from successive US administrations to successive Israeli governments; the former were, from the first, in the form of grants, the latter became wholly so only from the US fiscal year 1985, that began on October 1, 1984.

It is important to realise that sums received in the 1950s had a much greater weight than the bare numbers would suggest. This is not merely due to inflation, which alone requires multiplying them fourfold or fivefold. The impact of, say, a $1 mn investment in the capital starved and underdeveloped economy of Israel's first two decades was far greater than the marginal effect of $10 mn today, because it could buy far more labour and other inputs, especially when the much larger multiplier effect that then existed is taken into account.

ECONOMIC STRUCTURE

The government has channelled resources to its desired targets -

At the outset the government's control system involved rationing everything licensing every activity, since almost every item was in short supply and had to allocated according to a firm set of priorities. Only gradually, and starting in late 1950s, was rationing phased out for most goods, although licensing remai commonplace. Capital, too, was allocated by government fiat, with all financ flows passing through the Treasury and the rates of interest for different activit fixed either directly or in line with the amount of funds available. The governme itself owned many major companies and was involved in construction a manufacturing on a large scale, a feature of the economy that has grown ov time, rather than lessened, and to which increasing attention is now being paid.

- and become increasingly involved in industry -

The Israeli economy may be divided into three sectors as regards ownershi namely the private, the public and the Histadrut. The latter includes corporatio owned by the Histadrut or its subsidiaries, especially the Hevrat Haovdim holdi company, and the numerous kibbutzim with their agricultural and industri enterprises. For most purposes, Histadrut owned enterprises behave like private owned ones, although the collective approach often allows a unit in tempora difficulties to be "carried" by other, more profitable ones, until it recovers, whi a similar private firm might have failed for lack of resources. Chronic lame duck are not tolerated, however.

The public sector includes enterprises owned by local authorities an quasi-governmental bodies such as the Jewish Agency. As in other countries criteria quite different from those pertaining in the private sector rule the outlo of many public sector companies, and their boards and management positions ar frequently used by the politicians responsible for them as means of patronage fo party activists. The growing presence of the government, and also of th Histadrut, in industry may be ascertained from Table 5, which gives the "marke share" of each of the three sectors at three different points over the last 2 years. While the number of plants, counted on a unit basis, remain overwhelmingly skewed in favour of the private sector, with the Histadrut's share growing from 2 to 3 per cent and the public sector's halving to 0.3 per cent, the shares of industrial production and employment tell a very different tale.

The private sector's share of total production declined in this period from almost three quarters to just over half, while that of the public sector doubled from one eighth to one quarter. The Histadrut's, although increasing by 40 per cent, fell below that of the public sector. In terms of total numbers of employees the shift has been less dramatic but still pronounced. The private sector has fallen from over three quarters to less than two thirds, the public sector has risen from one tenth to one sixth and the Histadrut sector has also grown appreciably.

- including arms manufacture-

One of the main reasons for this pattern is almost certainly to be found in the later development of the defence industries, compared with the rest of Israeli industry. Whereas civilian industries were allowed to develop behind protective tariff barriers until they were believed ready to face foreign competition, defence imports were left free of taxes and duties since there were no home manufacturers to protect. After the Six Day War and the French arms embargo that followed it, however, the government decided to increase Israeli self-sufficiency by building as many weapons systems as it could. Most of these new industries were state owned, and they have grown to be amoung the largest in the country, such as Israel Aircraft Industries and Israel Military Industries. In the Histadrut sector, Tadiran became a major defence contractor and the largest electronics firm in the country. Of course, many private sector companies were caught up in this area's growth as well, but they remained for the most part small sub-contractors.

Table 5

Sectoral Distribution of Industry, 1965-81 (%)

	1965-67	1971-72	1980-81
Output			
Private sector	72	66	54
Histadrut sector	16	19	22
Public sector	12	15	24
Total	100	100	100
Employment			
Private sector	76	73	66
Histadrut sector	14	15	18
Public sector	10	12	16
Total	100	100	100
Number of plants owned			
Private sector	97.2	97.5	96.4
Histadrut sector	2.2	2.3	3.3
Public sector	0.6	0.2	0.3
Total	100.0	100.0	100.0

Source: Bank of Israel.

— and chemicals

Another area where a few huge government owned companies hold a major chunk of total output and employment is the chemical industry, where Israel Chemicals and its subsidiaries hold the sole rights to mine potash, bromine and other raw materials in the Dead Sea area. The oil refineries in Haifa and Ashdod are government owned and sit astride the petrochemical industry, while the largest of the three companies in the cartel of petrol distributors is government owned.

In service sectors the government and Histadrut are even more dominant, with Histadrut affiliated cooperatives having a near monopoly position in areas such as public transport and the production and marketing of many agricultural products. The two major banks, comprising some two thirds of the banking system, are owned by the Jewish Agency and the Histadrut respectively, and their closeness to government was a major factor in the development of the bank share "regulation" that almost destroyed the whole financial system in 1983 (see Chapter 4). In like manner, the two largest insurance companies are owned by the Histadrut and the Jewish Agency respectively.

THE EMERGENCE OF STRUCTURAL FLAWS

Attempted slowdown led to recession, with lasting policy lessons

The single divergence from the general growth strategy came in the mid-1960s, when the planners deliberately tried to cool off what they felt to be an overheated economy, primarily by cutting back on public and publicly financed building projects, since construction was then the leading economic sector. However, the plan misfired in that the slowdown soon snowballed into a serious recession which continued until the Six Day War, with unemployment rising to over 10 per cent sparking a wave of emigration. Although GDP growth remained positive, reachin low point of 2.1 per cent in 1966, the social and economic impact of experiment remained seared in the country's memory and the aversion of politic to economic recessions, large in any democracy, became almost total in Israel.

Rapid growth resumed after the Six Day War -

The Six Day War of June 1967 blasted the economy out of its downward spiral set it back on the path of high growth, as capital flowed in from abroad and economy plugged into a new source of plentiful cheap labour from the occup territories in the West Bank and Gaza Strip. Immigration, too, recovered Western immigrants in particular channelled both human and financial capital expertise into the economy. This boom peaked in 1972/73, with the emergence specific supply side bottlenecks, along with rising inflation, that made the pace growth unsustainable.

- until curtailed by structural problems -

These bottlenecks stemmed from the fact that the nature of the economy h changed, and that it was now fully utilising its available capacity of hum physical capital. In essence, it had completed the import substitution phase an was ready to move on to a more advanced phase of development. The labour for was no longer cheap, on a comparative basis, and the wave of social welfa legislation during the 1970s made it increasingly less so. Technologically, th manufacturing economy had come of age and was able to produce at the lev needed by the local market. But neither the labour force nor the capital base wa sufficiently large to enable a move to export led mass production. Nevertheless some basic change of direction was needed, to create a different economi structure suited to the country's comparative advantage in the internationa economy. Some industrialists and their financial backers believed, even then, tha this new direction would have to be based on technologically advanced industrie seeking niches in the major markets, especially in the USA. But these ideas ha not been widely developed, and the government and Histadrut preferred to stick to the old and trusted methods that had fuelled the country's stunning success to date.

- creating difficulties in absorbing Russian-Jewish immigration -

One of the factors that drew attention to the need to make some far reaching changes in Israel's economic structure, was the failure to absorb properly the Russian-Jewish immigration that had begun in 1969/70 and reached its peak in 1972-73 (see Table 1, Chapter 2). In terms of labour market and educational qualifications, these immigrants were the elite of the Russian economy. As an illustration, it may be noted that the percentage of employed Jews in the Russian Soviet Republic (the richest area of the Soviet Union) whose education was of secondary school level or above was over 50 per cent compared with an equivalent figure of only 8 per cent for the general Russian population. In consequence, and despite the boom conditions in the economy that existed on their arrival, many of these immigrants could not find suitable employment - the economy was simply not advanced enough to offer it.

This development, too, took time to be noticed and analysed and for its implications to sink home. One of the consequences was the gradual increase in "drop outs" from the Soviet Jewish emigration. These were Russian Jews who chose, on their arrival in Vienna or Rome, supposedly in transit to Israel, to go instead to other countries, usually the USA. The readiness of the USA to grant entry to these emigrés represented a change in its immigration policies and had a profound effect on the future of the Israeli economy, and indeed of every aspect of national life. In sharp contrast to the situation that prevailed since at least the 1930s, Jewish refugees had a realistic option of making a new home in the USA. One of Israel's most basic raisons d'être was therefore put under pressure, because it was no longer the automatic refuge for Jews forced to flee their native countries.

- and sparking rising emigration among young Israelis

Furthermore, and with growing effect after the Yom Kippur War, the USA became an alternative for native Israelis as well, especially the young and educated ones whose labour market skills were in demand. In short, Israel found itself in competition with the USA as a potential home for Jewish refugees and as an alternative or second home for footloose Israelis.

The effects of the Yom Kippur War and the oil price shock -

Most of these changes in Israel, the USA and the USSR had begun to occur, but had not come to the surface, much less been incorporated into policymaking and decisions, before the economy was struck by two massive shocks - the Yom Kippur War and the oil price rise that followed it. In addition to the direct cost of the war itself in material and the extended mobilisation of a large part of the work force, was the indirect cost of having to cope with an international environment in which the oil weapon, as a covert or overt method of pressuring Israel, was far more powerful than hitherto. The direct result of the oil price rise was, of course, the jump in import costs for fuel, since most of Israel's energy was imported. The Sinai oilfields, then under Israeli control, produced only a small portion of the country's requirements, although a later find increased this. The indirect outcome was the spurt in general inflation, in particular of raw materials. In a nutshell, the terms of trade worsened suddenly and dramatically.

- coupled with the surge in defence spending -

The war also led to a decision significantly to increase the size of the army, and to speed up the programmes to build major weapons systems at home. In the years immediately after the Yom Kippur War, defence expenditure reached its highest ever levels in terms of GNP, of almost one third (see Table 15, Chapter 5). The big increase in defence spending had come after the Six Day War, but had been largely covered up by the tremendous growth in total GNP. Now, however, in a stagnant economy, this increase could only come at the expense of something or somebody else.

- and the cost of burgeoning social welfare programmes -

In addition, the government continued after the war with its increased spending on social services, a trend that had begun in 1970/71, when rioting by the "Black Panthers" and other groups of disaffected Sephardi youths had forced the country and government to recognise the extent of the social gap between the haves and have nots of Israeli society, which corresponded to a large degree with the Ashkenazi/Sephardi ethnic divide. For a country that had prided itself on its egalitarianism, this revelation had come as a shock, and the government's reaction was to channel large extra resources to social service spending. This corresponded with its response to the emerging problems of Israeli industry, which were also met by the injection of public money, in the form of subsidies, tax benefits, grants and cheap loans, into the floundering development zones. In both cases, the cost in the course of the decade was very high, in both absolute and relative terms, while the returns were disappointing at best.

- led to a distorted allocation of resources

The change in the economy in the years after 1973 can be illustrated by analy the division of the new resources generated among competing uses in the period 1962-72, when growth was generally very high, and that of 1973-83, when it very low.

Table 6

Increase in Economic Resources and Their Uses, 1962-83
(constant 1983 prices; GNP increase = 100%)

1962-72			
Resources ($ bn)		Uses (%)	
GNP	9.9	Private consumption	50.5
Deficit	2.4	Civilian public expenditure	10.1
Total	12.3	Defence expenditure	29.3
		Investments	34.3
		Total	124.2
1973-83			
Resources ($ bn)		Uses (%)	
GNP	6.3	Private consumption	103.2
Deficit	2.1	Civilian public expenditure	12.7
Total	8.4	Defence expenditure	20.6
		Investments	-3.2
		Total	133.3

Source: Professor Haim Ben-Shahar, Tel Aviv University.

In the former period, total resources grew by $12.3 bn, or 124 per cent of GNP growth in that time. Only half of the growth in GNP was taken up by private consumption, leaving ample room for government spending on both civilian and military programmes, as well as maintaining a strong rate of investment. Accommodating all these competing uses required a larger deficit than had formerly been the case, but this was not a major burden, especially in light of the very rapid real growth taking place. In the second eleven year period, a very different picture emerges. GNP grew much more slowly so that, even with a larger deficit, the total increase in resources fell by 35 per cent in real terms. More than 100 per cent of the increase in GNP went to private consumption, as government subsidies and transfer payments rose steeply, so that any increase in other uses had to be financed by borrowing. Thus, although the proportion of defence spending fell after 1975, both it and the growing non-military public spending were paid for by loans at home and abroad, while there was no scope left for improving investment.

An initial attempt to tackle the problems -

The period after the Yom Kippur War was not one of uniform decline, however. Within the 1973-83 period were distinct sub-periods. In the first, from late 1974 to early 1977, the Labour government endeavoured to tackle the economic crisis that had developed since October 1973 and which expressed itself in high and rising inflation, balance of payments deficits and government budget deficits. This was largely successful, but at the price of slow growth of around 3 per cent a year in 1975-77, and an increase in unemployment.

- was followed by exchange control liberalisation -

The new Likud government entrusted economic policy to its Liberal wing when it took power in 1977. Despite the widespread hope and expectation of major policy changes that accompanied this change, the economic upheaval of October 1977 that followed the political one of May that year was a very partial affair. Exchange controls were abolished, the Israeli pound set floating and export subsidies and some import taxes were eliminated. The rest of the economy, in particular the capital markets, remained firmly under government control.

- but the second oil shock induced a policy of austerity

The failure to make any fundamental changes in the economy left it vulnerable to further external shocks, and the Iranian revolution and the second oil price jump in 1979/80 provided exactly these. Iran under the Shah had had close ties with Israel, selling it a large part of its oil needs and buying growing quantities of military equipment. The second round of shocks thus further aggravated the trade deficit, sending it from $1.5 bn in 1978 to $2.5 bn in 1979 and to $2 bn in 1980. Devaluation and hence inflation moved to triple digit levels in consequence. For a brief period, when the dour Yigael Hurwitz occupied the finance ministry from November 1979 to January 1981, the Likud made its only serious attempt to impose any kind of austerity programme on the country. Although cuts in subsidies and other spending helped the balance of payments recover, unemployment shot up from under 3 per cent to around 5 per cent. The inevitable unpopularity that ensued, especially within the Likud's own constituency in the poorer areas and development towns, coupled with the decision to hold a general election in June 1981, led to cabinet opposition to Hurwitz's policies, his resignation, and the rapid undoing of the improvement he had effected.

THE SELF-MADE CRISIS

The Likud's "election economics" triggered a rapid deterioration -

Mr Hurwitz's replacement was a Herut man, Yoram Aridor, with no previous ministerial experience. His initial task was to ensure the re-election of the Likud, in the face of a large opinion poll advantage to Labour. Under Aridor, the Likud's slogan of "being good to the people" reached its ultimate formulation. He proceeded to lower taxes on imports of consumer durables, touching off an import boom the like of which the country had never seen. This and a round of hefty wage increases proved enough to buy the election and return the Likud to power. Aridor was now put in untrammelled control of the economy to an extent unmatched even by the earlier Labour finance ministers; the second Begin government did not even debate economic policy at cabinet level until August 1983, two years after its formation. The rapid deterioration of the economy in this period compared with the previous years, later described by one leading industrialist as "ten years' slide telescoped into two", is summarised in Table 7.

Table 7

Increase in Economic Resources and Their Uses, 1973-83
(constant 1983 prices; GNP increase = 100)

1973-80

Resources ($ bn)		Uses (%)	
GNP	4.9	Private consumption	73.5
Deficit	0.4	Civilian public expenditure	20.4
Total	5.3	Defence expenditure	24.5
		Investments	-10.2
		Total	108.2

1981-83

Resources ($ bn)		Uses (%)	
GNP	1.4	Private consumption	207.4
Deficit	1.7	Defence expenditure	7.1
Total	3.1	Investments	21.5
		Civilian public expenditure	-14.3
		Total	221.4

Source: Professor Haim Ben-Shahar, Tel Aviv University.

When compared with the overall picture of the 1973-83 period contained in Table 5, the division into sub-periods highlights the extent to which the crisis was precipitated by irresponsible government policy in the early 1980s.

- in which government borrowing financed a consumer spending boom -

On the resources side, the overwhelming bulk of the deficit increase was created in the later period, as GNP growth came to a virtual halt, with GNP falling 0.4 per cent in 1982 and rising 1.4 per cent in 1983. This deficit translated itself into a growing hole in the balance of payments and was caused by the extraordinary growth in private consumption. This alone was more than twice the GNP growth of 1981-83. In 1973-80, in contrast, private consumption had absorbed less than three quarters of the GNP growth - still much more than the 1962-72 average, but hardly comparable to the Aridor years. Thus, whereas in 1973-80 there was still room for increased spending on both military and non-military items, and the overall size of the deficit shrank sharply at the expense of investments, in 1981-83 there was no room for either. Nevertheless, defence expenditure, which had fallen appreciably since the 1974/75 peaks, was boosted again by the Israeli invasion of Lebanon in 1982. This was financed by more taxation, more borrowing and less civilian spending.

The rise in investments in 1981-83, an apparently positive development, was a cyclical phenomenon, exaggerated by the rush of many firms to boost stocks and to install plant and equipment in 1982/83 and thereby take advantage of the tax shelters granted to such investments under the Law of Taxation Under Inflationary Conditions of 1982. The extent of the damage wrought by the policies in force in this period can be seen in Table 8.

Table 8

Current Account, 1980-83[a]
($ bn current prices)

	1980	1981	1982	1983
Civilian trade deficit (incl capital services)	2.0	2.1	3.1	4.0
Direct defence imports	1.7	2.2	1.5	1.1
Total trade deficit	3.7	4.3	4.6	5.1
Less unilateral transfers	2.9	2.9	2.6	2.9
Current account deficit	0.8	1.3	2.0	2.1

a Figures may not add due to rounding.

Source: Bank of Israel.

– and the trade deficit widened dangerously

The civilian trade deficit soared from year to year, as imports climbed while export levels actually fell in 1982 and 1983. The latter development stemmed from Aridor's final policy innovation, in force from September 1982 to August 1983, of holding down the rate of devaluation to 5 per cent per month in an attempt to reduce inflationary expectations. Apart from its other disastrous consequences (detailed in Chapter 4), this reduced exporters' earnings in local currency terms, while the tremendous boom at home encouraged them to increase production for the home market at the expense of exports. It can also be seen that only the fall in direct defence imports prevented the trade deficit from pushing up the total current account deficit even more strongly than was in fact the case. At the same time, Israel's foreign debt position was dramatically worsening, both because of the government to government debts piling up and because of the need to take on short term loans to finance the current account deficit. All this occurred at a time when dollar interest rates were at historically high real levels and still at high nominal levels, although below their 1980/81 peaks. The chronic problem of Israel's trade deficit, which had existed since the state's earliest years, was thus exacerbated, and its entire economic position was threatened by the growing current account crisis and the debt burden that it was assuming to finance its ongoing deficits. The inevitable result of these developments was the collapse of confidence in the currency, expressed by devaluation in the international markets and by inflation at home.

THE ROAD TO HYPERINFLATION

Israeli inflation took off in the 1970s –

Inflation had always been relatively high in Israel, compared with Western norms. But even the 12.8 per cent annual average increase of the 1950s, itself skewed by one or two years' very high rates, and certainly the 5.6 per cent annual average of the 1960s, were regarded as a tolerable price to pay for the very high growth rates the country was then achieving. Nevertheless, they gave rise to the creation of a system of linkage for most long term saving and for many other financial transactions, as well as the strengthening of the cost of living agreements (Colas) that the British had introduced during the war. Israeli inflation rates increased in the early 1970s, in response to the growing inflationary trends in the world economy. The 1971 devaluation made imports still more expensive, while the imposition of compulsory defence loans to finance the post-Six Day War arms build-up increased local costs. Annual price rises entered double digits in 1972.

- becoming, with devaluation, a policy weapon -

The aftermath of the Yom Kippur War saw a great boost to import inflation, oil and commodity prices, and this was aggravated again by a devaluation, time of 43 per cent, in November 1971. This move represented part o deliberate government plan to use inflation as a means of bridging the gro imbalance between the resources available to the economy and their uses, and specifically aimed at eroding private consumption. Inflation was to be "functio meaning it would erode real wages and disposable incomes and would also be least a partial tax on those assets that were unlinked. Furthermore, since government ran a surplus in its foreign currency transactions, receiving more it spent, it sought - not for the first time - to achieve a "real" or uncompens devaluation which would allow it to sell its dollars at a higher price in terms their purchasing power of local goods and services. In other words, the m effect of the devaluation was to be on relative prices in the real econo Previous attempts to achieve a real devaluation in 1962 and in 1971 had fail because in each case local price rises of wages and products had soon caught Only that of 1967 had worked, because the economy was still mired in recession the time. The hope was that the atmosphere of national crisis that prevailed 1974 would help it succeed again. However, within a year an atmosphere "business as normal" had re-emerged and the underlying economic forces for real wage and price increases. These forces were particularly potent in the labo market, as supply dried up. Russian Jews were increasingly going to the US rather than Israel, Israelis were emigrating in larger numbers, and a major exo of Palestinians took place, heading for the Gulf.

- but both failed to achieve their aims -

Neither the switch to "crawling peg" devaluations in 1975, nor the 48 per cent devaluation that accompanied the foreign exchange liberalisation moves of Octobe 1977 had any better results, but the policy remained in place. Thus, when the second major oil shock drove import prices higher and aggravated the trade deficit, daily devaluations were introduced to help exporters overcome rising input costs, and this soon fed through to higher inflation, making 1979 the first year of triple digit inflation. At this point the Bank of Israel decided to stop leading the "race" between devaluation and inflation. It gave up the hope of putting the governmen one step ahead, and made do with keeping the rate of devaluation in line with that of inflation. Given the now total indexation system in the economy, the spiral was able to keep going under its own momentum, with government inspired price rises or subsidy cuts sparking general price rises, leading to Cola payments and forcing devaluation, so that internal prices fell behind again, and so forth.

- and a misguided policy triggered a run on the currency

This cycle continued undisturbed by outside forces until 1983, and the rate of inflation consequently stabilised at a new "plateau" of 110-130 per cent a year from 1979 through 1983 (see Table 9). An attempt was made between September 1982 and August 1983 to influence the public's inflationary expectations by holding the rates of devaluation and of government directed price increases to a level of 5 per cent per month. This was known as the "5-5 policy". It boomeranged badly because the general inflation rate continued to hold above the targeted 5 per cent monthly pace, so that the public began to hoard dollars, expecting a devaluation to close the widening gap between the rates of inflation and devaluation. The longer this was delayed, the more convinced the public became of its inevitability, and the more intense became the flight from shekel denominated assets to dollar linked assets and cash dollars.

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Table 9

Annual Rates of Inflation and Devaluation, 1973-83
(% increase, Jan-Dec of each year)

	Consumer price index	Devaluation
1973	26.4	-
1974	56.2	42.9
1975	23.5	18.3
1976	38.0	25.4
1977	42.5	72.9
1978	48.1	23.6
1979	111.4	85.9
1980	132.9	113.5
1981	101.5	106.7
1982	131.5	115.7
1983	190.7	220.3

Sources: Ministry of Finance; Bank of Israel.

CRISIS AND STABILISATION, 1983-86

Instability climaxed and was resolved, exposing underlying problems

The period between mid-1983 and mid-1985 was generally perceived to be on economic crisis, while the 18 month period following July 1985 was one comparative stability. However, the terms crisis and stability need car definition. The former was primarily a policy crisis, engendered by professi confusion as to the nature of the inflationary spiral and hence how it should dealt with, and compounded by political instability. The latter refers primarily the rates of inflation and devaluation. The current account improved dramatica but this was due primarily to increased US aid, while the absence of growth GNP and investments is more correctly termed "stagnation" than "growth". Th both the crisis and the stability were primarily reflections of the state policymaking - the move from confusion and indecision to clarity in conception implementation. There was no crisis in the sense of mass unemployment, perman declines in living standards, or absolute shortages of foreign currency, altho there were fears regarding all of these. Throughout the period, the underly structural problems of the economy remained unanswered, as they had been si their emergence in the early 1970s. But only with the achievement of stability the nominal variables was it possible to return the focus of attention to the r variables. In 1986 the issue of structural reform moved to centre stage, and w dominate economic policy in the coming years.

The crisis, then, was a process wherein the distortions and imbalances created byproducts of the prolonged slide into hyperinflation came to the surface and through a series of crashes and shocks, were resolved.

THE COLLAPSE OF THE CAPITAL MARKETS

The tremors were first felt in the share market -

The initial shock occurred in the most sensitive area of the economic system, th stock exchange. The Tel Aviv Stock Exchange (TASE), although in existence sinc 1953, had never developed properly, as a result of the government's domination o capital raising and allocating activities. It remained, therefore, a shallow market poorly regulated and dominated by the major banks, which simultaneously played al the roles of the main stock market actors - brokers, underwriters, issuers, fun managers, counsellors and investors.

- where successive bull markets culminated in a speculative spree -

The upsurge in inflation from the mid-1970s and the liquidity created by th government deficit, as well as tax legislation that diverted corporate investmen away from index linked bonds, all combined to channel growing quantities of mone into the narrow, illiquid and easily manipulated share market. Three distinc periods of boom were experienced, each wilder and more speculative than the on before.

The first, from mid-1976 to November 1977, fitted into the regular business cycle, coming after a period of contraction and leading into a boom in fixed investment and real estate generally. The next surge took place from late 1979 until early

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1981 and was centred especially on the industrial sector. A major setback then gave rise to a half year hiatus, after which the general atmosphere of easy money, fed by the government's swelling deficits and by generally negative real interest rates, generated a wild spree. This continued almost unabated until January 1983 and saw speculative excesses that matched the most famous bubbles in the annals of other stock markets. By the end of 1982 the total value of all the shares registered on the TASE - whose number had swelled dramatically that year as companies rushed to raise cheap capital by selling overvalued shares with low voting rights - had reached over $17 bn, having more than doubled in a year and multiplied fivefold since 1979, in real terms. All this stood in sharp contrast to the stagnant GNP growth and worsening trade and debt position of the economy.

- precipitating a spectacular collapse that shattered the market -

In January 1983 the bubble burst with such force that, in a matter of days, the leading speculative vehicles had lost 50-70 per cent of their value and the mutual fund group that had orchestrated their manipulation had been all but annihilated. After a brief recovery there followed a prolonged period of price erosion that reached a bottom only in January 1984, by which time the market had shrunk to a fraction of its former value and daily volumes, which had run at $50 mn at the peak, were down to below $5 mn.

Although the market's performance in both 1985 and 1986 was good in terms of yields achieved, it remained almost devoid of significant investor interest in either the primary or secondary market, with capital raising limited to a few rights issues.

During this period, however, many listed companies that had fallen victim to the recession were liquidated or bought out, while others were taken private by their major shareholders. The potential and structure of the share market is a key issue in the debate on capital market reform, which will be examined in Chapters 7 and 8.

- and eventually engulfed the "regulated" commercial bank shares -

The second half of this stock market collapse came in October 1983, when the bank shares, which had until then remained aloof from the general market malaise, finally gave way too. The rise and fall of the bank shares represented one of the central developments in the economy from 1977 to 1983 and their crash created major problems which continue to cloud its future. The Israeli banking industry had expanded dramatically in the 1970s, both at home and abroad, a process that forced the banks to increase their capital base rapidly. The gradual advance of inflation in the Israeli economy, and its distorting effect on financial statements drawn up under historic accounting rules, only added to this thirst for capital. But in a capital market dominated by a government able and willing to issue endless quantities of index linked bonds, the banks found this capital hard to raise.

Their solution was effectively to transmute their shares into index linked paper, by creating a system that ensured that the price of their shares would keep pushing ahead, irrespective of the underlying market forces. Over the years, this process of "regulation", as it came to be called, grew larger and more sophisticated. Bank shares became a liquid, risk free and high yielding investment. In periods of demand their yields soared way past the minimum target set by the banks of exceeding the rise in the consumer price index, while when the public sold bank shares, the banks arranged to have them absorbed without any fall in price. For the banks, therefore, their shares effectively ceased being an asset and became a demand deposit. For the investing public, on the other hand, which was led to believe they were invulnerable and was mesmerised by the opportunity of larg supposedly risk free profits, they became irresistible.

The maintenance of this system cost a great deal of money. To this end, banks mobilised all their resources. Subsidiaries and affiliates, and later fo branches and even straw companies, became conduits for channelling money to and hold the stock of shares they needed to "regulate" the market. Using dominant position in the stock exchange, they maintained a joint front to pr procedural and regulatory changes that would incommode them; each b investment counsellors utilised its nationwide branch network aggressively promote their own shares, while the mutual funds and provident funds they man also helped buy excess supply in times of need. Even the allocation of custo credit was often made conditional, explicitly or implicitly, on holding the len banks' shares, and these were often used as collateral.

However, the problem was that the bloated price of the banks' shares bec steadily more detached from their true value, since the banks' inflation adju profits were meagre and in some years non-existent. This potential cause of a on the shares became real when the finance minister of the day, Yoram Arid introduced a policy in 1982/83 of artificially holding up the value of the sh against the dollar. As it became clear that this policy had failed, the prospect a major devaluation grew and the public began dumping shekel assets in favour foreign currency. The assets most widely held and most easily liquidated were b shares, and the selling wave that began in the summer of 1983 and climaxed in t first days of October forced the banks to borrow hundreds of millions of doll abroad in an attempt to soak up the flood of sell orders.

- necessitating a massive government rescue operation -

Eventually, however, even their resources ran out. Only the intervention of th Treasury, which ordered the exchange closed for two weeks while a rescue packa was worked out, prevented a total disaster. The net outcome was that th government took upon itself a $7 bn obligation to buy the public's holdings o banks' shares from them in 1988 at their dollar value before the crash. Th represented an estimated three times their underlying asset value, and, at on stroke, increased the total internal debt by one quarter.

The main outline of the "regulation" system had been fairly well known even during its existence, both to the authorities and the informed public. But for as long as everyone benefited from its continuation, nothing was done to stop it, although warnings were periodically heard from various quarters. After its demise, the whole issue became a major scandal and was investigated successively by the State Comptroller and then by a judicial Commission of Inquiry. The latter reported in April 1986 and the sweeping reforms it proposed, with regard to all areas of the capital market, became the focus of a general debate on capital market reform.

- and intervention to stem financial panic and prevent depression

The exchange was closed on October 6, 1983, ten years to the day from the outbreak of the Yom Kippur War. The date became known as the "economic Day of Atonement" and the end of the fool's paradise in which the country had lived for several years past.

The three months following its reopening, on October 24, saw widespread panic and continued heavy selling of "free" shares, bank shares - now effectively dollar linked, government backed bonds - and regular government bonds. Mr Aridor resigned on October 13 and was replaced by Yigal Cohen-Orgad. A 23 per cent devaluation took place on October 23, accompanied by austerity moves including a total elimination of the exchange control liberalisation introduced in October 1977. All in all there was a sharp change in the economic atmosphere from conspicuous over-consumption to across the board cuts. Yet all these developments failed to bolster the public's rapidly dwindling confidence in the government and its policies. The Bank of Israel was forced to intervene in the markets to the tune of almost [illegible] bn in this period, before prices found a floor from which they could bounce.

By that point, even the shares of solid and well managed companies were trading at a fraction of their book value, and the yield on the bank "shares" had reached almost 25 per cent a year. Thus, in the space of the twelve months from mid-January 1983 to mid-January 1984, almost $10 bn was wiped off the value of the share market, with additional losses in the bond market. The elimination of this paper wealth had a major impact on the household and corporate sectors, and made a recession inevitable. Indeed, without the government's injection of funds through the markets, a financial collapse would have sent the economy into a severe depression.

THE CRISIS OF POLITICAL LEADERSHIP

Political weakness led to inconsistent economic policies -

The new finance minister, Yigal Cohen-Orgad, was by profession an economic consultant, but he was a junior Likud politician who had the Treasury thrust upon him when several party leaders refused to take up what they saw as a poisoned chalice. He therefore lacked the clout to impose on the spending ministries the reversal of economic policy that he desired. To make matters worse, the Likud government was now in general disarray, following Mr Begin's surprise resignation from the premiership and withdrawal from active political life in August 1983. His successor, Yitzhak Shamir, lacked Mr Begin's authority and dominant position within Herut and hence the Likud. He was also untried and uninterested in economic affairs, so that Mr Cohen-Orgad had no top level support in his budget cutting efforts. The Histadrut, for its part, refused to accept a cut in real wages as a result of the devaluation, and succeeded in recovering the erosion within a few months.

The final blow to any hope of a fundamental policy reformulation was delivered in January 1984 when the defection of one of the minor coalition parties led to the loss of the Likud's parliamentary majority and the decision to hold elections in the summer of 1984. From that time on, economic policy decisions were based on political calculations, so that, for instance, subsidies were allowed to grow again, and the budget deficit widened accordingly. This pattern of "stop-go" economic policies, wherein the government would decide on budget cuts, subsidy cuts and tax increases, but then implement them either partially or not at all, became a hallmark of this period. At its extreme, it involved marathon cabinet sessions which were billed in advance as "crucial" but ended inconclusively, so that the public was kept constantly on edge, and even the most everyday economic activities were fraught with uncertainty.

- and triggered growing capital flight abroad -

As a result of the growing loss of confidence in the government, and despite the much tighter regulations on outgoing capital transfers, the flight of capital out of the country that had begun during 1983 gained momentum. Although accurate figures are not available, it is estimated that between $2-3 bn was transferred or smuggled abroad, or hidden "under the floorboards", between 1983 and 1985. However, the development most feared by the government and banks, that of large scale withdrawals from the $7 bn of deposits held in Israel by overseas resid[illegible] did not occur to any significant degree.

An alternative form of capital flight was the indulgence in expensive ove[illegible] trips, which peaked in 1984, when over half a million Israelis vacationed ab[illegible] causing a huge outflow of foreign currency. In the pre-election period, [illegible] government did nothing to stop this, but within 24 hours of the July [illegible] elections, the Bank of Israel, citing the very low level of foreign curr[illegible] reserves - which it had itself covered up during the election campaign - slapp[illegible] number of taxes and levies on foreign travel.

- and a slump in savings and investment

Finally, the sharp fall in the public's willingness to save may also be put down [illegible] declining confidence. This was exacerbated by speculation, even from governm[illegible] sources, that the growth of both internal and external debt levels gave rise [illegible] doubts about the government's ability to meet its obligations. The percentage [illegible] disposable income saved by the private sector, which had run at levels of over [illegible] per cent during the 1970s and had thus helped finance government spendi[illegible] slumped in 1981-83 as the spending boom diverted resources from savings [illegible] consumption. In 1983 it reached 22 per cent, and only a sharp increase in yie[illegible] offered, coupled with a reduction of the average maturity period, enabled t[illegible] government to turn this trend around and thereby recycle the internal debt falli[illegible] due in 1984. The terms were also changed, to accommodate the change in t[illegible] public's taste, with the emphasis switching to dollar linked savings, since ind[illegible] linked vehicles were now being spurned. However, the improvement was short-lived because in 1985 the savings rate plummeted to below 20 per cent, and fell furth[illegible] in 1986.

Investment, too, was badly hit, with fixed capital formation falling by 12.8 per cent in 1984, 10.1 per cent in 1985 and 6.8 per cent in 1986. This was undoubtedly linked to a basic change in monetary policy. Whereas in 1982-83 borrowing rates had been held deliberately low, further spurring consumption and borrowing for speculative purposes, from late 1983 real interest rates began rising steadily. Industry and commerce therefore slashed inventories, while investment plans were cancelled in the wake of the collapse of the capital markets and in view of the paralysing uncertainty that increasingly gripped the economy.

The fall in savings and investments was not solely influenced by uncertainty, however. The exaggerated consumption of and investment in imported goods and services in 1982-83 undoubtedly represented a form of advance purchasing, which was compensated for in 1984-85 by declines in consumption and investment levels, while in 1986 consumption rose and investment declined far more slowly. Except in 1985, savings moved inversely to consumption. Table 10 summarises the percentage change in the main economic indicators in 1983-86.

1984 election resulted in an unexpected deadlock -

The election of July 1984 was widely expected to bring about a Likud defeat, in the wake of the two major setbacks that its period in power had witnessed. The first of these was the growing economic disaster, which had by now fully surfaced and brought about the resignation of Mr Aridor, the finance minister whose policies were perceived to have led to it. The second was the intervention in Lebanon which had begun as "Operation Peace for Galilee" in June 1982 but had resulted in a prolonged, increasingly costly and increasingly unpopular Israeli occupation of southern Lebanon. The war had also led to the resignation of the defence minister who planned and initiated it, Ariel Sharon, and of Mr Begin himself, as noted. Despite all this, the pundits and the opinion polls were proven wrong again, as

Table 10

Main Economic Indicators, 1983-86
(annual % change)

	1983	1984	1985	1986[a]
GDP	2.5	1.7	2.8	1.1
Private consumption	7.8	-6.8	-0.4	12.0
Civilian public consumption	0.4	0.9	-0.2	-1.7
Exports of goods & services	2.2	13.8	7.5	5.7
Imports of goods & services	11.1	-0.5	-2.0	9.3
Gross domestic capital formation	10.3	-7.6	-13.4	6.8
of which:				
fixed capital formation	13.9	-12.8	-10.1	-6.8
Real wages	5.9	-0.4	-9.2	7.0
Consumer price index	190.7	444.9	185.2	19.7
Unemployment (absolute rate)	4.5	5.9	6.7	7.1

a Preliminary.

Sources: Treasury; Bank of Israel.

they had been in 1981, and the predicted Labour landslide failed to take place. In the event the election produced an unprecedented situation in which neither major bloc, try as it might, could put together a workable coalition. Table 11 gives the breakdown of Knesset seats after the election.

Table 11

Knesset Election Results, Jul 1984
(1981 results in brackets)

Alignment	44	(47)
Likud	41	(48)
Tehiya	5	(4)
All religious parties	12	(10)
Centre left/reform lists	10	(5)
Communists	4	(4)
Others	4	(3)

Source: Jerusalem Post.

It may be seen that both major parties lost ground to smaller lists on their respective flanks, although the Likud lost rather more than Labour. The established religious parties also fell victim to the inroads made by rival lists of breakaways and newcomers, so that the general trend was one of protest voting against the entrenched parties and in favour of new faces. An unprecedented dispersion of seats took place, with 15 lists achieving representation, of which three held one seat each, three obtained two, three others three apiece and three more four, with the right wing Tehiya Party's five seats making it the third largest single party.

– making a "National Unity government" the only viable option

[illegible] weeks of manoeuvring, the fact that the votes had been split among so many parties, but that together these comprised equal right/left blocs, forced the leaders of Labour and the Likud to the conclusion that only an alliance between them could create a stable government with a working majority. Even so, this reality was unpalatable to the ideological extremes of both parties, and the 16 year alignment between Labour and Mapam was terminated when the latter re to join a broad based coalition, while Tehiya similarly refused the Likud's off join it in the government. Other changes resulted in Labour being left with on seats to Likud's 41, but it still succeeded in having Mr Peres chosen as p minister of the coalition. The agreement between the two parties stipulated tha would step down halfway through the government's term of office, and hand to the Likud leader, Mr Shamir; this novel idea was termed "rotation". Membe of the government was offered to most of the other parties, although not al them accepted. The "National Unity government" that eventually emerged September 1984 comprised eight parties with 97 out of the 120 members of Knesset.

Despite, or perhaps because of its enormous majority, this government was wrac by periodic crises throughout the first half of its term, but succeeded confounding both the opposition and most commentators by holding together achieving two of its main aims. These were the withdrawal from Lebanon, a st by stage process terminated in June 1985, and the salvation of the economy, wh seemed on the verge of disintegration when the 26 member cabinet was fin sworn in in mid-September.

THE EDGE OF THE ABYSS

Inflation soared to new peaks -

The new economic policy introduced in October 1983 sought to correct the mista of allowing, or forcing, the rates of devaluation and of subsidised prices to la behind the consumer price index, as had occurred in 1982-83. It therefo switched the focus back from the attempt to reduce inflation while not causin unemployment - Mr Aridor's aim - to attacking the yawning balance of paymen gap, and did this by reverting to the pre-1979 policy of trying to achieve an maintain a "real" devaluation. Although it had some success in terms of the trad and current account deficits, the price paid in terms of higher inflation proved to be insupportable. The impact of the new taxes and subsidy cuts on local prices, in conjunction with the 23 per cent devaluation itself, pulled the devaluation wage/price spiral up to a new level of some 15 per cent per month, or nearly 45 per cent per year, and from that point the cycle fed on itself, climbing steadily higher.

At this pace, the monthly publication of the consumer price index was no longer sufficient to permit the use of the shekel as a means of exchange or a measure of value, let alone for storing wealth, and it was therefore increasingly abandoned as the currency unit in everyday use, to be replaced by the US dollar - although this was technically illegal. Hyperinflation also caused a drastic decline in the government's tax receipts, because although these were now paid monthly, even that period represented a significant erosion in their real value. Conversely, business activity was stunted by the inability to plan more than a few days or weeks ahead. The symptoms known from bouts of hyperinflation in other countries began to emerge with frightening force.

- as the economy reached the point of collapse

The prolonged coalition wrangling had resulted in further delays in taking the urgent decisions needed to correct the economy's slide, and inflation had now all but run out of control. The price indices for August, September and October 1984 were 16.5 per cent, 21.4 per cent and 24.3 per cent respectively, and the Treasury was warning privately that the coming months would see still higher rates - meaning, to all intents and purposes that the economy was heading for the crash and depression that had followed every known inflation which had exceeded 1,000 per cent per annum.

The government tried partnership with unions and management -

The government, however, and in particular the prime minister, sought to achieve a social compact or consensus policy in partnership with the Histadrut and the employers' associations. Negotiations in this vein were held through October and gave rise to a package deal that went into effect at the beginning of November. This froze prices and wages for three months, with the cost of living increment that should have been paid being split between the workers, who agreed to forgo one third, and the employers, who absorbed two thirds.

This proved a partial success, in that prices, after rising by 19.5 per cent in November - almost all of it attributable to "carryover" from October and the increases allowed as part of the introduction of the package - only went up 3.7 per cent and 5.3 per cent in December 1984 and January 1985. But the fact that the exchange rate was made to continue rising in line with the previous month's inflation, and the renewed attempt to steal a march by achieving a small "real" devaluation, meant that import prices for both manufacturers and consumers rose and that government subsidies, especially on basic imported commodities, increased as a percentage of the frozen price.

- but to no avail -

These flaws were not properly corrected before a second, less rigid package deal followed the first. The Treasury's own policy of price rises on subsidised goods led, again, to its demise after only two months, and a third and still less successful deal was never taken seriously at all. The April CPI was back to 19.4 per cent, with June at 14.9 per cent. Strikes spread throughout the economy and confidence gained from the first package deal was quickly lost again, as evidenced by the renewed erosion of foreign exchange reserves as money fled out of the system. It was therefore clear that the consensus strategy had exhausted its possibilities. In fact, many observers accused the Labour Party of deliberately putting off the adoption of harsher measures until after it had won a firm victory in the Histadrut elections held on May 13.

In any event, in May and June a group of senior Treasury and Bank of Israel officials, together with several independent economic experts, prepared an entirely new economic strategy whose aim was, for the first time in Israel, simultaneously to tackle the key problems of inflation and the balance of payments. This was instead of concentrating on one at the expense of the other - which had been the downfall of all the previous strategies over the years.

- necessitating the adoption of a radically different approach

The degree of self-perpetuation that the now ubiquitous linkage system had achieved contained an unavoidable degree of time lag in its mechanism, so that one set of relative prices was always "chasing" another. This bedevilled any plan of the "stop inflation at a stroke" variety, because whatever cut-off point was chosen would give rise to a distorted relative price structure that would carry the seeds of ultimate failure when the laggards sought to catch up, as they must do sooner or later. This, in fact, had been the flaw in the package deal approach.

For some time, attention was focused on the possibility of formally or informally "dollarising" the economy, since dollar linked pricing was now commonplace and was more efficient than index linkage, being based on exchange rates that were updated daily, while the CPI was published only monthly. The premature leaking of a Treasury/Bank of Israel "dollarisation" plan in October 1983 had been gr with ridicule, and had been the direct cause of Yoram Aridor's resignati finance minister, coming only one week after the bank share coll Nevertheless, alternative formulations to this basic idea continued to be aired.

Furthermore, the great taboo of Israeli economic policy making, that of wides unemployment and consequent large scale emigration, encouraged the search novel approach that would eliminate, or at least reduce, inflation without customary and undesirable byproducts of the disinflationary process. Govern and academic economists were hard put to persuade the politicians that no mi cures or short cuts existed and that the alternative to a policy employing at the main elements of the textbook treatment of hyperinflation was to allow economy to slide into an uncontrollable crisis. Only when this threat stared in the face did the political leaders reluctantly give their economic advisers th ahead - and even then, only after significant and unprecedented interventio the US administration, including the promise of substantial emergency econ aid.

THE ACHIEVEMENT OF STABILITY, 1985-86

<u>**Growing US influence in Israeli economic policy making -**</u>

The rapid deterioration of the Israeli economy had been watched with increas alarm from Washington. Relations between Israel and the USA had bec increasingly close in the 1980s, for reasons that will be discussed in Chapter These relations embraced the geopolitical, strategic, tactical, intellige gathering and counterterrorist concerns of both countries. In all these areas, wh obviously the junior partner, Israel had much to contribute. But the long te incompatibility of military might with economic weakness made the apparent "internal" matter of Israeli socioeconomic policy into an area of growing concern.

Israel's swelling foreign debt, which by the end of 1984 totalled some $23.4 b stemmed primarily from the large loans advanced to it by the US government fr the Yom Kippur War onwards (see Table 12). In fact, although the 1981-83 boo had been financed by a sharp rise in short term borrowing, Israel remaine throughout a net lender on the international markets, thanks to the large depos base of Israeli banking at home and abroad. The increasing flow of US ai therefore contributed directly to the country's total debt and aggravated its deb service position, while its foreign currency reserves were being eaten up both by debt payments and the flight of funds overseas, whether legally or illegally. This situation led the Reagan administration in 1983 to change the basis on which it gave Israel military aid, from half grant and half loan, as had been the case until then, to out and out grant, putting it on the same basis as economic aid, which had always been awarded on a grant basis. This was a de facto recognition that much of the economic aid was used up in paying the interest on previous military loans, as shown in Table 13.

Table 12

Foreign Debt and Net Reserves, 1972-85
($ mn; year end)

	External debt	Net external debt[a]	Net Central Bank reserves
1972	4,081	3,090	1,070
1973	5,093	3,254	1,658
1974	6,405	4,892	1,071
1975	7,918	6,315	1,039
1976	9,340	7,492	1,156
1977	10,773	8,499	1,359
1978	12,580	9,076	2,275
1979	15,160	10,990	2,588
1980	16,607	12,010	2,784
1981	18,337	13,476	2,847
1982	21,011	15,569	2,994
1983	22,784	17,932	2,873
1984	23,394	19,408	2,601
1985	23,850	19,213	3,190
1986[b]	24,437	19,585	4,153

a External debt less net foreign assets.
b September.

Source: Treasury.

Table 13

US Government Loans and Grants, 1981-86
($ mn; calendar year)

	1981	1982	1983	1984	1985	1986[a]
Grants (military & civilian)	1,424	1,258	1,618	2,271	3,883	3,385
Loans (long & medium term)	1,111	1,083	1,092	898	-	-
Total gross aid	2,535	2,341	2,710	3,169	3,883	3,385
Loan repayments (long & medium term)	664	746	906	997	1,056	1,100
Net aid	1,871	1,595	1,804	2,171	2,827	2,285
Net grants	760	512	712	1,274	2,827	2,285

a Approximate.

Sources: Bank of Israel; EIU estimates.

However, the worsening of other elements in the balance of payments in 1984 caused the improvement generated by this move to be swallowed up, and its importance tended to be overlooked.

[illegible] accompanied by offers of aid

The administration, and in particular the State Department under George Shultz, expected the new government to adopt harsh measures quickly to restore order to the economy. To this end, it offered Israel stand-by loans to bolster its reserves, and other aid to overcome the expected temporary dislocation that such measures

However, when the government opted for the package deal appro
it had no option but to go along. The $3 bn in military and economic aid for US fiscal year 1985, beginning October 1, 1984, was delivered in one sum November. To its chagrin, the USA saw the money and the package deal po come to early and unhappy ends; its pressure on the Israeli government incre as a result, and its own special advisers on the Israeli economy participated formulating the goals of a new policy, during the spring of 1985.

Even then, the plan that was finally approved by the Israeli government on July 1985, although warmly welcomed by the USA and backed up by the provision of one off emergency aid package of $1.5 bn spread over 1985 and 1986, fell sh of what had been recommended. The US authorities, like everyone else, were be amazed at the degree of success it achieved.

The July 1985 plan represented an overall approach -

The Economic Stabilisation Plan (ESP), as it was called, involved the simultane implementation of several policy moves.

- A devaluation of 18.8 per cent was made and the exchange rate was then fixed at the level of $1=IS 1,500 (NIS 1.5), although it was allowed to fluctuate within 2 per cent of this point.

- Prices were allowed to rise by 17 per cent and thereafter were frozen, with a stringent mechanism of price controls imposed to enforce the freeze.

- Subsidies were reduced by $750 mn, while tax increases and some spending cuts reduced the government budget deficit by a further $750 mn.

- The regular cost of living adjustment was suspended - at first by decree, subsequently by agreement with the Histadrut - and wages were not fully compensated for the devaluation and price increases, receiving only a 14 per cent increase in August and a one time 11 per cent bonus in September. Within three months, real wages had been eroded by the unprecedentedly large margin of 20-30 per cent. However, the Histadrut wrung concessions in the shape of several 4 per cent increases during the autumn and winter months, so that by March 1986 real wages had recovered their losses. Furthermore, the government tied the future of the exchange rate freeze to the stability of wages, so that any wage increases would cause a renewal of the inflationary spiral.

- Monetary policy became extremely restrictive. Interest rates had been running at 20-30 per cent in monthly terms to compete with inflation at similar levels; they did not fall at all at first although inflation was effectively zero from the day after the plan's introduction. Even later they fell only slowly. This sent a flood of money from dollar linked deposits to unlinked shekel deposits, where returns were phenomenally high; the central bank mopped up this excess liquidity by raising reserve requirements, paying out this income as interest to savers. This resulted in a major transfer of resources from the corporate to the household sectors, leading to a wave of bankruptcies and distress in construction, agriculture and industry on the one hand, and to growing income that created a spending boom on the other.

The plan was conceived as an emergency programme, to last for three months. In the event, its continued success in steadily reducing inflation allowed the government to extend it several times, although in the course of 1986 price controls were removed from a majority of goods and services, without any signs of "repressed inflation" appearing.

- based on anchoring wages and the exchange rate

Why was this attempt at stopping the inflationary cycle so successful, where so many others had failed? The theory behind the plan was to allow "advance synchronisation" of relative prices so as to remove the lags which would otherwise demand later correction. Wages, however, bore the brunt of the sacrifices demanded by the plan; although these sacrifices proved to be transitory for the most part, they were painful while they lasted. With relative prices roughly aligned, the economy could achieve stability, and retain it so long as devaluation did not recommence. This, in turn, was made contingent on wages remaining within acceptable parameters, so that wages and the exchange rate acted as anchors for the economy. Its success proved that the attempts to reduce real wages by keeping devaluation ahead in the race had been the root cause of the spiral, and that all such attempts should be abandoned. The rises in exchange rates, prices and wages allowed by the plan - 19 per cent, 17 per cent and 14 per cent respectively - were roughly equal, and could as well have been forgone. They were factored in mainly for the psychological reason that each should "have something to show", and to fix the exchange rate at the convenient round figure of $1=IS 1,500.

The plan also broke new ground in assuming that inflation, far from financing the government's budget deficit through the "real balance effect" - meaning inflationary taxation, fiscal drag and so on - actually increased that deficit by eroding the government's real revenues, forcing it to borrow more. This had been indicated by the surge in tax receipts in the course of the first package deal, when inflation had briefly plummeted, and was not fully vindicated.

It succeeded in balancing the government budget -

Coupled with the extra levies introduced, and a new and more onerous corporate tax law passed in August 1985, the decline in inflation boosted revenues to the extent that the planners' estimates of the reduction in the budget deficit were far surpassed. For the 1985/86 fiscal year ending in March 1986, the Treasury announced the first surplus in many years, and the absence of the customary supplementary budget was further testimony to the progress made. However, the $355 mn surplus included revenue from sales of government bonds, and the public sector's borrowing requirements still soaked up all the available savings in the economy.

- and dramatically reduced the rate of inflation

The plan's impact on the rate of inflation was little short of sensational. After breaking all records for July, when the CPI jumped 27.5 per cent under the direct influence of the rises announced on July 1, inflation fell to below 5 per cent in each of the following three months, and then to 0.5 per cent, 1 per cent and -1.3 per cent in November, December and January. Most of these fluctuations were caused by fruit and vegetable prices, which perforce remained uncontrolled. Excluding these, it was clear that inflation had stabilised at an annual rate of some 20 per cent by year end. This rate was maintained during 1986, and the 19.7 per cent annual rate recorded that year was the lowest since 1972, as well as ending the run of seven successive years of triple digit inflation. In the first half of 1986 prices rose by 8.6 per cent and reached a trough in mid-year, only to gain momentum in the final months, as wage and demand pressures pushed and pulled prices higher and energy prices stopped falling.

Exogenous factors assisted the plan's success against inflation -

The plan had been hailed in Israel and abroad as a brave and risky step, and events proved that fortune indeed favoured the brave. A number of external developments were more than instrumental in helping it achieve a degree of success that even its authors admitted was far beyond their expectations. In the first place, the timing of the plan's introduction coincided with the speeding up of the dollar's fall on the international markets, a process hastened still further after the Plaza meeting of leading industrialised countries in September. This allowed the Bank of Israel to peg the shekel at \$1=NIS 1.5, while it fell sharply against the European and Japanese currencies. Since Europe is Israel's main export market, this helped many companies' earnings. Conversely, the increased price of imports denominated in these currencies was a notable factor in the residual inflation rate.

Indeed, it was only the second factor, the sharp fall in the price of oil and hence in energy costs throughout the economy, that allowed the Treasury to offset price rises stemming from imported inflation from Europe by lowering oil, electricity, gas and water prices. The collapse of imported oil costs during 1986 was a key factor in pushing inflation lower. This also allowed the Bank of Israel, at the end of July 1986, to unpeg the shekel from the dollar and link it to a basket of the currencies of Israel's major trading partners. This was designed to stop the importation of inflation via the decline in the dollar on international markets.

- and with the balance of payments -

The plan had also set out to help at least maintain the progress already made on the country's trade deficit. The reversal of the policies of Yoram Aridor by his successor, Yigal Cohen-Orgad, had brought a significant improvement in this area in 1984, although as noted previously, this had been achieved at a heavy cost in higher inflation. In the wake of the October 1983 devaluation and other measures to boost exports and restrain imports, exports of goods rose by some \$650 mn and imports of goods fell by \$400 mn in 1984 compared with the previous year. Thus despite the higher defence import bill, the total trade deficit fell slightly from its peak of \$5 bn in 1983 to \$4.8 bn in 1984. This and higher unilateral transfers - meaning US aid in grant form - pushed the current account deficit down from \$2.1 bn in 1983 to \$1.4 bn in 1984.

- helping achieve a current account surplus in 1985 and 1986

Thereafter, as Table 14 shows, exports rose and imports fell sharply so that the trade deficit shrank in 1985, while the receipt of the first half of the \$1.5 bn in emergency US aid was a major factor in enabling Israel to produce its first current account surplus in over 30 years. The replenished foreign currency reserves, which were also boosted by the public's sale of several hundred million previously hoarded cash dollars in the year from July 1985, helped pay down some of the government's short term debts. Although Table 13 indicates that Israel's total external debt did not decrease in 1985/86, but actually rose slightly, this stemmed from the revaluation of non-dollar loans as the dollar fell, and from increased private sector commitments. The government's own short term debt was eliminated and Table 32 shows the government to have had no short term overseas loans outstanding on September 30, 1986.

Table 14

Current Account, 1983-86[a]
($ bn, current prices)

	1983	1984	1985	1986[b]
Total exports	10.3	10.8	11.0	11.9
of which:				
industrial goods (excl diamonds)	3.4	4.0	4.3	4.6
Civilian imports	14.4	14.1	13.2	14.8
of which:				
oil	1.6	1.6	1.5	0.8
Civilian trade deficit	4.0	3.3	2.1	2.9
Direct defence imports	1.1	1.5	1.8	1.2
Total trade deficit[c]	5.1	4.8	4.0	4.1
Unilateral transfers (net)	2.9	3.4	5.1	4.8
of which:				
US government grants	1.6	2.3	3.9	3.7
Current account surplus (+)/deficit (-)	-2.1	-1.4	1.1	0.7

a Figures may not add due to rounding. b Preliminary. c Goods and services.

Sources: Bank of Israel; EIU estimates.

1986 was a good year for exports, the more so when the slump in tourism - especially from North America - and the problems of the electronics industry are taken into account. The dollar figures were helped by buoyant earnings of such sectors as textiles and agriculture, whose main markets are in Europe, while the diamond industry had a bumper year. Diamonds, however, are an area of low added value, and more encouragement could be drawn from the 13 per cent growth in the metals and electronics sector; although this was a slower growth rate than in previous years, it was a solid performance in an unprecedentedly difficult year.

The deterioration in the balance of trade in 1986 stemmed entirely, therefore, from the surge in imports. Furthermore, given that defence imports fell sharply and fuel imports, of course, were almost halved by the slump in oil prices, there was no difficulty in identifying regular civilian imports as the culprits. Consumer imports, especially durables, soared to an extent reminiscent of, and in some cases surpassing, the boom of 1981-83, while in the latter part of the year imports of producer inputs and investment goods took off strongly. This confirmed that the economy had entered a boom period, after the trough that followed the introduction of the Economic Stabilisation Plan. The fall in real interest rates and lower corporate taxes in the business sector, and the sharp recovery in real wages along with lower savings rates in the household sector, provided ample resources for this import surge. But to a large extent there can be little doubt that the impetus to buy came from the fact that for two and a half years, from late 1983 to early 1986, imports, and consumption generally, had fallen. This was a "catching up" spree with a vengeance, and it resulted in a 40 per cent deterioration in the civilian import deficit, triggering alarm bells at the Treasury and Bank of Israel and leading to the devaluation of January 1987.

However, because of the receipt of the second tranche of emergency US aid of $750 mn, and the widespread dishoarding of foreign currency illegally "mattressed" in 1983-85, the foreign currency reserves ended 1986 at the record high level of $4.1 bn and the balance of payments recorded a second successive surplus, of some $700 mn.

Yet the momentum of progress had been lost

Lower prices for oil and other commodities and lower interest rates on foreign debt came as windfall gains for the Israeli economy, in exactly the same way as the increases in these items in the 1970s represented a worsening of the terms of trade. But neither they, nor the major internal policy achievements stemming from the ESP, namely the reduction in inflation and the elimination of the government's operating budget deficit, could in themselves deal with the deeply rooted structural problems that had been festering in the Israeli economy for 15 years or more.

The July 1985 plan had aimed to stabilise the economy as a prelude to the introduction of reforms that would attack these problems. But as the government revelled in the unaccustomed luxury of stability in the 18 months that followed the plan's initiation, the sense of urgency dissipated. In the second half of 1986, serious planning got under way on the main issues of taxation and capital market reform, and the focus of policy makers finally turned to breaking the economy out of the stagnant rut in which it had become stuck.

CHAPTER 5
THE STRATEGIC CONTEXT

THE ECONOMY AND NATIONAL SECURITY

Security has been the central consideration in Israeli life -

Israel was preoccupied with defence and security considerations even before it came into being as a modern nation state. The physical threat to the country's existence, that was illustrated by the joint Arab invasion on the day it was born, has remained a constant reality, hammered home by successive wars, and has taken precedence over every other policy consideration. The tendency to regard the Israeli attitude to these topics as obsessive must therefore be tempered by the truth of Henry Kissinger's remark in this connection that "even paranoids can have real enemies."

Nevertheless, the number of enemies, the scale of the threat and the degree of danger have varied considerably over time. Some of Israel's neighbours have effectively withdrawn from the circle of confrontation, most notably Egypt, starting in the mid-1970s and culminating in the 1982 peace treaty. Others, especially Syria, have remained or become more aggressive, and some - such as Iran - have switched from friendship to enmity. With respect to great power involvement, too, there have been major changes over the years. Israel's relations with the UK and France underwent dramatic swings before being almost completely overshadowed by the development of very close relations with the USA. Meanwhile, the formal relations with the USSR that existed until 1967 were not only broken, but gave way to a very antagonistic relationship.

The Israel-Arab conflict and its military, diplomatic and geostrategic ramifications are too well known to require elaboration here. The scope of this chapter is limited to an examination of the interaction of defence issues, particularly the defence budget, with economic policy making. Even this, however, must include such topics as overall defence spending, the flow and utilisation of US aid, especially the argument surrounding the development of the Lavi jet fighter, but also encompassing the wider economic implications of the US alliance. The West Bank and its economy will also be considered, but only in the context of the Israeli economy as a whole.

- necessitating an increased share of GNP for defence

The defence budget comprises two distinct parts, local and foreign. This applies both to its sources, which are made up of government tax revenues and internal debt as well as aid in the form of grants and loans, and to its uses, which are local defence expenditures and defence imports. It should also be noted that the total defence bill is much higher than that contained in the formal defence budget. The regular army consists of 130,000 people whose production is lost to the economy, and may be conservatively estimated at $1.5 bn per annum. The cost of reserve duty of a further 330,000 soldiers is borne by the National Insurance Institute, which in turn collects it from employers and employees as part of the general national insurance contribution. Finally, debt repayments on previous military loans, currently running at more than $1 bn per annum (see Table 13), are not paid from the defence budget, although they are defence related.

Table 15 summarises the growth of the share of total GNP taken by direct defence spending in different periods and how this has been split between local and foreign sectors. Whereas in the early 1950s this was as low as 6 per cent, the signing of a major arms deal between Egypt and Czechoslovakia in 1955 triggered a quick Israeli response and in fact may be seen as the shot that set the arms race in motion. Spending reached 10-11 per cent of GNP in the mid-1960s, prior to the Six Day War, but it soared to a level of 20-25 per cent in the following period, which witnessed the War of Attrition along the Suez Canal in 1970-71, and climbed further after the Yom Kippur War to peak at over 30 per cent in 1974-75. Thereafter, the share of defence fell sharply, to around 25 per cent in 1978 and 22.23 per cent in recent years. 1986 stood out from this pattern, because lower defence imports and budget cuts at home reduced the share of defence spending to below 18 per cent but this was planned to climb back to almost 24 per cent in 1987.

Table 15

Annual Defence Expenditure as a Percentage of GNP
(period averages; %)

	Defence imports	Local defence expenditure	Defence expenditure in GNP
1955-61[a]	...	...	8.3
1962-66	3.9	6.2	10.1
1968-72	8.6	13.1	21.7
1974-80	12.4	15.4	27.8
1981-84	8.1	14.1	22.2

a Not including the 1956 Sinai campaign.

Source: E Berglas, Defence and the Economy: The Israel Experience, Maurice Falk Institute for Economic Research in Israel, 1983.

Because the surge in the period before the Yom Kippur War came against a background of strong GNP growth, it was more easily supportable than even the declining levels of the last decade, which has been a period of stagnation. The economic crisis of the 1980s has fundamentally changed the relationship between defence spending and the economy as a whole.

The concept of national security has been broadened -

Recent years have witnessed the "desanctification" of defence and security as issues whose importance puts them in a separate category from matters such as welfare, education and the economy. Conceptually, defence has come to be seen as far more all embracing than the actual order of battle - the number and composition of military units comprising the armed forces, and the strategy and tactics that govern their use.

Thus, the strength or weakness of the economy has come to be accepted as part of the strategic balance, because the existence of a chronically weak economy subject to major constraints stemming from shortages of foreign currency has important short and long term implications for Israel's defence posture. Among these are the quantity and quality of arms that may be purchased, the degree of outside influence on decision making, the availability of technologically qualified manpower needed to operate modern weapons systems and, ultimately, the staying power that Israel can display to the Arabs in its attempt to find acceptance as a permanent feature in the region. To the extent that Arab hostility is based on the concept that Israel is an "alien implantation" in the Arab Middle East, this staying power is a major weapon in the long term goal of breaking that hostility. By extension, therefore, social discontent in Israel, particularly if rooted in economic inequalities, is a negative factor in the strategic balance and weakens Israel's deterrent posture.

- and economic dependence recognised as the most dire danger -

In the bluntest formulation, the relative positions of security and economic considerations can be measured in terms of the degree of dependence or independence Israel possesses in each area. In both respects, it is generally agreed that US support is vital; the difference, however, can be shown by taking the extreme theoretical eventuality of a total cut-off of that support. In the military arena, Israel has reserves, resources and infrastructure to survive on its own for some time, while formulating alternative policies. A withdrawal of economic support, by contrast, would immediately necessitate a radical restructuring of government spending and major changes in most areas of the economy. Furthermore, it is realised that economic stagnation has given rise to increased emigration and declining immigration and that this itself is a reflection of the basic fact that neither Israelis nor Jews abroad are prepared to live in a "latter day Sparta" or "fortress Israel" to use some of the catchphrases for describing a society living under permanent siege and devoting an ever growing proportion of its resources to physical survival.

However, the other side of the dilemma facing policymakers is that the Arab threat has not disappeared, nor is it likely to in the foreseeable future. Therefore, military spending will continue to be very high, by any international comparison, and will inevitably suck in a significant proportion of all available resources. The circle can be squared, ideally, by the economy returning to a pattern of rapid growth, so that the share of the cake allotted to defence could grow in absolute terms while falling as a relative percentage. But in order to arrive at the point where growth can take off, it is widely agreed that the government must reduce its spending and this, indeed, has been the recurring theme of political and economic debate for several years past. Given the size of the government budget - almost as large as total GNP - resources for growth have to be released from the government sector and made available to the private sector. Given the relative weight of defence spending within total government spending, the defence budget has been and will continue to be one of the main foci of the general budget cutting process.

- making local defence spending more vulnerable to budget cuts

As noted, however, the defence budget contains two distinct sectors, local and foreign. Table 16 demonstrates that in recent years local defence spending has hardly grown in real terms, with the blip of 1983 stemming from the effects of events in Lebanon, while 1986 saw a significant drop, as budget cuts hit home. Total defence spending, on the other hand, has been subject to sharp swings, because of the influence of overseas defence purchases. These are composed almost entirely of purchases in the USA, and they tend to be very volatile because the delivery dates of weapons systems are neither cyclical nor systematic. Thus it may be seen that 1980 and 1981 were years of rising defence imports, while in 1982 and 1983 there was an even greater decline, followed again by two years of strong rises and another sharp decline in 1986, with 1987 scheduled to be more than double the level of purchases made in 1986.

Table 16

Defence Expenditure, 1980-87
(% change on previous year)

	Actual							
	1980	1981	1982	1983	1984	1985	1986[a]	1987[b]
Total defence spending	20.9	9.9	-15.3	-7.6	10.3	5.9	-18.8	38.1
Local defence spending	14.5	2.2	-0.5	4.5	-0.91	-3.3	-9.4	3.9
Overseas defence purchases	43.1	30.2	-31.8	-31.2	37.4	24.1	-33.4	112.0

a Provisional. b Budgeted.

Source: EIU, based on Bank of Israel figures.

The budget cuts made in July 1985 and pursued in the 1986/87 fiscal year, had a major impact on local defence spending. Purchasing was cut back, building was slashed and wage and pension payments were eroded with 2,000 civilian employees being dismissed. In the armed forces proper, training in general, and tank exercises and the use of live ammunition in particular, were forced down to a level that the general staff felt was unacceptably low. In the run up to the 1987/88 budget, the defence sector fought hard to obtain a budget increase, while the Treasury sought to impose a further reduction. Neither side won, since the budget was left roughly unchanged in real terms, but the devaluation of January 1987 helped the armed forces by increasing the purchasing power of the segment of US military aid available for spending locally.

These changes show that domestic defence spending is more vulnerable to budget cutting activities than expenditure abroad, at least in the short term. Two main reasons may be cited for this. First it is more flexible and responsive to "stretching" of purchases over time, or their outright elimination, because it comprises numerous, relatively small contracts with many different firms. Even the local giants, such as Israel Aircraft Industries, Israel Military Industries, Tadiran and others, are either directly government owned, or in any case heavily dependent on government purchasing. Foreign contracts, by contrast, are usually very large, multi-year agreements with delivery and payment schedules fixed in advance, and thus leave the government little or no leeway to cut, stretch or otherwise alter them. Secondly, and even more importantly, the bulk of foreign purchasing is financed with US military grants, which are given solely on condition that they be spent in the USA on US manufactured equipment. It is therefore not part of the Israeli domestic budgetary process, except in so far as the purchases made abroad can replace others that would have been made at home.

THE PRINCIPLE AND PRACTICE OF SELF-SUFFICIENCY IN ARMS

The arms industry was born of experience and necessity -

One of the fundamental principles governing Israeli security thinking and defence strategy is to produce as many weapons systems as possible at home. In cost analysis terms this may not always be justified, because the production runs for the Israel Defence Forces alone are sometimes too short to cover research and development costs, while the export possibilities available to Israeli firms are often limited. Yet this consideration is felt to be outweighed by the strategic need to maximise freedom of action. The example said to underline the relevance and importance of this principle is the French embargo that was introduced in June 1967 after the Six Day War. For 15 years prior to that time, France had been Israel's closest ally and its major supplier of weapons. The abrupt snapping of this relationship was the primary factor behind the decision to build Israeli tanks, missile boats and even jet fighters, from which stemmed the rapid growth of the defence industry complex noted in Chapter 3. Although the weapons systems produced, such as the Kfir jet and the Saar missile boat, were basically clones of the French equipment Israel already had, their production at home solved the threat of sudden supply cut offs. At the same time it led to the development of an arms industry whose scope and sophistication is unmatched, and in many respects unthinkable, for other countries of similar size and resources, whose defence needs are much smaller.

- and expanded from local production to exports -

In time and because of the quality and battle experience of their products, these industries became exporters. However, sales of the major weapons systems, such as the Kfir jet and the Merkava tank, were inevitably restricted to countries which were impervious to Arab protests, such as those in South America. Furthermore, the fact that even these included major components bought from the USA, notably engines, and were financed at least in part by US aid, made their export conditional on US authorisation, which was often not forthcoming because of pressures exerted on the Pentagon by US defence contractors perturbed at the prospect of Israeli competition. On the other hand, partial systems, notably electronic and avionic components, developed by Israeli firms and successfully incorporated into US weapons, were then sold to the manufacturers and became part of the weapon's standard equipment. Thus, for example, F-15s sold to Saudi Arabia contain as many as 200 modifications and additions designed or manufactured in Israel.

- so that its size became the focus of debate -

Few people would deny that this is the area where the country has a major comparative advantage. The argument has raged over whether Israel should risk, or even needs to attempt to build complete systems such as aircraft or tanks, given that their engines and much of the platform are US designed and that US production is certainly cheaper, and probably better.

The main arguments of the two sides may be summed up as follows. The proponents of a broad based defence industry claim that it helps avert the danger of embargoes and other supply disturbances, if not totally eliminating them. The drive to produce first class products generates technological advances whose direct and indirect effects are felt throughout the economy, and which encourages more students to enter science based industries. In addition to the general, economy wide profit that these industries thus create, most of the firms and most of the products are themselves profitable, in strictly "bottom line" terms. Finally, the readiness and capability of Israel to produce its own weapons systems often persuades the USA to sell it items and systems for which it had previously refused sales permission. On more than one occasion, Israeli research programmes designed to produce items that Israel was barred from buying have been halted after their likely success forced the Pentagon to change its stance.

These claims are rebutted by the opposing camp, who point to the fact that most of the main components of the Israeli arsenal are still either wholly US-made or at least contain US-made vital components - notably engines - that are purchased in the USA. Self-sufficiency, and hence freedom of action, is not achievable in their view, especially since US pressure can now be far more effectively exerted via the economy than through purely military channels. The starting and stopping of research programmes to induce US willingness to sell is a waste of resources and creates frustration and discontent among the people involved. Another, quite separate argument, is the moral one that a large arms industry is inherently undesirable and should be avoided.

But the main counterclaim is that for the economy as a whole, the defence sector has already carved out for itself too large a relative size and the metals and electronics industries are dominated by firms whose primary market is the defence ministry. Given the vagaries inherent in any situation where sales are dependent on a single buyer or small number of buyers, the degree of concentration of Israeli industry has become dangerous; simply put, too many eggs are in one basket.

- which led to the budget cuts of 1985

A dramatic illustration of precisely these dangers was provided in the second half of 1985, following the announcement of the Economic Stabilisation Plan. This included total budget cuts of $750 mn, a large proportion of which were made in the defence budget, by cancelling, freezing or stretching contracts with local suppliers. Many small firms and some large ones, including many that were state owned, were caught unprepared by the sudden cut in defence ministry orders, and reacted by laying off staff and cutting back on investments. The obvious conclusion for them was not to remain too heavily reliant on government defence purchasing. But putting this into practice - whether by seeking export markets for their existing products or by developing new products for the civilian markets - must take some time, and requires resources that are not available to all of them. The eventual results of this shake-out will only become clear in the coming years, but it is likely that the lesson of over-reliance has been well learned and will be incorporated into many companies' strategies.

THE LAVI JET FIGHTER PROJECT

A controversial plan to build a "state of the art" aircraft -

The problems of the defence budget and the defence industries have crystallised around the Lavi jet fighter. This was initially conceived in the late 1970s as a relatively cheap replacement for the Israel Air Force's ageing Skyhawk and Kfir aircraft. However, the air force soon decided that a larger and more powerful plane was needed for the 1990s and the project mushroomed accordingly. Throughout the development of the Lavi it was attacked on various counts. Some said it was too risky a project to warrant the amount of human, technological and financial resources concentrated on it. Or it was seen as too costly, in terms of the share of total defence resources it would absorb if it reached the production stage. A third argument maintained it was absolutely unnecessary since an advanced version of the F-16 or the F-18 would be cheaper and less trouble to buy than producing an alternative. The factor that allowed its proponents to keep the Lavi project moving ahead, and even growing steadily larger in scope, was the unwillingness of the US aircraft manufacturers to grant coproduction rights to Israeli industry on the F-16 or F-18, which would have enabled Israel to incorporate its own avionics and other unique subsystems.

- succeeded in obtaining extra US financial aid -

The Lavi's development stage alone cost over $2 bn and, in the event, half of this sum came from the military aid grants of the US government. Despite the fact that these were supposed to be spent solely in the USA, the Israeli government succeeded in obtaining permission to spend $250 mn of each year's grant in Israel, on the Lavi. This was not unprecedented: the Merkava tank was also partially funded by a similar exception. Furthermore, in 1986 Congress agreed to allow a further $50 mn of the military grant to be converted into shekels and spent in Israel - and not necessarily solely on the Lavi.

These are important achievements, but they do not resolve the basic question of who is to finance the Lavi's actual production. It is clear that Israel's resources will not permit it to do so, while the USA is unwilling to grant the extra funds necessary. Only an increase in total military aid could make the Lavi's production feasible without severely damaging the acquisition programmes of the army and navy. Even within the air force itself, however, the project has numerous opponents, who claim it would concentrate available resources in one system and unbalance the structure of the air force as a whole.

- but its future is still in the balance -

The USA, for its part, has offered Israel a number of alternatives to the Lavi, including either buying wholly US aircraft "off the shelf" or obtaining coproduction rights in the F-16. These offers were aimed at persuading Israel that it need not proceed with the Lavi, and that even the issue of employment for the manpower tied up in the project could be resolved. They were made after the Lavi was formally displayed for the first time in August 1986 and made its maiden test flight at the end of that year.

The project's supporters therefore believe that the plane's existence and its acknowledged technological excellence will prove stronger than the forces opposing it. They also point to the growing number of US companies already involved, or seeking involvement, in its production. The better the plane is, and the greater the degree of US participation it includes (the rate already stands at 55 per cent, including the engine and the wings) the greater the chances of increased US funding for production. The greater also would be its export prospects, which they believe could yet make it a profitable investment.

- and the desirability of such projects is questioned

The risks involved in undertaking the Lavi and the concentration of 3,000-4,000 engineers and scientists on its design - almost 20 per cent of the total number available to the economy in 1984 - exemplify the arguments of those opposed to such mammoth projects. They also fear the creation of a lobby embracing industry, parts of the armed forces, and some politicians, which will always demand another project whenever the current one is completed, basing itself on the need for a "national challenge". Yet it is exactly this concept which has given rise to previous Israeli successes, first in agriculture, then in defence and more recently in advanced industries. Supporters of the Lavi and similar undertakings claim that they are the most effective way of ensuring that Israeli technology remains world class and in so doing, help attract suitably qualified immigrants. Each successive challenge will be bigger and riskier, however, and the price of failure will grow proportionately, unless civilian industry expands too.

The new chief of staff may make crucial changes

A development that may have an important influence on the future of the Lavi project, as well as on the entire structure and strategic outlook of the Israel Defence Forces, was the appointment in February 1987 of General Dan Shomron to succeed General Moshe Levi as chief of staff, with effect from May 1987. Shomron's reputation is that of an unorthodox but brilliant military thinker. He is known to be bitterly opposed to the Lavi project, mainly because of its effect on the allocation of resources among the services, and this was one of the reasons Levi sought to prevent his appointment. If Shomron gets the opportunity not only to decide the future of the Lavi but also to implement some of his other ideas the consequences could be even more far reaching. In addition to the very significant changes that could follow in Israel's strategic conceptions, with their military and geopolitical consequences, a move in the direction of making the army smaller, more professional and more flexible would have profound economic consequences, especially in the long term.

These can only be speculated about at present but the reversal of the post-Yom Kippur War strategy of building up the army's size in men and material will obviously affect every aspect of defence spending. Greater reliance on advanced weapons will mean much greater spending on research and development and paying competitive salaries to the top quality personnel needed to operate them as well as finding the sums needed actually to buy or produce them. On the other hand, to the extent that these will be Israeli made, the possibility of boosting export sales will be magnified. The shrinking of the army's size, as part of the pursuit of quality instead of quantity, will inevitably lead to savings in other parts of the government's budget, as reserve duty is reduced, especially for older men, and probably fewer youngsters are enlisted, freeing them to join the labour market at an earlier age. This, however, may have implications regarding unemployment and may also have repercussions on the education budget.

The centrality of the army in Israeli life makes a basic change in its structure a matter of paramount importance. Should such changes occur in the coming years, the economy will certainly be affected, but how and in which way will depend on the speed and extent of the changes themselves.

ISRAEL'S RELATIONSHIP WITH THE USA

US aid could go on increasing, even if indirectly -

The experience of recent years, which was highlighted by the Levi project, is that US aid can be increased, despite the general atmosphere of budget cutting in Washington. The decision to change military aid to an all grant basis, and the granting of permission to convert dollars into local currency for the Levi and other uses were important in themselves. They were also examples of the qualitative improvement of aid within the same quantitative framework - meaning that the terms were improved so that the same money went further.

Another important development in this connection was the decision, finally announced in February 1987 after long negotiations, to award Israel the status of "non-Nato ally", hitherto given only to Australia, Japan and South Korea. Parenthetically, it may be noted that the simultaneous granting of this status to Egypt as well as Israel also serves to emphasise the extent to which Egypt is being increasingly drawn into the US orbit. This makes Israel-Egypt hostilities less likely, although the example of Nato members Greece and Turkey shows that they can certainly not be ruled out. In the direct economic context, the non-Nato ally status has two implications. It allows Israel to buy weapons systems more cheaply, because it does not have to pay for their development costs, and it gives Israeli firms and research institutes access to joint projects or sub-contracting work. In the longer run, the second aspect, with its export boosting and employment generating potential, may prove more significant, but the first has immediate budgetary ramifications.

- through softening of terms -

Other proposals under discussion with the USA include the possibility of reducing the very high rate of interest on the military aid loans that date from the 1970s and that reflect the interest rates in force at that time, to a level in line with current market interest rates. This alone could save Israel several hundred million dollars a year on its imports of capital services, and the size of projected interest payments to the US government is outlined in Table 35. The possibilities have also been mooted of the Sixth Fleet leasing facilities in Haifa port, of prepositioning US equipment in Israel for use in emergencies and hence comprising a de facto Israeli reserve as well, or of the US armed forces buying more Israeli equipment. However, these and other ideas have been held up by the series of espionage and other scandals involving Israel that surfaced in the USA during 1985 and 1986.

Despite the often sensational aspects of these scandals, and their inevitable short term effects on the tone and content of the Israeli-US "agenda", they are extremely unlikely to have longer term effects. In general it is fair to say that they are relevant as far personal as relations between individuals in the two governments are concerned, but the underlying relationship rests on much broader considerations, that are enumerated in this chapter. Thus even the Israeli role in the "Irangate" scandal, exposed in late 1986, should be seen more from the tactical viewpoint - involvement in intra-administration squabbles and possible circumventing of Congress - rather than as having fundamental or strategic connotations. The best proof of this was the decision regarding non-Nato ally status, which was made in the midst of the Irangate affair.

- and is needed to repay maturing US loans

Civilian, or economic, aid from the USA was boosted in 1985/86 and 1986/87 through a $1.5 bn emergency grant that was disbursed in several stages between mid-1985 and the end of 1986. It was linked to the introduction of the Economic Stabilisation Plan and was clearly designated as a one off measure, so that the economic aid to Israel in US fiscal year 1987 would return to the base level of $1.2 bn. However, Table 13 makes clear that the primary need for, and use of, increased aid over recent years has been to meet the growing repayments of aid received in previous years in the form of loans. Since the cancellation or rescheduling of these loans would involve legal and political problems for the US administration, and could be interpreted as putting Israel on a par with South American and other states involved in the debt crisis, both parties have preferred to solve the problem through the round about, but equally effective method of giving larger grants to help repay old loans.

It will therefore be argued in the central forecast (Chapter 8) that the coming years are likely to witness an increase in effective US aid although this may come through indirect moves rather than through absolute increases in the size of the grants authorised. This increase will not be influenced, except in the manner of its presentation, by the domestic US budget cutting process, whether that follows the lines of the Gramm-Rudman amendment or any alternative approach. This assumption is of overwhelming importance to the continued smooth functioning of the Israeli economy and sets the parameters for all other policy decisions.

US aid stems from a much broader perspective -

The assumption can only be justified by examining the roots of the Israel-US relationship, since the economic and military aid that Israel receives, and the growing US involvement in Israeli economic policy making, are merely expressions of that relationship. These roots encompass a spectrum of ideological, political, strategic and geostrategic concepts, each of which has validity on its own, and which together create ties that, while not formalised into an alliance or treaty relationship, are certainly closer than those the US maintains with many countries to which it is formally linked.

In the first place is the affinity the USA has for any free and democratic country. In the case of Israel, this is couched in especially flowery rhetoric, such as "our shared Judeo-Christian heritage" but it nevertheless has a solid base in reality. The fact that Israel has the only democratically elected government in the Middle East and has maintained an open society despite the pressures under which it exists, has also been appreciated by successive US administrations and by most US citizens.

The realities of US domestic politics provide a second layer of the Israeli relationship. The US Jewish community, some 6 mn strong, is a major voting force in several key states, especially New York and California. It is prominent in political and cultural life, to a degree quite disproportionate to its share of the population, and in the last 20 years its traditional affiliation to the Democratic Party has been considerably weakened, so that its financial and other support and activity is increasingly bipartisan in nature. The issue that unites it, however, is support for Israel, in the most general sense, and the trend towards single issue politics has served to make the influence of the Israel lobby all the greater.

- and is ultimately rooted in US strategic perceptions -

However, the degree of support for Israel consistently demonstrated by both Congress and the Senate and by almost all presidential candidates surpasses anything that could be attributed either to ideological motives or narrow political calculations. It reflects the perception that the interests of the USA in the eastern Mediterranean and in the Middle East as a whole, require it to support Israel and build up its strength.

This strategic concept was formulated only very gradually and vied for many years with another view of US interests, which said that good relations with the Arab world were more important than with Israel, and given Arab antipathy to Israel they should be paramount. As a result, the USA has never offered a formal treaty to Israel, because this might be interpreted as an anti-Arab alliance. Similarly, aid to Israel has always been included in the foreign aid budget rather than the military budget. The rationale for a "pro-Arab" policy was clear: the need to safeguard the availability and supply of oil to the USA and the West, the desire to curb Soviet expansion into Asia, and - in the wake of the oil shocks - the growing economic power of the Gulf states. However, the US experience in the years after 1973 suggested that the best safeguard against supply or price disruptions was to develop other sources of supply and cut consumption of oil and that the Arabs were unwilling, or unable, to act as buffers against the Soviet Union. The fall of the Shah of Iran and the Islamic revolution that followed, coupled perhaps with the events in the Great Mosque in Mecca in 1979, seem to have impressed on the USA the inherent instability of most of the regimes in the Middle East and the fact that, from the US strategic viewpoint, they were unreliable. The idea of Israel as a strategic asset, which had been ridiculed in the USA when it was first raised in the mid-1970s, steadily gained acceptance until, under the Reagan administrations, it became axiomatic. The tendency of these administrations to view the world in "East-West" terms, and the very genuine pro-US and anti-Soviet feeling of the great majority of Israelis, only hastened this change.

Furthermore, experience also proved that a pro-Israeli policy did not, ipso facto damage relations with Arab states, other than those with which relations would have been poor for other reasons. On the contrary, the USA emerged as the only party which could talk to both sides in the Arab-Israeli dispute, and the peace treaty with Egypt could hardly have been achieved without the mediation of the USA, especially President Jimmy Carter. In short, the USA has moved to an increasingly close relationship with Israel which, although giving rise to tensions, has not caused a rift with most of the Arab world but has, instead, contributed to an ongoing rift within it.

- and the reality of the Israeli nuclear option

Finally, US support is prompted by the knowledge that Israel's only alternative to outside help in carrying its military burden is to fall back on the nuclear option. This the USA is determined to forestall, on the geostrategic grounds that the Middle East is potentially the most dangerous area of the world, and that the possibility of nuclear weapons being used there could trigger the "nuclear Sarajevo" that would lead inexorably to a direct superpower confrontation.

That Israel has developed nuclear weapons has never been admitted officially but that it has them, and the means to deliver them, has long been assumed and often discussed by strategic analysts.[1] According to some experts, the US-Israel military relationship has progressed in direct proportion to the level of Israeli nuclear capability. Thus, only after it was discovered in 1960 that Israel was building a nuclear reactor in the Negev, was the US arms embargo, imposed on Israel in 1948, finally lifted. There followed a slowdown in the nuclear development programme, but by the late 1960s Israel had bomb making capacity, and only the US agreement to sell it Phantom aircraft persuaded the Israeli government against formally "going nuclear". In the period since the Yom Kippur War, the USA has been forced to take on a growing portion of the huge Israeli defence budget, including partial financing of new weapons programmes, because had it not done so Israel would simply not have been able to afford a conventional army of the size it needed, and would have had to fall back on its nuclear deterrent as the primary method of preventing or responding to any Arab attacks. Furthermore, the USA is strongly in favour of a large Israeli conventional army, as part of its global anti-Soviet strategy, and is therefore willing to help pay for its equipment and expenses.

Thus, in this view - which is not universally held, although no one seeks to deny the reality of the nuclear option itself - Israel may be compared with Pakistan. The latter country is not a democracy, has no ethnic voting power or lobbyists in the US political system, but does have the option of the bomb. It is also a strategic ally against the USSR, as has been amply demonstrated in the years since the Soviet invasion of Afghanistan. On these grounds, and with no rhetorical flourishes, it receives significant US aid.

Cost benefit analysis comes in too

Another school of thought among Israeli strategic thinkers bases its approach to US-Israeli ties on a straightforward cost benefit analysis of Israel's value to the USA, compared with that of Nato and other countries with whom the USA is allied. In most of these, the US presence costs vastly larger sums than the few billion dollars of aid to Israel, yet it involves thousands of troops and their arms and support equipment. Israel, on the other hand, does not request the stationing of US troops on its soil, merely that it be helped to finance its own defences. Given the congruence of Israeli and US interests in the Middle East, it is argued, there is more than sufficient justification for a US approach that would classify assistance to Israel as part of the defence budget. Here an amount of $3-4 bn is a relatively minor item, compared with Nato related spending in excess of $100 bn per annum, whereas the same amount coming from an aid budget totalling $10-12 bn invites criticism and cutbacks.

To sum up: the Israeli-US relationship is a complex and mutually beneficial one, resting on a number of separate factors. Taken together, these would seem to ensure that the relationship will remain close, and that each side has means of

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THE OCCUPIED TERRITO

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Table 17

Labour Force Participation in Occupied Territories, 1984
('000)

	West Bank	Gaza Strip	Total
Working age population	436.3	264.9	701.2
Work force members	160.0	88.0	248.0
Participation rate	36.7	33.2	35.4
Male participation rate	63.7	65.5	64.4
Total employed	154.1	87.2	241.3
of which:			
employed in Israel	50.1	40.2	90.3
employed locally or abroad	104.0	47.0	151.0
unemployed work seekers	5.9	0.8	6.7
unemployment rate	3.7	0.9	2.7

Source: Compiled from Bank of Israel figures.

Given that, even according to official statistics, the GDP of the West Bank and Gaza Strip was in the region of $810 mn in 1984, it may be seen that these areas do not represent a large additional market for Israeli firms to sell to. The economies of these areas remain underdeveloped, although their rate of growth was outstanding in the 1970s. The Jordanian and Egyptian administrations in the West Bank and Gaza Strip respectively in 1948-67 had done little to encourage development, while in the Gaza Strip the mainly refugee population was left to fester.

The 1970-75 period, in contrast, saw GNP rise at an annual average rate of 14 per cent per annum. When the Israeli economy slowed after 1973, its influence was replaced by that of Jordan and the Gulf states, which sucked in Palestinian labour whose remittances kept GNP rising at a 7 per cent annual average rate in the second half of the decade. Only in the 1980s when growth stopped completely in Israel - the construction industry being especially hard hit - and the Gulf economies slowed down, with a spillover effect on Jordan, did this rise terminate. The return of many Palestinians from the Gulf, and growing unemployment among those formerly employed in Israel, as well as a drought in 1983-84, all contributed to the downturn, with GNP advancing only 2.3 per cent per annum in 1983 and 1984 and GDP per employee falling 1.2 per cent per annum.

- buying from Israel more than they sell to it

For the time being the occupied territories have no status except as adjuncts to the Israeli and Jordanian economies that they abut. The Israeli administration has been unwilling to promote industrial development, partly to protect Israeli manufacturers from competition, and agriculture remains the primary economic activity. Table 18 breaks down the sectoral distribution of GDP in the West Bank and Gaza Strip and also emphasises the high proportion generated "abroad", meaning in Israel and via remittances from those employed in Arab countries.

Trade is similarly limited to Israel and Jordan. In 1984 the West Bank sold $100 mn worth of goods to Israel and bought goods worth $363 mn, representing 55 per cent of their exports and 90 per cent of imports. Trade with Jordan represented only 2 per cent of imports and 45 per cent of exports, while trade with other countries was negligible, although exports to Jordan are often forwarded to other countries. The Gaza Strip was even more Israel oriented, with 92 per cent of its imports and 86 per cent of its exports coming from or going to Israel and only 9 per cent of its exports sent to or through Jordan. The chronic trade deficit of the areas has been financed by receipts from services, mainly labour sold in Israel and the Gulf, and by unilateral transfers from Unesco, the Israeli government, the Jordanian government (to former Jordanian civil servants) and private organisations.

Table 18

Sectoral Distribution of GDP in Occupied Territories, 1976-84
(%; period averages at current prices)

	West Bank		Gaza Strip	
	1976-80	1983-84	1976-80	1983-84
Agriculture	33.7	23.2	26.7	14.9
Industry	6.8	7.6	10.6	10.6
Construction	14.9	16.3	21.0	22.7
Public & communal services	11.4	16.1	18.4	27.5
Trade, transport & other services	21.9	22.0	17.5	17.5
Housing services	11.3	14.8	5.8	7.5
GDP	100.0	100.0	100.0	100.0
Distribution of GNP				
GDP	76.3	76.2	68.5	55.2
Foreign income of local production factors	23.7	23.8	31.5	44.8
GNP	100.0	100.0	100.0	100.0

Source: Compiled from Bank of Israel figures.

Important changes took place in 1986

The most recent statistics available for the occupied areas are those for 1984, and even these are regarded as rough rather than accurate. Nevertheless, given the sharply worsening economic situation in Jordan and the Gulf states, and the stagnation in the Israeli economy, the situation in the West Bank and Gaza must be presumed to have deteriorated. Somewhat surprisingly, this has not been reflected in a significant worsening of the local security situation, although attacks on individual Israelis have increased. This may be due to the greater availability of security resources, following the completion of the withdrawal from Lebanon in mid-1985. In any event, economic progress will clearly continue to be determined by political developments.

In this respect 1986 witnessed several significant developments, including the first formal document signed by both Jordan and Israel since the 1949 armistice agreement. This was the agreement reached in London in September 1986 after two years of US mediation, allowing for the reopening of the Cairo-Amman bank in Nablus - the first Arab bank to be permitted to operate in the West Bank since the 1967 war. The fact that the negotiations were conducted by senior officials of both countries' central banks and led to an agreement that involves parallel Israeli and Jordanian supervision of a commercial entity has been seen as a clear example of the degree to which Israel and Jordan are prepared to cooperate in the West Bank in overall policy.

The announcement by Jordan of a five year plan under which it will seek to channel $150 mn a year to investment in the West Bank - an amount that could provide a boost to the economy and spur increased industrialisation - was welcomed by Israel. Of even greater potential importance, however, was the move by Jordan to waive import restrictions on most products from the West Bank and Gaza Strip, even those manufactured using machines or raw materials imported through Israeli ports. This ban has been a primary factor in the low rate of industrial investment, since it forced potential exporters to Jordan to import their raw materials and machinery through the Jordanian port of Aqaba and thence across the Jordan bridges to the West Bank, thereby involving payment of both Jordanian and Israeli duties and rendering the entire exercise uneconomic. The elimination of restrictions could stimulate the development of industries such as processed food, textiles and plastics.

If the promise of these initiatives is realised, and if Israeli-Jordanian cooperation continues to develop, the West Bank and Gaza Strip economies may be set for a period of renewed growth. If, on the other hand, political obstacles come to the fore again, these economies will shrink further, until either the Israeli or the Jordan/Gulf state economies recover and once again draw in labour resources from them, although this can be no substitute for self-generated growth.

CHAPTER 6
WORLD ASSUMPTIONS IN THE CENTRAL FORECAST

World economic trends have great importance for Israel -

The Israeli economy is extremely open to the influence of the international economy, especially developments in the USA and Europe. Total imports and exports exceed GDP by some 20 per cent, and total external debt is also larger than GDP, so that changes in world trade and in interest rates are of major significance.

The terms of trade have moved sharply in Israel's favour over the past few years, reversing the trend of the 1970s. Oil prices have fallen to an extent that has reduced the import bill for fuel by between one third and one half, while other raw materials have also become significantly cheaper. Furthermore, interest rates came down at a much faster rate in 1985-86 than had been expected, reducing the weight of debt servicing.

The volatility of international currency markets has confused Israeli policy makers and businessmen alike. In the years of the dollar's rise, major efforts were made to switch the focus of exporting activities to the US market. These culminated in the Free Trade Agreement with the USA that went into effect in September 1985, the very month that the Group of Five meeting accelerated the dollar's decline. Gradually, and out of necessity, the export sector, even at the level of individual firms, is learning the need for diversification or at least currency risk management. An important development with respect to the currency markets was the decision in July 1986 to peg the Israeli shekel to a basket of currencies of Israel's major trading partners, rather than to the dollar alone.

- and US developments are especially critical

Despite these developments, and the fact that Europe as a whole still constitutes a larger trading partner than the USA, it is the US economy that is perceived as the main potential growth area, although the Far East is also beginning to figure in exporters' plans. Developments in the USA, including the details and extent of the budget cutting process and the growth of protectionist sentiment, are of central importance to Israel, since they crucially affect both government income and the pattern of trade throughout the economy, as well as the rate of development of many Israeli industrial sectors, notably the defence industry and electronics generally.

This chapter details EIU assumptions as to the most probable developments in the world economy through 1991. Given their importance to the Israeli economy, however, an attempt to assess the possible impact of more extreme changes in some of these variables is included in Chapter 10.

WORLD TRADE

Strong recovery is forecast for the turn of the decade -

World trade is expected to expand at a faster rate than combined GDP growth in OECD countries. Between 1985 and 1991 its average annual growth rate is expected to be 4.7 per cent, rising from 1986 through 1988 before slowing sharply in 1989, and then recovering strongly in 1990/91, to reach a 6 per cent rate at the end of the period.

This degree of elasticity represents an improvement on that existing between 1979 and 1985, though hardly matching the standards of the post-war generation. It is achieved by the greater weight attached to areas such as Western Europe and the developing countries, whose growth rates will pick up more strongly in the emerging environment of low oil prices and monetary and fiscal relaxation, than will that of the USA, which is less open to foreign trade.

- at which point the USA will experience stronger growth

The expected improvement in growth in the Western European economies, that will stem from lower inflation and reduced budget deficits, will produce a superior European performance vis-à-vis the USA from 1986 to 1990. This is a sharp change from the 1979-85 period, although it will be reversed again in 1991, when the US economy may be expected to re-emerge into stronger growth. On average, however, neither US growth of 2.5 per cent a year in 1985-91, nor European growth of 2.6 per cent a year, will match the weighted OECD average of 2.7 per cent, much less the Japanese performance of 3.4 per cent per annum. US domestic inflation is similarly expected to run at a slightly higher level than Europe's and a much higher level than Japan's projected 1.3 per cent average annual rate.

Within Europe, West Germany is expected to resume its locomotive role and take the Benelux countries with it, with France not far behind and Italian growth outstripping that of its main EC partners. Only the UK will lag, slowed down by the adverse effects of lower oil prices on its public sector.

PRICES

Manufactured goods' price rises will moderate -

Price movements are expected to moderate over the next few years, after the very sharp moves registered in 1985 and 1986. Manufactured prices are estimated to have risen by 21 per cent in dollar terms in 1986, but in 1987 and 1988 this rise will slow to 5-9 per cent a year and turn marginally negative in 1988, with only slow increases in 1990/91. The average annual increase for the period, of almost 6 per cent, therefore tends to exaggerate the year by year changes, having been skewed by the jump that occurred in 1986. Prices of commodities other than oil, which fell in 1985 and 1986, are predicted to bottom out in 1987 and begin to rise thereafter, by around 2 per cent per annum in 1988/89 and by about 4 per cent annually in 1990/91. Non-food prices will be the factor behind this surge in prices in the later years.

- while oil prices slip again in 1988/89, before recovering slightly

Oil prices remain the joker in the pack. After an estimated slump of over 45 per cent in 1986, to an average price of $15 a barrel, 1987 is expected to start a renewed, but much slower period of erosion. For 1987 itself the average price will still be higher than that of 1986, but in the second half of the year prices will be dropping - a trend that is likely to continue for over two years. Only when the US economy begins to pick up steam again, at the turn of the decade, will oil prices make up the lost ground and recover their nominal level of 1987, namely $16-18 a barrel. In real terms, of course, even this will represent a fall.

This gentle U-shaped curve does not, of course, preclude the possibility of sharp divergences along the way; it merely projects the underlying trend, based on supply/demand fundamentals. The ability of Israel, as a small scale buyer in terms of the total market, to utilise market swings, will be referred to in the following chapters.

Consumer price inflation will remain low -

The weighted average of OECD consumer price rises expressed in local currency terms, will remain low at an annual level of 2.5-3 per cent per annum in 1987-91, although this will represent a sharp increase over 1986's 1.9 per cent. In dollar terms these figures will look rather different, because of that currency's declining value. The Israeli economy, however, will pay more attention to overall, or "basket" movements in future, as noted above.

- and the dollar will remain weak

The pattern of currency movements is expected to centre on a continued, if slower, decline in the effective exchange rate of the dollar. Thus, after the dramatic slide from its 1985 peak of 141 (1975=100), to an average 115 in 1985, or a drop of 20 per cent, 1987 should see that rate of decline moderate. A further fall in 1988 will bring the dollar rate to 95 per cent of the 1975 base, and despite a slight recovery in 1989 it will remain below 100 through the end of the forecast period. The main decline, of course is against the yen and the Deutschemark.

Table 19

Summary of
Main International Assumptions in Central Forecast
(% change)

	1985	1986	1991	Average 1985-91
World trade	3.3	4.3	6.0	4.7
Real GDP growth:				
(% per annum)				
USA	2.7	2.5	3.5	2.5
Europe	2.4	2.4	2.8	2.6
weighted OECD average	2.9	2.5	3.5	2.7
Prices (% per annum)				
Consumer prices:				
USA	3.6	1.9	3.0	3.1
Europe	5.2	2.5	3.1	2.9
weighted OECD average	3.9	1.9	2.9	2.7
Export prices:				
manufactures	-	20.9	2.0	5.9
oil	-3.5	-41.8	13.8	-8.2
$/b	27.5	15.0	16.5	-
Other commodities	-13.0	-4.1	4.6	1.4
Total	-3.0	0.9	5.0	2.4
Libor rate	8.4	6.8	4.5	6.0
$ effective exchange rate 1975=100	141	115	93	96

Source: EIU.

The fact that the dollar will remain generally weak in the forecast period will have importance for the structure of Israeli trade. The trend towards increased trade with the USA will be dampened, although by no means reversed, and those companies whose exports are dollar denominated will be forced to become more competitive. Conversely, the awareness of the potential of Far Eastern markets, still a relatively new concept for many Israeli exporters, is likely to grow into a dominant theme, especially if the pressures being exerted on Japan and other Pacific basin economies, to become more open towards imports, bear fruit.

THE US ECONOMY

Oil and dollar prices have helped avoid negative scenarios -

The importance of the US economy to both the world economy in general, and the Israeli economy in particular, necessitates making explicit a number of assumptions. These are primarily with regard to what is not expected to happen. Thus the threats posed by the debt crisis, including foreign and domestic problem areas, are assumed to be containable, especially in the wake of the oil price slump and the reduction in international interest rates. The fall in the value of the dollar is expected to remain under control, and the currency will not enter a "free fall". Therefore, no sharp reversal of the accommodatory monetary policy now in force is envisaged until 1989, and even then it will be a temporary and limited affair, with rates falling again in 1990 and ending the forecast period at their lowest level in over a decade.

- and avert an uncontrolled trade war -

US trade problems, exemplified by the size of the US current account deficit, are not expected to boil over into an uncontrolled trade war, either against European or Far Eastern countries, although it is clear that relations between these parties have worsened and are likely to deteriorate further. The underlying acceptance by all the parties involved that a complete breakdown, resulting in shrinking trade and a probable worldwide slump, is in no one's interests will serve to prevent such an eventuality from being realised.

In positive terms, therefore, it is assumed that the main developments since September 1985 have significantly improved the outlook for the US economy. The decline in the dollar's value points to an eventual reabsorption of the US current account deficit, although this process is clearly a lengthy one. The fall in oil prices has given rise to very low, or negative, inflation rates in 1986 and helped to bring interest rates down much more quickly than had been thought possible. The continuation of these positive trends will allow their full influence to be felt in the coming years.

More specifically, the improvement in the US trade position - when it finally comes - should weaken protectionist pressures. Although Israel is less vulnerable than most countries to such measures, because it is the only nation with which the USA has concluded a Free Trade Agreement, specific industries could be hurt by quotas and other barriers. Examples of just this kind of development were provided very soon after the FTA came into force, first in the textile industry and then in chemicals. In the former, for instance, US manufacturers attempted to impose a quota on Israeli exports of cotton sheets, on the grounds that this product was damaging domestic producers. The volume of goods involved was miniscule in terms of the total US textile market, but both sides treated the dispute with the utmost seriousness, recognising its value as a precedent. In the event the Israelis won, but not so convincingly as to close the door on future attempts in other industries. In strictly legal terms, there is significant doubt whether the terms of the FTA override other US trade laws, including those with provisions often cited by protectionists in their defence.

- although the advantages to Israel have yet to be assessed

In fact, it would be true to say that no one yet knows whether the FTA will bring all the advantages that Israel hoped for, in terms of access to the enormous US market. Israel-US trade in the period from late 1985 to the end of 1986 was distorted by various factors, including the effects of the FTA, the slump in the semiconductor, computer and other branches of the electronics industry, the major changes made in July 1985 in subsidies and export finance provisions available to Israeli exports (themselves partially due to the then imminent introduction of the FTA) and the impact of the fall in the value of the dollar, both in world markets and vis-à-vis the rate of inflation in Israel. Trade in both directions did increase in 1986, but against this exceptionally complex background it has been impossible to ascertain whether either the hopes of the optimists - in terms of access to new markets - or the fears of the pessimists - in terms of over-rapid exposure at home for too little effective gain abroad - are on the way to realisation.

As a generalisation, though, it may be said that the less general protectionist sentiment there is in Congress, the easier it will be for Israel and its lobbyists to fight off protectionist moves initiated by special interest lobbyists on behalf of US firms and industries. In other words, the more crudely political the protectionism is in nature, the better Israel is equipped to withstand it. This issue is examined further in Chapter 10.

The US budget deficit will be brought under control

Finally, the budget cutting process, whether through the Gramm-Rudman amendment or some other mechanism, and whether done in an orderly or disorderly manner, should bring about a reduction of the budget deficit over the medium term. The influence that the recent sweeping tax reforms will have on the US economy, and particularly on government revenues, cannot yet be ascertained, but it is likely to be positive on balance, if not in every sector.

The shift in policy priorities in 1987/88 towards effectively cutting the deficit, together with a normal cyclical downturn, will keep the level of activity relatively subdued in 1988/89, with GDP growth falling to only 1 per cent in 1989, although lower inflation will be a positive side effect. The downturn, however, is not expected to develop into a major recession, and growth is expected to recover in 1990/91. The achievement by then of smaller deficits in both trade and the budget, and the renewed decline in interest rates, should forestall the emergence of inflationary pressures and create the basis for a more soundly based period of expansion.

CHAPTER 7
DOMESTIC ASSUMPTIONS IN THE CENTRAL FORECAST

THE DELAYED REVOLUTION

Timing of elections will decide timing of reform -

The central forecast is based on four key assumptions regarding the content and timing of government policies. These are as follows.

1. No return to hyperinflation will be allowed and any prolonged rise in inflation will lead to a renewed bout of counter-inflationary measures, even at the price of austerity.

2. No balance of payments crisis will be allowed to develop, and deterioration in the trade balance will lead to corrective measures, again at the price of a further bout of recession.

3. The underlying problems of the economy will not be tackled in the period prior to the next general election, following the failure of the attempt made at the end of 1986 to introduce structural reforms. The election is officially scheduled for November 1988, but the forecast expects it to take place earlier that year, and possibly even in late 1987.

4. However, the pressure for reform will not subside but will grow stronger. The next government, therefore, irrespective of its party composition, will put into place a series of far reaching reforms in the fields of taxation, the capital markets, and privatisation and deregulation, in the first two years of its term of office.

- but the risk of political deadlock will remain

The forecast period is therefore predicted to contain a period of "go" followed by a fairly sharp "stop" after which the implementation of the long delayed structural reforms will permit a more soundly based and longer lasting period of expansion. The latter development is, however, contingent on the reform process. The possibility of political deadlock and government weakness preventing the adoption of policies that would tackle the deterioration expected in 1987 and the consequences of a failure, for whatever reason, to implement reforms in the post-election period, are examined as alternative domestic scenarios in Chapter 9.

All these key assumptions stem directly from the course of events in late 1986 and early 1987, when the policy represented by the Economic Stabilisation Plan of July 1985 broke down without a coherent replacement emerging for it.

HOW STABILITY WAS SQUANDERED

The positive environment of 1986 sparked a boom -

1986 was a year of rare opportunity for the Israeli economy. As noted in Chapter 4, a combination of external and internal events produced a uniquely favourable set of circumstances in which the economy could have been pushed to reshape itself. So positive were these factors that, even though the opportunity was wasted, the second half of the year saw a significant upturn in the level of activity, and this broadened out over the months to include investment as well as consumption. This looked set to continue for most, if not all, of 1987.

The factors that led to the boom were: the reduction of the government deficit; lower government borrowing and hence lower real interest rates on short and long term borrowing; sharply reduced inflation; rising real wages on the home front, supported by the fall in energy prices and international interest rates; and a generally positive world economy.

The first part of the upturn was entirely consumer led, as real incomes recovered from the sharp but short-lived erosion they had suffered in 1985-86, with the introduction of the Economic Stabilisation Plan. Because the ESP had "anchored" the shekel against the dollar, and later against a trade weighted basket of currencies, a growing incentive developed to buy foreign goods and services, which resulted in a tremendous surge in consumer imports, more than cancelling out the benefits to the balance of trade from the collapse in oil prices.

- that led to labour shortages and rising real wages -

This revealed a major flaw in the strategy underlying the ESP. The stability of the exchange rate had been made conditional on real wages not rising, and perhaps even not fully recovering. But, as had happened so often in the past, the forces at work in the labour market proved more powerful than the resistance to them provided by the government's policy. The fact that the budget deficit had been reduced by lowering subsidies and raising taxes, instead of by actually cutting ministries' spending, ensured that there would be no shake-out in the public sector of the labour market, despite the protestations to the contrary.

Furthermore, in the first part of 1986 the government began pumping resources into failing firms and agricultural entities, whose poor management and inefficiency had been cruelly revealed as soon as the inflationary fog had been blown away. As it did so, the pockets of weakness that had been created in the private sector labour market began to shrivel up, as the pressure to shed excess labour eased.

In this environment it became steadily easier for skilled labour groups to demand and obtain wage rises to compensate for the losses suffered earlier. This led inexorably to competing wage claims and thus to over-compensation in some areas, and also spilled over into higher wages in industries which really could not afford them.

- which, coupled with labour market rigidities, kept unemployment down

This was one major factor explaining why unemployment did not reach much higher levels than the 8 per cent or so at which it peaked in the second quarter of 1986, although it had been expected to go as high as 10 per cent. Another contributory factor was the reluctance of employers to shed labour in the brief recession. Their past experiences of austerity periods had taught them that it was usually better to hold on to labour for the duration of the recession, even at the cost of some underemployment, than to fire quickly and then be caught undermanned when the turnround came and have to seek additional staff in a tight market. This, in turn, explains why productivity did not continue to improve in 1986 after the sharp gain it registered in the second half of 1985, as disinflation took hold.

In addition, it should be noted that the unemployment that developed was concentrated in specific geographic areas, especially in the development towns on the periphery of the country. The immobility of labour, to which the shortage of rented housing in the private sector contributes greatly, meant that these pockets were left to fester. Many of the unemployed in these areas soon dropped out of the work force altogether (a clear example of the "discouraged worker" syndrome) and thus helped towards an artificial reduction in official unemployment statistics. Many industrialists claimed that they could not obtain unskilled labour because the welfare system made it not worthwhile to work at low paying jobs. Independent analysts tended to support this assessment.

Finally, and even more worrying in its long term implications, was the phenomenon of exporting unemployment, especially among the young and better qualified people seeking to join, or rejoin, the work force. Many army leavers and other young people who found no jobs for themselves when they joined the labour force, simply moved overseas to work for family or friends, or to spend some time travelling.

Rising wages led to the devaluation of January 1987 -

The rise in real wage levels hit the trade balance on both sides. It boosted demand, especially for imports, and increased manufacturers' costs, thereby undermining exporters' competitiveness. The theory behind the ESP demanded that the government stand firm against the growing pressure from exporters to grant them relief, either by devaluing or by subsidies of some sort. However, labour market reality and the ominous rise in imports proved stronger than the theory and on January 13, 1987, the government agreed to devalue the shekel by 10 per cent.

- and signalled the demise of the July 1985 ESP -

Despite assurances by senior officials that the new exchange rate of $1 = NIS 1.65 would again remain fixed for a lengthy period of time, the capitulation on the matter of the exchange rate, which had been the most visible symbol of the economy's new found stability, was for most people the psychological signal that the ESP was now dead. The economic logic of at least a corrective devaluation, in the face of over 30 per cent inflation since the last exchange rate adjustment, and the need to realign relative prices of imports and exports, could not cover up the fact that the mechanics of the inflationary cycle of devaluation/price rise/wage rises were once again in motion. Nor did the agreement of the Histadrut labour federation to forgo 2.7 per cent of the next cost of living adjustment as a contribution to nipping this cycle in the bud persuade the public that the devaluation could be an isolated event. Manufacturers' even vaguer undertakings not to raise prices inspired even less confidence. Thus, to the reality of already rising prices and wages was added the renewal of inflationary expectations.

In fact, the ESP had been killed by neglect long before the devaluation. The pillars on which it rested had been whittled away in the course of 1986, and the devaluation merely delivered the coup de grace. Price controls had been gradually dismantled, and were being increasingly disregarded. Wages had run far ahead in real terms. Prices had thus started to pick up in late 1986 instead of falling further below the 15-20 per cent annual increase recorded in the first half of the year. The budget, which had been held under tight control in the 1986/87 fiscal year, was under siege by numerous sectors seeking increased allocations or demanding government aid. Worst of all was the failure to advance beyond the temporary stability the plan had achieved, towards implementing the promised structural reforms.

The government had preferred to bask in the glory of having reduced inflation and had made stability an end in itself. The result of this policy was that it was left with neither reforms nor stability, and this outcome will dominate the economy for the remainder of the National Unity government's term of office. Indeed, it may well contribute to the shortening of that term.

<u>- but its soul lives on as a new political reality</u>

The abiding legacy of the ESP will be the knowledge that inflation can be overcome, that the budget deficit can be reduced and that daily devaluations need not be the norm in the Israeli economy. Especially noteworthy is the conclusion that the revenue gathering process is the main victim of rising inflation and the main beneficiary when the inflation rate falls. These economic lessons will be examined in the context of their applications in budgetary, monetary and exchange rate policies, but their political relevance needs to be stressed at the outset. A population that has endured the dislocation of hyperinflation and the tough measures needed to overcome it will strongly resist policies that threaten a return to that path, thereby creating a major lobby against renewed inflation. The desire to win votes by projecting an "inflation fighting" image and the converse aim of depicting political opponents as "inflation causers" will dominate electioneering. It will also ensure that rising inflation in 1987 will provoke a sharp government response, which will bring the 1986/87 boom to an abrupt halt.

THE AGENDA FOR REFORM

<u>A changed intellectual environment paved the way for reform -</u>

The period of nominal stability, or near stability, experienced in the 18 months from July 1985 to January 1987 allowed attention to shift to the underlying problems that beset the economy, of which inflation, devaluation and the balance of payments and budget deficits were only symptoms. These problems are usually referred to under the general heading of "the structure of the economy" and include the issues of productivity, the dominant position of the government in almost every form of economic activity and market rigidities or inefficiencies.

In the course of the last decade, and in line with or influenced by developments around the world, there has taken place a basic change in the intellectual climate in Israel away from the traditional centralist statism and in favour of more open, free market oriented policies. The series of crises that occurred in recent years, beginning with the capital markets in 1983, continuing with the balance of payments and foreign currency reserves crisis from 1983 to 1985 and climaxing with the business sector crisis encompassing agriculture, construction and large parts of industry that emerged in 1985-86 and has not yet subsided, all served to strengthen this trend.

As in other countries, notably the USA and UK, so too in Israel, the practical agenda for achieving the aims of boosting private initiative and reducing the government's role have focused on reforms in the tax system and capital market, and the need to sell off state owned enterprises.

<u>- despite delays caused by vested interests and political feuding</u>

However, the entrenched strength of the centralist tradition in Israel and its political importance in terms of power and prerogative for the parties in government, have been sufficient to prevent the reformers from making much headway. Most leading politicians have gradually been converted to a belief in, or at least lip service to, the need to reduce the government's role, often under the influence of a new generation of senior civil servants who had earlier arrived at these conclusions. Yet the party bureaucracies have remained obdurately opposed to far reaching changes.

This background may explain why the government failed to follow through on the initial success of the ESP, as it had originally intended. Another source of delay was personal and interparty feuding, which resulted in the enforced resignation in April 1986 of the finance minister who had introduced and carefully executed the ESP, Yitzhak Modai, of the Liberal Party wing of the Likud. His successor and party colleague, Moshe Nissim, soon surprised those critics who had written him off as an economic ignoramus by proving to be the most genuinely liberal in outlook of any of Israel's finance ministers. Under his aegis, the Treasury and the Bank of Israel planned a series of far reaching reforms that were announced in December 1986.

In the interim, however, the "rotation" agreement had been implemented and the premiership had switched from Labour's Shimon Peres to the Likud's Yitzhak Shamir. This was to prove crucial in the battle that developed around the reform proposals, because Shamir proved unable to provide the degree of support for his finance minister that Mr Peres had given Mr Modai before their falling out.

TAX REFORM

Tax receipts fell when inflation took off in 1983 -

One of the main developments that forced the adoption of a radical anti-inflationary strategy in 1985 was the clear evidence that the tax system was collapsing as the economy moved into hyperinflation. Whereas the stable period of triple digit inflation from 1979-83 had negative effects on investment, growth and other areas, it did not prevent the government from collecting its revenues. Indeed, despite the fact that industry as a whole paid very little direct tax in the years 1982-85, because of the complexities of the 1982 Law of Taxation Under Inflationary Conditions, the total amount of taxes collected in 1982 and 1983 was very high. The special levies and compulsory loans imposed in mid-1982 to pay for the invasion of Lebanon were a main factor, as well as the restoration of the indirect taxes that had been temporarily rolled back in the run up to the 1981 elections.

With the upsurge in inflation from late 1983 onwards, however, tax revenues were very rapidly eroded, and even administrative measures such as collecting VAT and advance income tax on a monthly instead of bimonthly basis, were not enough to counter inflation of 15-20 per cent per month. At the same time, the real values of subsidies and transfer payments were held at a higher level than was originally budgeted for, especially in the pre-election months in 1984.

Table 20 shows that every measure of taxation was running in 1982-83 at levels above its 1975-85 average, for the reasons noted above, and that 1984 saw a drastic drop in tax receipts, taking taxation to levels far below the long term average at a time when government spending had not been significantly cut. The first attempt at slashing the rate of inflation, made under the first "package deal" in late 1984, gave an indication of what effect lower inflation would have on tax revenues, when the latter shot up in real value in December 1984 and January 1985 in response to monthly inflation of "only" 4-5 per cent. The planners of the ESP confirmed this effect in their theoretical modelling, and built it into their assumptions on the reduction of the total government deficit that they expected to achieve.

Table 20

Taxes, Support and Transfer Payments, 1975-85
(% of GNP at current prices)

	1975-85	1980	1981	1982	1983	1984	1985
1. Net taxation							
Without imputed credit subsidies	25.1	26.6	21.0	26.1	27.3	18.9	27.0
Including imputed credit subsidies	19.5	19.4	15.5	21.9	23.8	15.4	24.9
Total taxes & transfer payments from public	47.5	46.5	45.4	49.4	49.8	41.8	49.3
Total support & transfer payments to public	22.5	19.9	24.4	23.4	22.5	22.9	22.2
Imputed credit subsidies	5.5	7.2	5.5	4.2	3.5	3.5	2.1
2. Net direct taxation	9.9	10.3	10.4	11.6	11.4	6.2	10.3
Direct taxes, compulsory loans & transfer payments from public	26.5	27.3	26.9	28.9	27.9	22.2	27.4
of which: income tax	16.4	18.0	17.6	17.8	17.4	14.2	17.6
Transfer payments to public (excl interest)	16.6	16.9	16.5	17.3	16.4	16.1	17.1
3. Net taxation on local production	5.6	6.6	2.1	4.5	6.4	4.4	8.2
Indirect taxes on local production	12.7	13.2	11.7	11.8	12.6	11.4	13.7
Direct grants	3.9	2.8	6.5	4.6	4.0	5.0	3.7
Credit subsidies to firms	3.2	3.8	3.1	2.7	2.1	2.0	1.8
4. Net taxes on foreign trade	5.1	3.5	3.5	6.0	6.2	4.9	6.4

Source: Bank of Israel.

- and more than recovered when disinflation began -

In the event their expectations were surpassed, because the rate of inflation fell further and more quickly than had been thought likely. A new corporate tax law was passed in August 1985, designed to deal with an inflationary environment, only this time aimed at making industry pay some tax. This was a second factor that quickly turned tax receipts around, while extra taxes and levies that formed part of the ESP package were still another positive factor. Finally, the reduction of subsidies that had begun in late 1984 was speeded up. The effect of all these changes is highlighted in Table 21 which not only shows the sharp "V" pattern of taxation in 1983-85 but also emphasises that this change was much more pronounced in the second half of 1985, after the introduction of the ESP, than in the first half. The net result was that the government operating deficit was more than wiped out. This was a desirable outcome in itself, but almost too much of a good thing under the circumstances.

Table 21

Taxation, 1983-85
(% of GNP in current prices)

	1983	1984	1985	1985 1 half	1985 2 half
Taxes & transfer payments from public	49.8	41.8	49.3	47.6	50.4
Direct support & transfer payments to public (without interest payments & credit subsidies)	22.5	22.9	22.2	22.4	22.1
Net taxes	27.3	18.9	27.0	25.2	28.2

Source: Bank of Israel:.

- creating an oppressive tax burden on companies and individuals -

The extra taxation produced a quite unintended overkill effect. Industry, after a four year tax holiday, suddenly found itself paying heavy taxes, including on inventory changes and other "paper" profits hitherto excluded. At the same time it was saddled with real interest rates of up to 100 per cent a year, a short but sharp recession in the local market and the abrupt elimination of many of its traditional subsidies and supports. Corporate income tax rates of 61 per cent and National Insurance employers' contributions of 16 per cent, as well as local government rates and other levies, became an insupportable burden, and investment was the first area to suffer in consequence.

At the personal level, too, taxation became more onerous because, although fiscal drag effects had almost stopped, the surcharge on income tax for the 1985/86 tax year, higher ceilings on National Insurance contributions, lower subsidies and hence lower effective net disposable income, all combined to make the wage earner's effective tax burden heavier. Perhaps most important of all, the removal of inflationary distortions allowed both households and firms to assess their true - and often grim - position, for the first time in many years.

- and bringing growing pressure for reforms

The income tax schedule for salaried employees in these years encompassed a tax threshold of earnings of $400-500 per month and a series of tax brackets that rose quickly from 20 per cent to a top marginal rate of 60 per cent on incomes of $2,000 per month, at a time when the average wage in the economy was around $800 monthly. These punitive rates came increasingly to be seen as a major disincentive to work, and hence to productivity gains, as well as an obvious incentive to under-report true earnings.

The approach adopted by the government in 1986 was that lower tax rates were desirable, but that any reform must be "revenue-neutral" in that alternative sources of revenue or lower spending must counterbalance the effect of reduced tax rates. Table 20 makes clear that the Israeli tax system is comprised of large tax "bites" that are funnelled back to the public to a large extent. Indeed, an interministerial team asked to examine the scope of government subsidies in their widest sense (namely services granted without payment being made directly, such as education, health and other state services) concluded that some $5 bn a year, almost one quarter of GNP, was taken from the public in taxes and then returned as a subsidy of one sort or another. This estimate compares closely with the assessment of total support and transfer payments to the public in Table 20, which is based on Central Bureau of Statistics figures reworked by the Bank of Israel.

Tax proposals aimed to lower marginal rates and abolish exemptions -

The tax reform proposals tabled by the Treasury in late 1986 sought to reduce the top marginal rate of personal and corporate taxation to 45 per cent, from 60 to 61 per cent respectively. At the same time they intended to raise the tax threshold, broaden tax bands and eliminate many, but not all, of the host of exemptions, partial breaks and tax shelters that had grown up over the years and that distorted decision making throughout the economy. Meanwhile direct support would be offered from the budget to those groups or sectors that the government wanted to help and the distinction between "industrial" and "service" companies for tax purposes would be abolished. This latter had long been so blurred and obsolete that manufacturers of exercise books were undoubtedly an industry, according to the dèfinitions, but software producers were not.

The insistence on achieving a "low cost" tax reform stemmed from the difficult situation facing the Treasury in the run up to the 1987/88 budget. For one thing, record levels of government debt are due to be redeemed, in particular the multi-billion dollar obligation to redeem the bank shares in October 1988. For another indirect taxes were sharply reduced by the lowering of customs duties on imports from the EC and USA on January 1, 1987, in line with the Free Trade Agreements that Israel has with both those entities. Similarly, a number of temporary taxes enacted in 1985-86 had been, or were scheduled to be abolished. The Treasury therefore felt it could not afford a one sided reduction of tax rates, without counterbalancing revenues by broadening the tax base.

- but encountered fierce opposition and were largely defeated -

The Treasury made a series of tactical errors in preparing and putting over its plans, which allowed the opponents of reform to mount a prolonged and ultimately successful campaign to emasculate the tax reform. As a result, while most of the rate reductions were accepted, most of the exemptions and tax breaks survived intact. Far from being nearly revenue neutral, therefore, the limited reform now became strongly expansionary.

The opposition to the original proposals came from the large manufacturers, both from the private and Histadrut sectors, and an alliance of welfare and other groups, all of whom stood to lose from the abolition of their existing exemptions and tax breaks. The Treasury's assurances that no one would end up losing from the reform were not believed, and it lost the battle for public opinion and hence the vote in the cabinet. What was finally agreed by the government left only the corporate tax reduction intact, while individual marginal rates fell only to 48 per cent and few of the exemptions were abolished. Unearned interest, for example, remained untaxed, as did employer contributions to pension and provident funds.

- causing a revenue shortfall in the 1987/88 fiscal year

The results of this very partial reform will be to reduce the level of taxation in the 1987/88 fiscal year that runs from April to March. Although higher real wages and higher spending will boost the tax intake from direct and indirect tax respectively, they will not be able fully to offset the effects of the fall in tax rates in both these areas. But a worse threat to the revenue gathering mechanism will be the resurgence of inflation, which is predicted to reach 40 per cent in the course of 1987, at a time when the tax system is reverting to bimonthly instead of monthly tax payments. The inevitable result will be the erosion of tax revenues as happened in 1983-85 although on a lesser scale. The vulnerability of the tax system to rising inflation will thus be demonstrated anew, but the possibility of countering this erosion with new or higher taxes is limited, for a number of reasons.

In the first place, the imminence of elections in 1987/88 when the problem will emerge in full force, will increase even further political unwillingness to increase the tax burden. The public regards itself as being very highly taxed already and the international comparative figures amply bear this out. Secondly, the consensus of professional opinion in and out of government is against more taxation. Both public and professionals are aware of a background factor that looms increasingly large over the economy - the international trend to lower tax rates.

Tax reforms abroad will have an impact

This trend may be exogenous but, given the openness of the Israeli economy, it will exert a growing influence. Thus the impact of the US tax reforms, and of others planned in Canada, France and other Western countries, will be to apply further pressure on Israel to get into line, since it will not be able to compete for either human or financial investment if its individual and corporate tax rates are much higher than those of other countries. This will ultimately lead to much greater tax reforms, probably in 1988/89, but in the 1987/88 period it will act as a disincentive to the government to react to a shortfall in tax revenue by simply pushing taxes higher. With the "easy" route of higher taxation thus blocked by internal and external factors, the only way left to deal with eroding tax revenue will be the "hard" one of reverting to a tough anti-inflation policy.

This is expected by late 1987 or early 1988, and will at least resolve the inflationary side of the revenue drop. But the problem of the tax base will remain and it will have to be tackled as part of the round of reforms that the next government is expected to embark upon. The main element of the tax reform that the forecast predicts for 1988/89 will be the broadening of the tax base that was avoided in 1986/87. Unearned income will have to be brought into the tax net, and the exemptions to welfare cases, development areas and all the other current beneficiaries will either be whittled down or eliminated altogether. At the same time, marginal rates will probably be further lowered, to around 35-40 per cent, the number of tax brackets reduced and their thresholds raised. A better balance between the taxation of earned and unearned income, and between different economic sectors and parts of the population, will produce less distortions in the allocation of investments and contribute to higher productivity.

Indirect taxation will also be reduced, as the gradual reduction of customs duties mandated by the free trade agreements with the USA and EC take effect notably in January 1989. VAT is unlikely to move from its current 15 per cent level, at which it is an important and effective source of revenue. Purchase taxes will probably be used as a swing factor against imports, with rises being imposed in late 1987 on luxury goods, to foster an impression of austerity measures, but these will then be rolled back in later years.

MONETARY POLICY AND THE BUDGET

A surplus in the operating budget prompted reduced government borrowing -

The government used its achievement of an operating budget surplus in 1986/87 to reduce its recourse to the capital market as a means of raising funds. It thus created the opportunity for corporations to issue bonds on the Tel Aviv Stock Exchange, by reducing the extent to which non-government borrowers were crowded out by the weight of government credit needs. Indeed, in 1985 the government had absorbed all the available savings in the economy, so that the private sector was forced to make net redemptions of several hundred million dollars. Consequently, there was no other direction for the government's share of investment funds to go but down. In the course of 1986, and cushioned by its operating surplus in the budget, the government deliberately failed to recycle all its maturing debt, thereby making available almost $1 bn to the private sector. The reduced demand for funds also had the desired effect of pushing interest rates down, and by the end of the year non-government borrowers were able to issue ten year bonds at around 6 per cent real interest, plus full index linkage, compared with 8.25 per cent previously. The government itself was meanwhile paying 4 per cent fully linked, down from over 6 per cent at the beginning of the year.

- and initiated a deregulation process in the financial markets -

However, the flow of applications from non-government borrowers for access to the market was still controlled by the Treasury. Most of the permits granted were for entities for whom the government and banks were interested in achieving debt rescheduling, swapping onerous short term bank debt for the easier terms of long term bonds and thereby easing their financial burden. This process also involved the beginnings of deregulation of the institutional investment sector, which had hitherto been forced to invest almost all its funds in government paper, but was now freed to divert part of the flow to other issuers.

All this was envisaged as the beginning of a gradual, but steady policy of withdrawal by the government from its dominant, and sometimes monopolistic role in the capital markets. At the short end of the market, the growing popularity of unlinked short term deposits enabled the commercial banking sector to develop consumer lending for the first time, instead of funnelling all the funds it received directly to the Treasury and then relending them to large corporate and public sector borrowers according to Treasury imposed criteria and directives.

- which the reform programme sought to catalyse -

The mooted reform programme of December 1986 sought to institutionalise the opening up of the market which had thus far proceeded on an ad hoc basis. In addition to pledging the government to make a further $1 bn available to the non-government sector in the 1987/88 fiscal year the plan also involved the waiving - but not the abolition - of the finance minister's right to approve every individual share and bond issue. These and other decisions, including a relaxation of the rules that had more or less prevented access to foreign markets for Israeli companies, represented an important change in the tone and substance of capital market policy, while concurrent changes in the money market were designed to give the commercial banks more freedom to lend money at their own discretion, instead of acting as mere conduits to and from the Treasury.

The financial reforms were approved without the same acrimony that accompanied the tax reform debate, although they too involved the abolition of preferential treatment for some sectors, notably the large manufacturers, who have been the main recipients of "directed" credit via the banking system. But they depend crucially for their success on the government keeping its spending down.

- but which budget overruns will probably hinder

Since the cuts proposed in the 1987/88 budget were small to start with, and had little chance of being implemented anyway, the prospects on this front were never good. But the subsequent political crisis over demands for aid to various sectors allied to different political parties made it appear certain that the 1987/88 framework would not survive in anything like its original format. If the budget deficit expands, the government will be forced to borrow more than it originally intended, and the planned withdrawal from the market will be at a slower pace and on a smaller scale than was envisaged. By extension, more borrowing will drive interest rates back up, and there must be some doubt as to whether the opening up of the economy to foreign borrowing will be implemented. The current account forecast in 1987 is for a rough balance or slight deficit which, while not a cause of alarm, will be sufficient to persuade the government to go slowly on the matter of overseas borrowing.

Monetary policy will be forced to bear the burden of the failure to cut the budget. One early sign of this was the sharp rise in the interest rate at the Bank of Israel's discount window in early 1987, which sent the prime borrowing rate soaring from 19 to 31 per cent per annum in one fell swoop. With inflation set to reach around 40 per cent in 1987 the government will be forced to use a very tight monetary policy to reassert control until it can get a grip on its spending. This makes the prospect of a crunch in late 1987 or early 1988 even more likely and has grim implications for many firms who will not have recovered from the 1985-86 shake-out before the next one hits home. The need to recycle record quantities of government debt in 1987 and 1988 further ensures that both long and short term interest rates will remain high.

Restructuring of the markets will continue all the same -

The government's withdrawal is the main, but by no means the only, item on the agenda of reform for the capital markets. The entire legal, regulatory and organisational basis on which they work is in the process of undergoing a thorough review that will crystallise over the coming years in a series of laws that will completely revamp its structure.

The catalyst for change was the bank share collapse of October 1983, whose causes and course were outlined in Chapter 4. The judicial Commission of Inquiry appointed to examine this issue found that the banks had grossly abused their privileged position in the share market, and that their numerous roles as underwriters, issuers, brokers, investment advisers, traders and mutual and provident fund managers had resulted in glaring conflicts of interest in which the public had come off a poor second best. Among the commission's recommendations were: hiving off investment activities from the banks' regular business, either into an "arm's length" subsidiary or outside the bank altogether; sweeping regulatory powers for the Central Bank over the commercial banks; the strengthening of the Securities Authority (the state regulatory authority that hitherto had no teeth and a small bark) vis-à-vis both the private and self-regulating Tel Aviv Stock Exchange and the Treasury itself; and, underlying all else, the need to end the government's domination of the capital market, which was identified as the ultimate source of everything that had gone wrong. Some of these ideas were being implemented by the banks and other bodies involved during 1986, but the legislative process itself will not be completed until 1988.

- and the momentum of reform will gather pace

As with the tax system, the delays that are likely to affect capital market reform in 1987/88 will not ease the pressure for change. On the contrary, the pressure will intensify. Here too, the international trend towards the free movement of capital will be an added force for change, over and above the urgent internal logic in favour of eliminating the inefficient and expensive system of allocating capital that the government has fostered.

The budget difficulties that will serve to slow the process in the first part of the forecast period will reach their climax in the 1988/89 fiscal year. At that point in addition to the scheduled repayment of a record quantity of internal debt (see Table 34), it is assumed that an anti-inflation policy will be in force, with consequent attempts to reduce, or at least restrain, government spending. However, starting in the 1989/90 fiscal year the pressure will ease, as debt maturities drop sharply. It is also assumed that the next government will undertake a programme of sales of government companies and other assets, and will use the proceeds primarily to repay debt at home and abroad. This will be the ideal background against which to implement the withdrawal of the government from the markets and their freeing for capital raising by non-government borrowers. When this is done, the way will be clear for real interest rates to fall and for investment to pick up, thus facilitating the solid economic expansion that we expect to begin at the turn of the decade.

Government spending will be kept tight throughout the period

Civilian government spending will rise in 1987, and thereby contribute to an increased budget deficit and to a rise in inflation. The backlash this may be expected to unleash will ensure that 1988 and 1989 see renewed efforts to bring the deficit back under control and, given the problems the government then in office will face in raising taxes, it will this time have no choice other than to cut its own spending - even at the price of creating unemployment. If at the same time it begins selling some of the larger state owned companies and also promotes private sector growth through tax and capital market reforms, then most of this unemployment will prove temporary.

It may also be expected that the composition of government spending will change in the second half of the forecast period, as more activities are privatised or charged for directly to their users. The fall in current spending will be offset by a long overdue return to infrastructure investment, especially in roads and telecommunications, but even then the share of the national product taken by civilian government expenditure will continue to fall.

FOREIGN TRADE, AID AND DEBT

Lessons learned on devaluation will be successfully applied -

The coming years are expected to be far less troublesome on the balance of payments front than has been the norm in Israel's history. This will be the result of more consistent internal policy decisions and of US aid neutralising the effect of the volatile military imports bill.

The lessons learned about exchange rate policy may be summed up as follows. On the one hand, devaluations feed inevitably into price and wage rises, so that the present economic structure translates devaluation into inflationary pressure. Incomes policies cannot by themselves do more than delay these adjustments and only a far less rigid labour market will prevent the price rises that stem from devaluation being passed on into higher wages across the board. Conversely, attempts to stabilise the exchange rate cannot succeed for long if locally generated inflation continues to creep upward, because the price distortions lead to increased imports and damage exporters' competitiveness.

The only solution to this dilemma is to apply a mixture of budgetary and monetary policies that will force inflation down, and keep devaluation rates roughly in line, or at least not far behind, the rate of internal price rises. If public sector wage rises are held down, as they were in 1985/86 and a firm and uncompromising stand is taken to persuade the private sector that wage rises can only be given in return for productivity increases, then the scenario that developed in 1986, when excessive real wage growth was allowed to force a devaluation, can be prevented. There is a growing realisation of the connection between real wage rises (as distinct from cost of living adjustments), competitiveness and exchange rate policy. Even so it will take a strong government to stand up to the inertial pressures from labour and manufacturers to keep the inflationary cycle in motion. The present government will not do so, having once been defeated in late 1986, and only the resurgence of inflation in the course of 1987 will give its successor the public support to impose a budgetary policy tough enough to create labour market slack and force real wages into line.

- so that the trade deficit will shrink -

Devaluation will thus be limited to the extent needed to maintain relative prices. But this policy combined with a further bout of austerity on the home front and continued growth in world trade, will be enough to keep export growth moving in 1987/88. The import boom of 1986 will subside naturally during 1987 and civilian import growth will be curtailed by the government's renewed anti-inflation drive which will dominate the economy in 1988-89. The civilian trade deficit will therefore shrink over most of the forecast period, only growing again when economic activity picks up in 1990-91.

- and the balance of payments will show a small surplus

With military imports covered by US military aid, and debt servicing covered by US economic aid and other unilateral transfers, the balance of payments will not be under pressure and should register small surpluses in most of the coming years. This will enable a gradual reduction of some of the government's foreign debt, while the bulk will be rolled over without difficulty. The forecast assumes that the balance of payments surpluses will also be used more for the conservative aim of building up foreign exchange reserves than to allow large scale borrowing overseas by the private sector, at least during the recessionary years of 1988-89. Thereafter, with the reforms in place and demand for investment capital growing, this attitude will be relaxed.

THE EXTERNAL ENVIRONMENT

A background of "no war, no peace" in the Middle East -

The forecast includes certain implicit assumptions which must be made explicit, for the sake of completeness. These refer primarily to Israel's external position, and include the essential premise that the forecast period will not witness any major hostilities with one or more Arab countries and, conversely, will not see significant diplomatic breakthroughs of the kind that might lead to a general resolution of the Israel-Arab dispute. The possible effects of any violation of these assumptions is examined in Chapter 10.

Thus the situation of "no war, no peace" in the Middle East is projected as continuing in the coming years. Israel, especially in the wake of its experience in Lebanon, is very unlikely to initiate a major military operation, except as a pre-emptive measure against imminent attack. Most of the Arab countries are similarly thought to be uninterested in the military option for the foreseeable future, and their internal problems, notably in the economic sphere, will argue against an aggressive policy. Even the conclusion of the Iran-Iraq war, which some Israeli analysts fear could lead to the recreation of a powerful eastern front alliance, is unlikely to have any immediate impact on Israel, whatever its final outcome, since even the victorious side - if there should be one - can hardly be expected to seek direct participation in another conflict in the immediate post-war period.

- could be disturbed by Syria

The most likely aggressor will continue to be Syria, but even this country appears increasingly constrained by internal political and economic problems from realising its undoubted ambition to launch a military strike with the aim of regaining the Golan Heights. Furthermore, any such action on its part would have direct superpower ramifications that must be considered a further moderating factor. The extent of Soviet support for a Syrian initiated attack, and the possible US reaction to such an occurrence in light of existing US policy statements regarding Syrian involvement in terrorist operations, will be key considerations in Syrian calculations.

Foreign policy divergences will contrast with economic policy consensus

With regard to the domestic Israeli political scene, it is assumed that the main blocs of Labour and the Likud will contest the next election over foreign and defence policies, in which they are able to show clear differences. In contrast, behind the rhetoric of blame for economic failures that they can be expected to hurl at each other, there will be little to choose between them in terms of social and economic policy. Both parties will seek to conquer the crucial centre ground of the electorate, and this will require them at least to promise to reduce the level of government intervention in the economy. An important indicator in this regard may be the performance of one or two small free market oriented parties in the election, while the tone of the major parties' manifestos will also cast light on which groups within them have the upper hand in formulating social and economic policy.

In any event, the harsh realities of the domestic and international markets will force the victor in the election to move ahead with the reform agenda outlined earlier in this chapter, and it is assumed that the populist and socialist opposition from the flanks of the Likud and Labour respectively will not be able to repeat its success in scuttling the 1986 reform programme.

CHAPTER 8
THE CENTRAL FORECAST

POPULATION, PRODUCTIVITY AND EMPLOYMENT

The labour force will grow faster than total population -

Total population grew more slowly in 1986 than in earlier years as emigration exceeded immigration for the second year running. In the forecast period, the rate of population growth is expected to remain steady at 1.6-1.7 per cent per annum, while both the population of working age and the civilian labour force will expand at a faster rate. This reflects the trend to lower birth rates on the one hand, and the entry of the "baby boom" generation of 1967 and after into the labour force. While it is true that the number of persons reaching retirement age is also increasing faster than the population as a whole, the trend towards increased female participation in the labour market will ensure that growth in the labour force, as statistically measured, will run roughly parallel to that in the working age population.

- while migration in both directions slackens -

Little net input into these figures is expected from emigration or immigration, since these are likely to be fairly balanced. Although in recent years many Israelis, especially young people finishing their army service or university studies, have chosen to go abroad in the face of the weak employment market that has characterised the economy since 1984, the boom of 1986/87 will help to turn this trend around, at least temporarily. Thereafter the US economy is expected to weaken and past experience has shown that there is a close relationship between Israeli emigration and the strength of the US economy, so that the austerity period in Israel foreseen in 1988-89 will not cause as much emigration as might otherwise have been the case. Immigration, however, must be expected to remain at a low ebb, barring unexpected developments regarding Soviet Jewry, since the pattern of economic developments suggests nothing to encourage immigration from the West on any significant scale. Even the resumption of growth in the Israeli economy in 1990-91 will come too late to affect immigration trends in the forecast period, although it will probably have a positive effect in subsequent years. It should also serve to moderate further emigration, despite the recovery expected then in the USA.

- and total employment growth turns sluggish -

Overall labour force participation will be almost unchanged throughout the period as more youngsters and women enter the labour market and more men either retire or leave it, discouraged. The important changes, therefore, will be in the rates of employment and unemployment, as Table 22 shows.

Table 22

Population, Employment and Unemployment, 1986-91
(annual average)

	1986	1987	1988	1989	1990	1991
Population ('000)	4,300	4,373	4,443	4,519	4,591	4,670
% increase over previous year	1.6	1.7	1.6	1.7	1.6	1.7
Aged 15+	2,906	2,970	3,030	3,090	3,160	3,230
% increase over previous year	1.9	2.2	2.0	2.0	2.3	2.2
Civilian labour force	1,472	1,504	1,534	1,563	1,598	1,632
% increase over previous year	1.8	2.1	2.0	1.9	2.2	2.1
% in total labour force	50.6	50.6	50.6	50.6	50.6	50.5
Total employment	1,368	1,399	1,419	1,429	1,454	1,484
% increase	1.4	2.3	1.4	0.7	1.7	2.1
Unemployment rate (%)	7.1	7.0	7.5	8.6	9.0	9.1

Source: EIU forecast.

Employment grew in line with population in 1986, but the labour market showed clear signs of strengthening as the year progressed and by year end vacancies were over 50 per cent higher than at the beginning. Unemployment, meanwhile, had dropped from around 8 per cent in the winter of 1985/86 to below 7 per cent a year later. The strong economy of 1987 will initially boost employment, while only a slowdown towards the end of the year will bring the average unemployment rate back to 7 per cent.

- as unemployment rises sharply and remains high

From that point, however, the employment situation will worsen steadily, as the government is expected to switch the economy into a recessionary pattern to counter rising inflation, laying special emphasis on a shake-out in the inefficient and grossly overmanned public sector. In the first stages of the recession, the private sector will not shed labour, preferring to rest on its experience that downturns are short and sharp and that the cost of underemployed labour in the recession is ultimately less than that of trying to obtain extra staff in the recovery. But the implementation of a consistent government policy whereby state aid will only be granted to firms offering a clear rationalisation programme, will eventually force many firms to cut their work force.

As a result, even when the economy recovers from 1989 onwards, employment will not show strong gains, because firms will be reaping productivity gains and will add staff only when necessary. Unemployment over the coming years will therefore climb to, and then remain at, unusually high levels by Israeli standards, helping to keep real wage rises low or negative and thus easing inflationary pressures. The rise in unemployment will come in two waves, with the first in 1988-89 stemming from dismissals in the public sector, while the second, which will start slightly later, will come from the private sector. Although most of the unemployment should prove frictional, a substantial residue will remain, mainly of older workers whose skills are no longer marketable, or who are unable to acquire new ones.

Productivity growth will be negligible overall

The rate of productivity growth, which many economists see as the key to the Israeli economy's decline in the period since 1973 (see Table 23), will remain very poor. Although the disinflationary environment of 1985 produced the first meaningful rise in four years, the positive performance was not maintained into 1986. Even if, as may be expected, the strong economic growth of 1987 allows output per worker to rise, this improvement will disappear as soon as the strength that caused it comes to an end. Thus 1988/89 will produce little, if any, productivity growth. However, the actual declines that occurred in 1983, 1984 and 1986 will not recur because, as noted above, employers will be shedding excess labour, rather than keeping workers underemployed.

Table 23

Labour Productivity, 1961-91
(% change in output per hour)

1961-72[a]	6.3
1973-85[a]	1.7
1982	0.28
1983	-0.5
1984	-0.1
1985	2.3
1986	-0.3
1987	1.2
1988	0.5
1989	-
1990	1.4
1991	2.0

a Period averages.

Source: EIU forecasts.

The improved economic climate that should follow the enactment of the main reforms in the tax system and the capital markets during 1988 and 1989, and the stimulus provided to the huge state owned corporate sector by the threat and reality of privatisation, may be expected to boost productivity levels in the second half of the period. With investment then picking up into the 1990s and the labour market's rigidities being ironed out, this recovery could gather strength and provide a basis for economic growth beyond the forecast period.

EXPENDITURE ON GDP

Growth in GDP to average 2.6 per cent -

Real GDP growth will follow a straightforward "V" pattern, as the boom of 1986-87 will trigger a sharp reversal in policy that will send the economy sliding into a renewed recession in 1988-89. The enactment, in those years, of a reform programme along the lines discussed in the previous chapter, will enhance the recovery from this recession. However, the tightness of both budgetary and monetary policy until the reforms are in place and the hump of internal debt in the 1988/89 fiscal year is out of the way, will delay the onset of recovery. When the turnround comes, therefore, in 1989-90 it will probably be quite sharp. Yet the background of structural reform will prevent the next expansion from suffering the same fate as that of 1986-87. In the event that investment responds to the more encouraging economic environment envisaged in the early 1990s, there is no reason why growth should not enter a more stable and longer lasting trend.

- as the share of public consumption falls -

The most important trend over the forecast period will be the gradual reduction in the share of GDP taken by public consumption. Although total public consumption will, like private consumption, remain remarkably stable throughout the period, this overall figure masks a downward trend by including the distortive effect of defence imports. These tend to be very volatile from year to year, and thereby conceal the underlying changes.

Table 24

Composition of Expenditure on GDP, 1986-91
(%)

	1986	1987	1989	1991
Private consumption	63	63	62	63
Public consumption	33	39	35	33
of which:				
defence imports	5	12	10	9
Fixed investment	17	17	17	16
Exports	42	43	45	48
Imports	-57	-62	-59	-60
of which:				
civilian imports	-52	-51	-49	-51
GDP	100[a]	100	100	100

a Including stocks equal to 2 per cent. Stocks in other years are less than 0.5 per cent.

Source: EIU estimates and forecasts.

In Tables 24 and 25, therefore, public consumption and imports are given in "before and after" terms, that is to say with defence imports included and then factored out. The justification for this presentation is that, as discussed in Chapter 5, the financing of defence imports comes from US grants, and these tend to move up and down in line with the annual fluctuation in actual purchases. The degree of correlation between defence imports and military aid is high enough to allow the whole item to be treated exogenously in both GDP and balance of payments figures; that is in fact the accepted practice in official statistics and has been used for the forecast. Because projections of year by year spending on military imports are not available beyond 1987, the historic pattern of sharp yearly jumps has been extrapolated on an arbitrary basis. These figures, however, are not strictly relevant and are provided for the sake of completeness. What matters, in terms of economic developments, is the trend in public consumption excluding military imports - henceforth referred to as net public consumption - and civilian imports.

Table 25

Expenditure on GDP, 1986-91
(NIS bn at constant 1986 prices; % change in brackets)

	1986	1987	1988	1989	1990	1991	Average % change 1987-91
Private consumption	25.4	26.5	26.3	26.9	27.7	29.0	
	(12.0)	(4.8)	(-0.8)	(2.3)	(3.0)	(4.7)	2.7
Public consumption	13.4	16.2	14.1	15.0	13.7	15.3	
	(-11.4)	(20.9)	(-13.0)	(6.4)	(-8.7)	(11.7)	2.7
of which: defence imports	2.2	4.7	2.8	4.2	2.7	4.2	
Public consumption net of defence imports	11.2	11.5	11.3	10.9	11.0	11.1	
	(-5.2)	(2.7)	(-1.8)	(-3.5)	(0.9)	(0.9)	-0.2
Gross domestic capital formation	7.7	7.4	7.5	7.2	7.1	7.3	
	(6.8)	(-3.9)	(1.4)	(-4.0)	(1.4)	(2.8)	-1.1
of which: fixed investment	6.9	7.2	7.4	7.1	6.9	7.2	
	(-6.8)	(4.3)	(2.7)	(-4.1)	(-2.8)	(4.3)	0.9
stocks	0.7	0.2	0.1	-	0.2	0.1	
Exports	17.1	18.0	21.5	19.4	20.5	22.0	
	(5.7)	(5.3)	(4.4)	(3.2)	(5.7)	(7.3)	5.2
Imports	-23.2	-26.1	-24.3	-25.4	-24.8	-27.8	
	(9.3)	(12.5)	(-6.9)	(4.1)	(-2.0)	(12.1)	3.7
of which: civilian imports	-21.0	-21.4	-21.5	-21.2	-22.1	-23.6	
	(15.4)	(1.9)	(0.5)	(-1.9)	(4.2)	(6.8)	2.4
GDP	40.4	41.9	421.5	43.1	44.2	45.8	
	(1.1)	(3.7)	(1.4)	(1.2)	(3.0)	(3.8)	

Source: EIU estimates and forecasts.

An example of the distortions caused by the volatility of military imports is provided by the comparison between the breakdown of GDP in 1986 and 1987. In the former year, when defence imports were far below their average level, total public consumption was 33 per cent of GDP and total imports amounted to 57 per cent, while in 1987, when defence imports were high, public consumption is set to run at 39 per cent of GDP and total imports will rise to 62 per cent. Stripping out this factor, however, shows a quite different picture, with public consumption net of military imports slipping from 28 to 27 per cent of GDP and civilian imports showing a similar drop from 52 to 51 per cent.

– under the influence of tight budget discipline

Extending the analysis shows that this trend is maintained steadily over the forecast period, so that by 1991 the share of GDP accounted for by net public consumption will be down to only 24 per cent. In fact, this falling trend began in 1985, after net public consumption had run at a consistent level of 30 per cent from 1980-84, and the achievement of a consistent reduction in public spending will be the major policy gain of the period.

It will stem from the renewal of budgetary discipline in late 1987, after the effects of the overruns in the planned 1987/88 budget begin to show through in higher inflation. The main mechanisms used in achieving this reduction will be the rationalisation of the bloated government work force and the increasing introduction of user costs to finance the provision of services, including health and education. Subsidies, especially to capital, will also be eliminated when the capital market reforms are completed. These measures will push spending down in real terms in both 1988 and, even more sharply, in 1989. A key factor in the push for budgetary stringency will be the need to take the onus off monetary policy, so that real interest rates are not higher than absolutely necessary when the government faces its massive internal debt roll over in the 1988/89 fiscal year. Thereafter, with the tax base having broadened after the passage of the tax reform, and the debt problem surmounted, the government will be able to ease its self-restraint. This will help to push net public consumption up slightly in 1990-91, although still by much less than the expected growth in GDP in those years.

Average private consumption growth will match that in GDP -

In contrast to net public consumption, private consumption will end the period with the same share of GDP as it began it, namely around 63 per cent. The average rate of growth in private consumption will be much the same as that of GDP, but the pattern of this growth will differ. Following the dramatic surge in private consumption in 1986, which will inevitably spill over into 1987, a slowdown would have been inevitable in any event. This process will be exacerbated by the expected switch in government policy, in late 1987 or early 1988, to tackle the rising rate of inflation. Consumers may therefore be expected to pull in their horns and, in the face of high real interest rates, to start reducing the debts they accumulated in their spending spree. Beginning in 1989, however, and spurred by changes in the tax system, private consumption will begin to pick up again, at first at a moderate pace, but by 1991 at a rate that will exceed that of GDP growth.

The next round of tax changes will probably include an end to the anomalous situation whereby personal (but not corporate) unearned income is tax free. The December 1986 reform plan included proposals to tax interest from short term deposits, employers' contributions to provident funds and stock exchange activities - either through a straight turnover tax or a capital gains tax - but these were rejected. Next time around the outcome will probably be different, and this will cause a shift in household resource allocation that will lower savings and increase consumption, at least in the short term. This will lead to an increase in private consumption in 1989, a year in which GDP is expected to remain almost flat.

- while capital formation will be distorted by volatile stock movements -

Investment will contribute little to economic growth for most of the forecast period. 1986 represented the third successive year of declining fixed investment, a fall that was masked in the figure for gross domestic capital formation by an unusually high level of stock building. This development, in turn, came as a reaction to the frantic destocking that occurred in the second half of 1985, when real interest rates were running at a level of 60-100 per cent per annum. As these rates fell in 1986, and economic activity rapidly increased during the year, stock building took off. However, this must be seen as a once only phenomenon.

In general, inventory trends in the Israeli economy are hard to predict, because they are dominated by factors exogenous to the trade cycle. In the case of military items, this is obviously the case, and even measurement of stock levels is complicated by the significant lag before data become available, while future plans are a closely guarded secret. But even within the civilian sector, several vital components are not amenable to normal analysis. Thus, fuel and grains represent two areas in which the government controls imports and maintains strategic stocks, fluctuations in which are determined by a number of factors, including expected price trends, budgetary considerations and the level of foreign currency reserves. For example, in the summer of 1986, with oil prices below $10/barrel and with the government running an operating budget surplus and having record levels of currency reserves at its disposal, large scale purchases were made in what was, by any calculation, an excellent investment, but one that had a dramatic effect on stock figures, quite out of proportion to the normal level of economic activity.

Diamonds, too, may be stockpiled by the Israeli industry in response to trends in the diamond industry, of which Israel is a world centre, and whose cycle is determined primarily by consumer demand in the USA. Only industrial raw materials follow the domestic business cycle, so that the relatively small overall changes in stocks projected in the central forecast represent only rough estimates. Over the medium term, of course, even the exogenous fluctuations cancel themselves out, but it is worth noting that year by year changes alter total GDP for that year, although not usually by significant amounts.

- but underlying fixed investment will be sluggish -

Fixed investment enters the forecast period overdue for a cyclical rebound. However, the resurgence of inflation and other negative features in the economy will dampen the enthusiasm of would-be investors, while the partial tax reforms legislated during 1987 will do little to rekindle it. In the background, the impact of the US tax reform, and any imitations it might spawn in other countries, will further detract from Israel's position as an attractive place in which to invest.

The investment upswing of 1987-88 will therefore be a sedate affair, with caution easily getting the upper hand over bravery in most corporate boardrooms. The reduction in corporate taxation will be used, first and foremost, to help restructure corporate balance sheets and reduce the burden of short term indebtedness. Only then will investment in new plant and equipment be considered.

The move to austerity in 1987-88 will put investment programmes back in the freezer, and the government's need to recycle record quantities of internal debt in 1988 will keep the cost of long term capital high enough to keep them there until better prospects beckon for business. Another blow will be delivered by the reduction of savings levels that, as noted, may be expected to follow the taxing of personal unearned income. On top of this will come the government's belated conversion to the idea of selling off state owned companies, which will soak up a good proportion of the savings still available and, at least temporarily, crowd out large non-government firms from the equity market. For all these reasons, total fixed investment is projected to fall again in 1989-90 and not to start rising until the last part of the forecast period. From that point, however, with the capital markets rationalised and access to capital at home and abroad permitted under a more liberal set of monetary and exchange control regulations, the way should be clear for a prolonged and substantial rise in investment.

- more so in construction than in plant and equipment

However, within overall fixed investment, the divergent trends of investment in residential and non-residential construction on the one hand, and in plant and equipment on the other, will continue. Demographic trends - particularly the drying up of immigration and the increase in emigration - have resulted in a prolonged decline in new building of all sorts, and government budget cuts hit particularly hard at this sector in 1984-86. Some NIS 7 bn of fixed investment in 1986 was split 40:60 between construction and plant, and the first component has been falling steadily throughout the 1980s, with the decline in residential investment far outpacing the decline in non-residential construction. In sharp contrast, investment in plant and equipment rose in 1981-83, fell in 1984 and was almost unchanged in 1985 and 1986.

The demographic outlook provides no reason to believe that the downward trend in residential investment will change in the coming years, while another bout of austerity and budget cutting will do little to help non-residential construction. Even assuming a recovery in the latter component in the second half of the forecast period, as the government puts a higher priority on road building and other infrastructure construction projects, the total level of investment in construction is expected to fall by 8-10 per cent by 1991, or from NIS 2.75 bn to about NIS 2.5 bn in constant 1986 prices. Only in 1987 is a small increase likely, as a response to a temporary recovery in demand; thereafter the main trend will reassert itself.

This will be offset by increasing investment in plant and equipment of some 12 per cent over the whole period, with the main rises occurring in 1987-88 before recommencing in 1990 and rapidly gaining momentum thereafter. Because some government subsidies to capital were eliminated in 1985-86 and the price of capital has been rising since 1983, the feature of previous investment booms, in which many decisions were made on the basis of distorted or unreal calculations, will not be repeated and the bulk of investments made will be economically justified. The phenomenon of the 1970s, when the government poured funds into areas and industries which had no long term viability, will become much rarer, and the average return on equity will be much healthier.

Exports will rise slightly faster than world trade -

The investment background, and the selectivity which will characterise the choice of investment projects, help to explain the positive showing of exports compared with the rest of the economy. In fact, the resources released over the forecast period by the steady decline in net public consumption will flow to exports via increased investment in plant and equipment. Although the scale of this switch will be limited and the pace slow, the cumulative effects will be important and they should lay the basis for more rapid growth in the 1990s, when the results of the expected reforms will become more apparent.

The pattern of total export growth will follow that of both the domestic and world economies, and will reach a low point in 1989 - a year when world trade is expected to shrink under the impact of a poor economic performance by the USA. Thereafter it should recover quickly (see EXPORT AND IMPORT SECTORS).

- while imports follow domestic developments

Imports, on the other hand, will be mainly affected by domestic policies. This represents the great good fortune of the Israeli economy in the wake of the oil price slump and the generally depressed level of commodity prices. The outlook for these prices, and for Israel's overall terms of trade, is for the dramatic improvement of the last few years to be maintained, with further slight improvements in the first half of the forecast period, followed by a worsening in the second half, as oil prices pick up and manufactured goods prices rise more slowly than commodity prices.

This allows the government to exercise primary influence on the rate of import growth and hence on the country's import bill. In view of the huge rise in imports in 1986, and the spillover of this trend into 1987, there can be little doubt that the government will seek to use this ability to stop the deterioration of the balance of trade. This will remain a dominant consideration throughout, and will be part of the rationale for the policies regarding the budget, the exchange rate and wages. It is expected that the restrictive economic policy that will be in force in 1988/89 will succeed in bringing the civilian trade deficit down from $2.9 bn in 1986 to $1.8 bn by the end of the decade, although economic expansion and the rise in import prices will bring this improvement to an end in 1991.

PRICES, DEVALUATION AND WAGES

The lessons of recent years will be applied -

Given its intensive experience with the problems of inflation, accumulated over the last 15 years, it would be rather surprising if Israel allowed itself to slip back into the hyperinflationary instability from which it emerged in 1985. Economists are still sharply divided over several policy considerations, in particular the desirability of using the exchange rate as an "anchor" for the rest of the economy, as was done under the ESP in 1985/86. But on the importance of the budget deficit and its role in pushing the inflationary cycle along, or at least enabling other factors such as wages to do so, there is a clear consensus.

The public, which has its own level of sophistication based on hard empirical evidence gathered in everyday activity, will not treat seriously any anti-inflation plan that does not involve reduced government spending. It has also learnt to regard the exchange rate as the bellwether of stability. Furthermore, all the evidence of all the anti-inflation plans ever tried in Israel points to the conclusion that real wages cannot be pushed down very much over anything except the very short term. Even then, as 1985/86 proved so powerfully, the greater the temporary erosion inflicted on real wages, the stronger their recovery thereafter. It would also seem that a policy aimed at holding real wages steady - as distinct from trying to reduce them - can only succeed when the labour market is weak.

- after being re-emphasised in 1987 -

All these lessons will be reinforced by the events of 1986/87, when the ESP broke down, as described in Chapter 7, and the budget framework was breached. Perhaps a basic mistake in government policy was to maintain for some time that no devaluation was being contemplated, before finally executing one and then seeking to persuade the public that it was merely a corrective move to restore relative prices - which indeed it was. Had this been clear earlier, the devaluation would not have been perceived as signalling the end of stability, and the pattern of expectations and the behaviour of consumers and manufacturers in its wake would all have been far more moderate.

Table 26

Rates of Inflation and Devaluation, 1986-91
(annual % change)

	1986	1987	1988	1989	1990	1991
Consumer price inflation	20	40	25	10	12	15
Devaluation against a basket of currencies	-	30	25	10	8	15

Source: EIU estimate and forecasts.

The outlook for 1987 is therefore for inflation to work steadily higher and probably double compared with the 20 per cent annual rate of 1986. A series of small devaluations will be forced in the wake of this rise in local prices, but the ground lost in 1985-86 will not be made up. Export performance has been sufficiently good overall to allow the government to use a slow pace of devaluation to help moderate the pace of imported inflation, while at the same time shaking out the export sectors and forcing many firms to shape up or get out of business. This painful process began in 1985-86 and will continue for years, with important medium and long term benefits for the economy, although the short term effects are obviously negative. In this connection it may be noted that the fact that it was the export sectors that successfully lobbied for the January 1987 devaluation, which ended the ESP and set the inflationary spiral in motion again, will make it more difficult for them to repeat that success when a new policy aimed at reducing inflation and restabilising the economy is introduced.

- leading to a new anti-inflation programme for 1988/89 -

By the second half of 1987 the internal situation will force the government to introduce new austerity measures. However, the extent and even the exact timing of these steps will depend on political developments within the coalition, and specifically on the date of the next election. Even if delayed, it may be expected that the austerity package will be in place by no later than the first part of 1988 and will dominate the next two years. As in 1985 the success of this policy will be aided by exogenous factors, such as a renewed fall in oil prices, and very moderate price increases on non-oil commodities (see Table 19 in Chapter 6). But the main factor will be the imposition and execution of a tight budgetary policy, and this will be supported by high real interest rates aimed, in part, at facilitating the recycling of the internal debt in the peak year of 1988.

Another factor that will aid this policy will be cyclical. Whereas the 1985 ESP followed 18 months of falling private consumption, especially of imports, the next anti-inflation package will terminate the tremendous boom in these areas that took place in 1986-87. In other words, at precisely the time when consumption and imports would have been naturally slackening off, government policy will depress them further. This will be the primary cause of the recession of 1988-89, and against the background of a slack level of economic activity, inflation should drop to about 10 per cent, and may even reach single figures.

The strengthening economy in 1990-91, and the rise in oil and other import prices in those years, will inevitably lead to an increase in the rate of inflation. However, the amount of locally generated price pressure should by then be quite low, and continued budget discipline, coupled with the higher rate of unemployment that will then exist and dampen wage pressures, ought to be enough to prevent any significant resurgence of inflation along the lines of events in 1986-87.

- while devaluation is kept in line with local price rises

The rise in inflation in 1987 will, as noted, force several small exchange rate adjustments that will keep import and export prices more closely aligned with internal price developments than was the case in 1985-86. But these will be clearly labelled as adjustments, and will not seek to achieve more than that aim. The weakness of the economy in the following years will allow the government to pursue a slightly more aggressive devaluation policy, so that it will fully adjust exchange rates to the rise in the consumer price index, albeit on a lagged basis, without the fear that all the price rises generated by these devaluations will be fully passed on into the internal price mechanism. Thus, in effect, there will be a small real devaluation against most other currencies in those years, which will encourage exporters and help them expand while their local markets are depressed.

Once the economy picks up again, after 1989, the rate of devaluation will have to be eased, because it will have inflationary repercussions, and exporters will have to make do with the general growth in world trade and the gains of the previous years. The expected jump in oil prices in 1991 will leave the government no choice but to devalue at a faster pace than it might otherwise want. In that year the exchange rate might come to lead internal price increases, rather than following them as it will for the rest of the period.

Wages will be restrained by the recession and structural change -

The failure of most of the anti-inflation policies of the last 15 years, including the ESP of July 1985, stemmed ultimately from the ability of real wages to make up any ground lost in the initial bout of austerity. This fact reinforces the argument that better results would be obtained if an austerity programme sought to have a smaller initial impact on the labour market, and instead to sustain the pressure for longer, while at the same time other policy measures sought to relax that market's structural rigidities. The key to restraint in real wages is therefore to be found in a combined strategy of budget cuts based on public sector rationalisation including manpower cuts, coupled with a firm and consistent line regarding government assistance to private sector entities.

- as the government comes under pressure to maintain a firm line -

In both of these areas the government suffers from its poor record in translating its frequently announced intentions into reality. However, a renewed crisis in 1987/88 would provide two sources of counter pressure on the government to help it stand up to the inevitable pressures exerted by sectors in distress and by the social and political effects of growing unemployment. One is the likely backlash to higher inflation, and fears of a return to the chaos of hyperinflation, which would give the public a higher "pain threshold" regarding austerity than was the case before 1985. In particular, if ministers and their departments set a clear example of cost cutting, even on symbolic matters with little budgetary significance, a great deal of potential opposition to budget cuts would be diffused.

The second could be even more important. The growing influence of the USA in Israeli economic policy making during the 1980s was noted in Chapter 4, along with the importance of the $1.5 bn in emergency US aid given in 1985/86, which played a vital role in stabilising Israel's external position. The impressive economic performance achieved in the wake of the implementation of the ESP brought much relief to both the Reagan administration and to Congress, but the gradual deterioration during 1986-87 renewed doubts about the long term efficacy of the strategy the Israeli government had adopted. In particular, the failure of the economic reforms proposed in December 1986 quickly became a source of concern to those US officials who closely follow the Israeli economy.

In the event that the Israeli government is forced to admit that its strategy has failed - as it would at least tacitly be doing by introducing a new anti-inflation policy - it is very probable that the USA would exert strong pressure on Israel to adopt a more radical, and perhaps harsher, approach than it has hitherto been willing to do. In these circumstances it might be very hard for Israel to refuse these US suggestions, however diplomatically they may be phrased.

- and will seek to separate different groups of workers -

Thus bolstered in its resolve, the government will be able to apply a policy aimed at keeping real wages steady, while changing the labour market mechanism which determines wage rates in different sectors. It is therefore expected that, after their sharp gains in 1986 and expected further improvement in 1987, real wages will enter a period of overall decline when the government moves to slow the economy down. Initially, budgetary and monetary policy will act to depress gross real wages across the board, although net incomes will benefit from the tax reform of 1987, which will partially absorb the blow. In the subsequent period, which will begin after the next elections, the new government will have to adopt policies regarding both the budget and public sector wages, as well as towards requests for assistance to the private sector, based on a clear set of priorities. Even if these become blurred under the pressure of day to day events, they will still have an important effect on the behaviour of the government itself and on non-government bodies such as unions, employers and other pressure groups.

The crucial period will therefore be 1988-89, when the domestic economy will be in recession and the world economy - especially in the USA - will be slowing down. At this time, when the next government will be engaged in implementing a series of economic reforms, it will be able to address one of the basic structural problems of the economy, namely the interlinking of different sectors of the labour market which causes the wage gains of one group or sector to spread rapidly throughout the whole economy. Along with the abolition of many tax exemptions giving preferences to specific groups or sectors, the government will be able to reduce the personal tax burden and, more importantly, establish closer links between real wage gains and productivity increases, while breaking the almost automatic linkage between wage rises in different sectors. A privatisation programme could also be a factor in changing attitudes within the public sector, involving higher real pay for fewer workers producing greater output. In the private sector, the rigid implementation of a formula tying any form of government aid to the preparation and implementation of an approved recovery programme for the entity in question will be the best way of achieving and maintaining the required impression of firmness.

- although indexation will remain for nominal wage adjustments

One basic element of the wage structure that is unlikely to be changed is the system of cost of living adjustments. These will probably continue to run at a level of around 70 per cent of the rise in the consumer price index, so as to leave scope for union/employer wage bargaining and flexibility at the national, industry and workplace levels. It is the redistribution of real wages within the market, making wage levels more responsive to supply and demand in each industry and sector, rather than the size of the overall erosion in real wage levels or the system of nominal adjustment in a traditionally inflationary economy, that should be the dominant feature of this period. This will represent an intensification of trends already present in the economy since 1983-84, but this time encompassing many more areas. If successful, it will continue into the recovery years of 1990-91, in that sectors benefiting more from the recovery will pass this on in higher real wage rises than those given in other sectors.

EXPORT AND IMPORT SECTORS

Economic restructuring centres on export led growth -

The central forecast sees the resources released from net public consumption flowing primarily to exports, while within the export sector firms will be forced to use these resources more efficiently because most export subsidies have been abolished and their access to credit on favourable terms is being steadily reduced. Faced with a home market that is growing more slowly than either potential or existing overseas markets, it is assumed that the corporate sector will take up the challenge of broadening export activity. That this challenge can be successfully met is proven by the record that Israeli industry has built up over the years for flexibility and initiative in identifying niches in a wide range of industries, and then producing the goods and services to exploit them.

- through nimble exploitation of niches

Most industrialists enthusiastically accept this concept of Israel as a niche economy and believe they can deliver the goods, both literally and metaphorically, for themselves and the economy as a whole. But this will only happen if tax and capital market reforms are introduced that make it worthwhile to work and possible to raise capital at competitive prices. The government, for its part, recognises the need for this quid pro quo, and the fact that the corporate tax reforms proposed in late 1986 were less mauled than the personal ones, and the capital market reform least of all, gave grounds for hope that the process of reform had at least begun.

1986 was a year of reorientation -

The relatively poor performance of exports in 1986, at least compared with initial expectations, may be attributed to a number of factors. In the first place, the world economy did not respond as vigorously to the fillip provided by lower oil prices as had been thought probable at the beginning of the year. More specifically, the effects of the dollar's slide at a time when Israeli industry had been gearing itself for a major push into the US market and the need to adjust to the abrupt switch to the new policy introduced in July 1985 - especially the frozen shekel/dollar exchange rate - as well as the difficulties caused by higher taxation and very high financing costs, all combined to force companies to reassess their plans. At the same time, the boom in the home market that gathered pace during 1986 made export expansion, which is always a tough task, much less urgent than it had been in 1984/85.

Table 27

Exports of Goods by Sector, 1982-86
($ mn)

	1982	1983	1984	1985	1986a
Agriculture	552	504	529	469	554
Industry (excl diamonds)	3,510	3,357	4,009	4,311	4,600
of which:					
metals, machinery & electronics	1,559	1,394	1,760	1,924	2,179
rubbers & plastics	107	118	142	146	182
chemicals	647	644	750	835	778
food	343	316	372	383	322
textiles, clothing & leather	353	344	373	379	463
Diamonds (net)	905	1,001	1,035	1,263	1,665
Total (incl other)	4,990	4,890	5,622	6,080	6,920

a Preliminary.

Source: Central Bureau of Statistics.

Most specifically, certain key sectors suffered from unusual problems. The electronics industry was dragged down by the worldwide slump in semiconductors, computers and allied areas. In the service sector, tourism had a terrible year because of the sharp decline in North American holiday travel in general, and to the Middle East in particular, due to fear of terrorism. In this connection, it should be noted that although official receipts from tourists actually rose, because the stable exchange rate killed off the black market and funnelled foreign exchange through the banks instead, this statistic is quite misleading. In fact the total amount of foreign currency entering the economy from tourism, even if illegally, was much lower because the volume of tourism fell significantly, with the top end of the market, dominated by high spending North Americans, plummeting by almost 50 per cent.

- but the longer term trends look solid -

However, the longer term trends of sectoral and geographical distribution of exports, illustrated in Tables 27 and 28, demonstrate which industries and countries have been responsible for most of the merchandise export growth of recent years and suggest that the coming years are likely to witness a continuation of these trends. Although the fall in the dollar makes exporting to the USA relatively less profitable compared with Europe, the advantages accruing from the Free Trade Agreement with the USA, together with the much greater interest being shown by both the US government and the US Jewish community in buying Israeli products and in helping to boost Israeli exports to the USA, will go far in counterbalancing this factor.

Table 28

Geographical Distribution of Exports[a], 1980-85
(% of total)

	1980	1981	1982	1983	1984	1985
Europe[b]	52	45	42	45	42	40
North America	13	17	18	21	24	29
Rest of world	35	38	40	34	34	31
Total	100	100	100	100	100	100

a Excluding diamonds. b EC and EFTA.

Source: Bank of Israel.

- and a broader US-Israeli partnership is possible

Israeli industry is perceived by many US businessmen as being sophisticated in its research and manufacturing, but backward in its marketing and service aspects. The makings of a mutually beneficial partnership are clearly available, if the missing factors, of stability in the nominal economic variables and a clear and consistent tax and investment policy, could be provided.

The electronics industry is likely to remain in the vanguard of export growth, with increasing investment by US companies in Israel and in coproduction agreements or other forms of cooperation between companies. As the world electronics industry recovers from its slump, and the new crop of Israeli high tech companies in computer assisted design and manufacturing, robotics, telecommunications, software and numerous other sectors reaches maturity, this sector will be ready for its next great leap forward. It should be recalled that in 1973, electrical and electronic goods were exported to the value of $15 mn, and that most industry experts are convinced that only now is the financial and ancillary infrastructure of this sector sufficiently advanced to support export levels of $1 bn or more. Nor are they worried at the crises that have struck the leading corporations of the previous generation; they regard this as a natural development in sectors where both rise and fall are breathtakingly fast.

In fact, the metals and electronics sectors were already showing clear signs of recovery by the second part of 1986, and final figures for the year are likely to show an increase of 16 per cent in constant price terms, or nearly double the growth achieved in 1985. Compared with the previous setback in these areas in 1982-83, when volume growth was 0.3 and -8.4 per cent respectively, it is clear that 1985-86 represented a tailing off of growth rather than a genuine slump. Furthermore, since several leading electronics firms are known to have done badly and the metals sector to have been worse hit still, it is clear that the next generation of growth in the electronics sector is already under way.

Meanwhile, low tech developments in the more traditional sectors, such as food, chemicals and textiles, have enabled companies to expand into new markets. Whereas the high tech industries will benefit most from the interest of the US government, it is in these sectors where Diaspora Jewish businessmen are forging alliances with their Israeli counterparts to market, or even coproduce. Disappointingly, food exports actually dropped in 1986, by 11 per cent in constant price terms, after rising 15 per cent in 1984 and 8 per cent in 1985. One possible explanation for this is the competition from the home market, and another is the problem of competitiveness in foreign markets under a fixed exchange rate regime. Chemicals, on the other hand, which have a limited home market but face tough competition abroad, nevertheless achieved constant price export growth of 5 per cent in 1986, after 7, 16 and 12 per cent rises in the three previous years. Most dramatic by far though, was the 45 per cent increase in volume scored by the textile, clothing and leather sector in 1986, which decisively snapped the run of three years of minor gains and losses in exports. This sector, together with diamonds, which benefited from the ongoing boom in that industry and agriculture, which took advantage of the freezing European winter of early 1986 to achieve a bumper year, were the surprise successes of 1986. Even so the major growth potential for long run development must be regarded as being with the metals, machinery and electronics groups.

Finally, tourism should bounce back to at least the volume it achieved in 1985, which would mean much larger price growth than occurred in 1986. Looking further ahead, there seems no valid reason why this industry, which seeks to exploit several of Israel's obvious advantages, such as climate, cultural and historical interest, and of course the religious heritage of Jews and Christians, should remain the Cinderella of the country's export sector, as it has for so long. Nor should 1.5 mn tourists a year be regarded as a major achievement, when far more could easily be handled if the industry were better organised and financed.

The import boom of 1986 should prove unsustainable -

With exports growing in 1986, and the added boost of $700 mn saved on oil imports, the deterioration in the trade balance in that year clearly stemmed from sharp growth in other import sectors. Table 29 illustrates just how significant this growth was, and also shows that imports surged in every category. In percentage terms, the area of consumer imports registered by far the largest gain, and within this group, consumer durables showed even greater rises, in the order of 100 per cent overall. But in sheer quantity, the 24 per cent growth in imports of production inputs other than diamonds and fuel headed the list. A rather more positive development was the 13 per cent rise in investment goods imports in 1986, the first rise in three years, and a sign that some economic sectors were expecting longer lasting growth.

Table 29

Commodity Imports by Main Economic Destination, 1981-86
($ mn; % change in brackets)

	1981	1982	1983	1984	1985	1986
Consumer goods	756	832	953	656	620	1,022
	(39)	(10)	(15)	(-31)	(-5.5)	(65)
Production inputs						
net diamonds	529	571	782	880	1,169	1,598
	(-53)	(8)	(37)	(13)	(33)	(37)
other inputs[a]	3,508	3,374	3,398	3,532	3,484	4,314
	(11)	(-4)	(1)	(4)	(-1)	(24)
Investment goods[b]	867	1,225	1,583	1,412	1,412	1,597
	(1)	(41)	(29)	(-12)	(-)	(13)

a Excluding fuel. b Excluding ships and aircraft.

Source: Bank of Israel.

- especially in the consumer sector

The scale of the 1986 imports boom, which became almost an explosion in the later months of the year, is clearly unsustainable. Consumer goods imports were most obviously the sector involved in catching up from the long recession they had suffered since late 1983, and they were assisted by the sharp rebound in real wages during 1986 and the unusually low exchange rate that resulted from the ESP policy of fixing the dollar-shekel rate. Neither of these factors will be available to the same extent in 1987, and they are expected to be reversed in 1988-89. The likelihood, therefore, is of a roller coaster cycle in consumer imports, with the boom tailing off during 1987 and giving way to possibly sharp falls in the following two years, before recovering in 1990-91.

Diamonds and fuel imports are determined exogenously

The two exogenous factors of diamonds and fuel imports will be determined by developments in their respective international markets. Oil prices are not expected to rise significantly until the end of the forecast period, and Israel has already demonstrated its ability to take advantage of short term price fluctuations on the oil market to cover the country's requirements, which are modest by international standards and allow effective use of the spot market as a supplement to long term contracts with Egypt and Mexico. Diamonds represent a quite different category, because they are imported only to be subsequently exported, and therefore do not represent a net debit on the balance of trade. The slump in the industry in 1980-82, which caught many Israeli firms with speculative stockpiles, has had a lasting impact on both the industry itself, which has been shaken out and now operates more cautiously, and on the banks which provided finance and which now tend to be more cautious still. For these different reasons, neither of these sectors is thought likely to inflict damage on the balance of trade in the coming years.

Industrial and investment inputs will follow domestic economic trends

The amorphous "other inputs" will therefore be the key to trends in overall imports. It may be expected to follow the pattern of the general economy, and will therefore be vulnerable to government moves to cool off the pace of activity, which are forecast for late 1987 or early 1988. The extraordinary growth rate of 1986 is unlikely to be maintained through 1987 in any event, and thereafter the austerity period of 1988-89 will probably cause a decline, although not necessarily of great magnitude, before levels rise again in 1990-91, in response to the renewed expansion of the economy. Throughout the period, the greater alignment of devaluation policy to internal price rises will prevent relative prices moving out of line as they did in 1986, and thus create a disincentive to speculative purchases based on exchange rate considerations.

Imports of investment goods will probably rise again in 1987, if by a smaller margin than in the previous year, as firms react to the boom in the local market of 1986-87 by ordering new capacity and updating obsolete equipment. The change in the economic climate to one of recession in 1988-89 will reverse this trend, and only with the expected enactment of a reform programme in those years, and the subsequent pick up in activity, will investment, and hence imports of investment goods, begin to climb again in the last part of the forecast period.

THE BALANCE OF PAYMENTS AND FOREIGN DEBT

The civilian deficit on goods and services will average $2.1 bn -

As with GDP figures, so with the balance of payments, the distorting effect of military imports must be factored out before tracing the development of the economy. In the context of the balance of payments, the key variable is the civilian trade deficit, and this is forecast to fluctuate over the forecast period between $1.8 bn and $2.5 bn. The total trade deficit is obtained by adding in military imports, and therefore shows much greater volatility, rising for instance from $4.1 bn to $5.3 bn between 1986 and 1987, before slumping to $3.6 bn in 1988 and reaching as low as $3.4 bn in 1990. These forecasts cannot pretend to be accurate as the future flow of military imports from year to year is not predictable; nor do the totals matter, given that almost the entire military import bill is directly covered by US government military aid, which is part of unilateral transfers. The civilian trade deficit, however, is a crucial factor in determining the economy's performance and in influencing the course of government policy.

The significant deterioration in the civilian deficit in 1986, to $2.9 bn from $2.1 bn in 1985, reversed the sharp improvement recorded in 1984 and 1985 which had halved the 1983 deficit of $4 bn. It came despite the very favourable turn in the terms of trade, in which the collapse of oil prices played a major role. The main cause was the surge in imports, which was a response to the sharp rise in real wages and no doubt a release of pent up demand following almost two and a half years of falling consumer imports. On the export side, several factors, which will be analysed separately, caused a slower than expected growth rate, although the overall increase of 5.7 per cent was by no means entirely unsatisfactory.

One element behind the widening trade deficit was undoubtedly the change in relative prices that stemmed from the stable dollar/shekel exchange rate mandated by the ESP. This began to change with the devaluation of January 1987 and it is expected, as noted above, that the forecast period will see a close alignment between the rates of inflation and devaluation, with a small real devaluation being achieved in 1988-89. This will therefore be an important factor in the shrinking of the civilian trade deficit over the period as a whole, although the expected budgetary policy and especially the deliberate slowdown that the government will impose from 1987-88 will be paramount in depressing civilian imports from late 1987 through early 1990. Another positive force at work over the period will be the weakness of the dollar which, given that most Israeli imports are dollar denominated while most exports go to non-dollar countries, will improve the trade figures as reflected in current dollar prices.

Table 30

Balance of Trade, 1986-91
($ mn; current prices)

	1986	1987	1988	1989	1990	1991
Total exports	11,943	13,300	14,445	14,918	15,923	17,244
merchandise exports	6,865	7,832	8,573	8,751	9,412	10,264
exports to occupied territories	775	733	710	735	759	792
interest	812	850	805	904	815	785
other services	3,491	3,885	4,357	4,528	4,937	5,403
Total imports	14,819	15,790	16,520	16,680	17,710	19,540
fuel imports	924	972	913	890	960	1,176
other merchandise imports	8,356	9,123	9,695	9,732	10,430	11,581
imports from occupied territories	279	257	205	180	210	233
statistical adjustments	-910	-945	-890	-920	-930	-1,040
interest	2,579	2,539	2,460	2,658	2,500	2,615
other services	3,591	3,844	4,137	4,140	4,540	4,975

Source: EIU estimates and forecasts.

The discrepancy between the value of 1986 imports in dollars in the balance of payments figures in Table 30, and that given in the shekel equivalent in the national accounts figures in Table 25, stems from different accounting conventions for the two series. Import statistics in the balance of payments include interest payments, but exclude taxes on imports, while the reverse is true for the national accounts. Another, more minor, contributory factor is that the two sets of preliminary official figures for 1986 were prepared several weeks apart, and therefore reflect slightly different data collections.

- which will be covered by unilateral transfers -

The average amount of unilateral transfers in the forecast will be some $4.5 bn. The absolute level of US aid has been assumed to remain stable at around $3 bn a year, or at the same level of 1985-87, exclusive of the $1.5 bn emergency aid grant, which was intended as a one time grant. The composition of this sum has been $1.2 bn civilian aid and $1.8 bn military aid, and this is also not forecast to change. Their respective uses, as noted, are to pay the interest on previous US aid taken in the form of loans (until 1984), as per the schedule laid out in Table 34 (Chapter 9), and to pay for military imports. However, while the quantity of US aid is not expected to change, its "quality" is expected to improve. The ability to use larger amounts of the military aid grant on local defence purchases is likely to increase somewhat, providing greater flexibility, and the awarding to Israel of the status of "non-Nato ally" gives notable advantages in the price of some weapons systems, sometimes to the extent of 20-30 per cent. Additional effective aid could be made available through such buyback arrangements as the purchase of port facilities in Haifa for US Sixth Fleet ships, or even the building of warehouses and other pre-positioning facilities for US military equipment in Israel. In the latter case, in addition to the direct export of goods and services sold in the construction and maintenance processes, Israel would benefit by being able to reduce its own stockpiles of items held in the US stores, and rely on these being lent to it in case of emergency. Pentagon authorisation for the spending of more US defence budget funds on buying Israeli produced equipment, thereby boosting Israeli military exports, represents another channel for reducing the net impact on the balance of payments of the burden of military imports.

Table 31

Balance of Payments Current Account, 1986-91
($ bn; current prices)

	1986	1987	1988	1989	1990	1991
Exports	11.9	13.3	14.4	14.9	15.9	17.2
Civilian imports	-14.8	-15.8	-16.5	-16.7	-17.7	-19.5
Civilian balance	-2.9	-2.5	-2.1	-1.8	-1.8	-2.3
Military imports	-1.2	-2.8	-1.5	-2.3	-1.6	-2.2
Unilateral transfers	4.8	5.2	3.9	4.7	4.1	4.5
Current account balance	0.7	-0.1	0.3	0.6	0.7	-

Source: EIU estimates and forecasts.

Other unilateral transfers are expected to grow slowly in current dollar terms over the forecast period. These include, as illustrated in Table 4: personal restitution payments from West Germany, where the decline caused by demography has been reversed in dollar terms by the rise in the Deutschemark; other private remittances, which will fluctuate around $400-500 mn a year, depending on the availability of opportunities in the Israeli economy in the areas of financial, residential and other direct investments; and the flow of institutional remittances of $600-700 mn annually.

- leaving a small surplus -

As a result, the government will achieve its main aim of avoiding a crisis in the balance of payments, and hence in foreign currency reserves. In fact, the balance of payments should run a small surplus in most of the period, with 1987 slipping into the red mainly as the result of an unusually high level of military imports, and the 1991 figure reflecting strong growth in civilian imports as the economy expands strongly and oil prices recover on the international market.

- which could be distributed in various ways -

The existence of a current account surplus was itself almost unprecedented in Israeli history until 1985. The prospect of continuing surpluses presents policy makers with entirely new choices regarding how to divide the surpluses between competing uses. The options include paying down foreign debts, improving the level of foreign exchange reserves and allowing more foreign borrowing by the corporate sector overseas. Initially, in 1985-86, the policy of seeking to reduce total foreign debt, especially by paying off expensive short term loans, was given precedence, so that by the end of the third quarter of 1986, the public sector had only $52 mn of short term debt outstanding. At the same time, the level of foreign currency reserves was boosted, to reach the record amount of $4.1 bn at the end of 1986. The oil stockpiling operation of summer 1986, mentioned earlier, represented the first case of the more aggressive application of a healthier reserves position to achieve other aims.

At the same time, however, ideas began to circulate as to the desirability of allowing foreign borrowing again, after a three year hiatus, since the price of capital abroad was cheap both in absolute terms and also relative to its price in the Israeli capital market. A transfer of borrowing from home to foreign markets would also ease demand on the home market and help bring interest rates down more quickly. These ideas found expression in the proposals for capital market reform, and may be implemented at least to some extent, starting from fiscal year 1987/88 beginning April 1, 1987.

- although a cautious approach has been assumed

The forecast, however, assumes that foreign borrowing will remain at a low level, and that capital inflows and outflows will be in rough balance. The real level of foreign debt will therefore continue to fall slowly, although this process will be distorted by the effect of the dollar's fall, which pushed up the dollar value of non-dollar denominated debts in 1985-86 and will continue to do so in 1987 and 1988.

Table 32

Capital Account, Reserves and Foreign Debt, 1986-91

($ bn; current prices)

	1986	1987	1988	1989	1990	1991
Current account surplus	0.79	-0.1	0.3	0.6	0.7	-
Net long term capital inflows (+) or outflows (-)	-	0.2	0.1	-0.3	-0.2	-0.4
Short term capital movements	0.3	-0.1	0.1	-0.3	-0.1	0.1
Foreign exchange reserves (end year)	4.1	4.1	4.4	4.5	4.9	4.5
Foreign debt	24.4	24.9	24.8	24.4	23.9	23.4

Source: EIU estimates and forecasts.

Should this turn out not to be the case, it will be the result of a deliberate policy decision to prefer foreign to domestic borrowing, rather than an unforeseen development. One rationale for such a decision might be that domestic savings were not sufficient to provide the resources needed for extra growth, in which case the government would move to ease its restrictions on the import of capital at a faster pace than previously planned. It is not expected that the Israeli government or banking system will have any difficulty raising loans through the international banking system, since Israel's existing medium and long term loans are overwhelmingly from the US government, and to a lesser extent from Diaspora Jewry, while the net obligations of the banking system are more than outweighed by its large short term net lending position in the international markets. A country with a flawless debt servicing record, an improving external payments position, a net lending position in the financial markets and a massive pipeline into the US Treasury may be expected to have no difficulty raising medium term investment funds, especially when banks are looking for good lending risks to which to increase their exposure.

Another development that may take place within the capital account, although not necessarily change the picture of net inflows and outflows, would be if the government made an effort to sell state owned companies to foreign investors, as well as or even in preference to local ones. This might feature in a privatisation programme that should be expected to begin in 1988/89. The proceeds from these sales would almost certainly be applied to the reduction of foreign debt, so that the net impact would probably be small, but the underlying capital flows in both directions would then be much larger.

CHAPTER 9
ALTERNATIVE DOMESTIC FORECASTS

Coherent post-election policies are not guaranteed

The central forecast explicitly assumed that government policy would set itself the targets of preventing a return to high and rising inflation rates and/or a deterioration in the balance of payments, by initiating austerity measures if and when these became necessary. It was further assumed that the failure of the reform proposals made in late 1986 would ensure that no further attempts would be made in the life of the present government, but that the next government would take up the challenge of attacking the structural flaws in the economy, this time with success.

In this chapter, most of these assumptions are relaxed, and the consequences of alternative policies, and particularly of the absence of coherent policies of any sort, are examined. Only the assumption that reform is impossible until after the next election can be taken as having a very high degree of probability. The state of internal relations within the National Unity government in the early part of 1987 seemed to point to its early demise, and certainly to rule out the possibility of it regaining the degree of cohesion and authority that would be needed to overcome the vested interests that have already torpedoed one set of reform proposals.

Furthermore, the trends in the economy at that time suggested that the continued breakdown of the stability achieved under the ESP would continue through 1987, while the factors promoting growth in that year were already in place, so that the first part of the forecast has no realistic alternative. Only the speed of the deterioration on the inflation and budget deficit fronts, and the extent and timing of the government reaction remain in doubt. The date of the next general election is a crucial variable in this process, and this could be set for any time between the late summer of 1987 and the final deadline of November 1988, depending on political developments. The alternative scenarios are therefore ones that deal with a more negative turn of events in the years from 1988 through the end of the forecast period.

POLITICAL PARALYSIS

The National Unity government might linger on, ineffectually -

The first danger is that the internal dissension within the National Unity government might worsen, so that policy making became subject to the push and pull of party and factional interests, but yet not reach the point where the government actually fell. In this case, the Treasury would be unable to pursue any kind of restrictive budgetary policy, because its initiatives would be defeated by ad hoc parliamentary coalitions of disparate lobbyists representing interests which stood to lose from the implementation of such a policy. The Bank of Israel might try to hold the line by the use of tight monetary policy as a compensating factor, but this is unlikely in the assumed political context, as well as being undesirable from an economic point of view. Monetary policy is too blunt an instrument to replace the more selective weapons available to the Treasury. When its inevitable impact was felt in the corporate sector, there would be immense pressure exerted to have it eased.

In this environment, labour unrest would grow almost automatically. Faced with a weak and divided government, the stronger unions, especially in the public sector, would table demands for real wage rises, and leap frogging would rapidly ruin any pretence of wage restraint. Indeed, the dispute with the hospital nurses, which began in the summer of 1986 and continued on and off for the next nine months without reaching any final resolution, could serve as a warning of what might occur on a broader front, if the political will to stand firm was lacking. This process would result in the widening of the budget deficit, which would in turn force interest rates up. Faced with rising input prices from wages and finance costs, manufacturers would respond by raising their prices, and the inflationary spiral would quickly gather speed.

- or the elections might produce another hung parliament

The likelihood of stability collapsing altogether under the National Unity government is small, however, if only for the purely political reason that the members of that government, individually and collectively, have a strong stake in maintaining as much as possible of their remarkable achievements on the economic front in 1985/86, to parade before the electorate in the next election. Clearly, it is preferable for any politican to lay claim to a success story than to seek to put the blame for failure at his opponent's door. Besides, the partnership aspect of the unity government will make it difficult for any of its constituent parties to evade responsibility if things go wrong.

A more serious threat to the economy, therefore, and certainly one that could be longer lasting than the death throes of the National Unity government, would arise if the next election were to produce results akin to those of 1984. If, once again, neither major party was able to form a coalition without the other, and possibly even if a very narrow coalition could be put together based on one of the major parties and a string of minor ones - as happened in 1981 - then the prospects for the economy would be poor. Major reforms would become an almost impossible job for such a government to tackle, and even the more modest task of keeping the economy on an even keel, in terms of inflation and the budget deficit, might well become too much for it, leading to a sequence of events similar to that outlined above.

In either of these cases, the latter part of the forecast would be radically altered. Instead of a "V" curve of recession and recovery, aided by structural reforms, the economy would probably struggle to achieve 1-2 per cent GDP growth in 1990-91, investment would remain negative and, worst of all, civilian public consumption would grow instead of shrinking. Initially, these trends would be unlikely to damage exports, so long as exporters were given the incentive of a rapidly depreciating exchange rate to offset their rising local costs. But in the medium term, the ongoing erosion of the capital base and the lack of investment in research and development, equipment and manpower, would take their toll on export competitiveness and this would show up in reduced market share and in slower export growth. This process would inevitably lead to a worsening trade deficit, necessitating the imposition of import controls of some sort.

THE NO GROWTH TRAP

The triumph of vested interests could defeat reform again

Perhaps the most pernicious threat to the Israeli economy is the continuation of the lack of growth experienced in recent years. The period of stability achieved under the ESP, while infinitely better than hyperinflation and rapid devaluation, still represented only a relief, not a solution of the basic problems besetting the economy. Similarly, the spurt of growth forecast for 1987 represents a reaction to the stimuli of internal and external events in 1985-86, but cannot be sustained without the introduction of badly needed reforms in the key areas of taxation and the capital markets, accompanied by a widespread privatisation and deregulation.

Therefore, even in the more positive case of a government strong enough to keep inflation down, maintain a firm line on wages and hold the budget deficit to manageable proportions, there exists the possibility that further attempts at reform could meet the same fate as that of 1986. The same vested interests that defeated the earlier proposals would seek to repeat their achievement, buoyed by their previous success. In the same way as the central forecast assumed that inflation, having been reduced once, could be lowered again if the need arose and the will was there, so too the alternative forecast can posit that structural reform, having been prevented once, could be pushed off again or even buried altogether.

Continued stagnation will feed on itself, dragging the economy down -

If the stagnation that has held increasing sway since 1973 is not broken, the economy will continue to wither at a slow, undramatic but remorseless rate. This process has been going on for long enough to allow its results to show through quite clearly. These are a declining rate of investment, flat or negative productivity growth and the growing incentive for both human and financial capital to move overseas.

Only some of these negative trends were temporarily reversed in the wake of the introduction of the ESP, while the others continued their downward trend. Thus investment, from both foreign and domestic sources, continued to fall through 1985 and 1986 and its overdue cyclical recovery in 1987, and perhaps into 1988, will be a weak one even in the best case. Given the high tax rates and the cancellation of many investment incentives, this abstention from investment cannot be considered surprising. By extension, there is no reason to assume that there will be a change in this trend, even if inflation ceases to be a problem. In other words, the removal of inflation from the economy is, from the viewpoint of potential investors, a necessary condition for promoting investments, but not a sufficient one. The tax regime, the complex bureaucracy and the frequent changes in laws and regulations, are all factors that must be tackled before a prolonged investment boom can take place. Thus, only positive changes in the environment will move the economy forward, while lack of change will leave it mired. The burden of proof, so to speak, is on the reformers. The economy must be considered stagnant unless and until it can prove itself otherwise.

- as foreign investment dries up -

The figures for foreign investment underline this fact. Gross investment by foreigners fell from over $1 bn in 1983 to around $200 mn each year in 1984-85. After deductions of liquidated investments, the net figures were $600 mn in 1983, -$38 mn in 1984, and $89 mn in 1985. As against this, official investments by Israelis abroad came to a net $191 mn in 1983, before enforced liquidation of foreign securities investments through tighter foreign exchange controls brought negative figures of $93 mn and $82 mn in 1984 and 1985 respectively. Subtracting one from the other gives total overseas investment of $417 mn, $69 mn and $216 mn for 1983-85, but even these figures, boosted as they are by forced disinvestment by Israelis, are negligible. When the amount of money illegally flowing out of the economy in those years is guessed at, they must be presumed to become negative.

- deterred by high taxation rates and capital costs

The pessimistic argument becomes much stronger when the sources of the improvement in the economy under the ESP are analysed. Since the major boost in government revenues came from tax increases, especially on the corporate sector, the incentive to invest has been lowered even further. Nor has the drop in the private savings level led to a boost in investment, although consumption increased dramatically in 1986. The bulk of this spending has gone to imports, or import substitution. There was, for instance, a boom in domestic tourism in the summer of 1986, when Israelis took advantage of cheap offers from hotels suffering from the slump in US tourism. This kind of temporary shift cannot persuade entrepreneurs to install additional capacity.

Furthermore, the level of investment in human capital has also suffered from the distortions of the inflationary years. Resources were directed to the finance and accounts departments, rather than to production and marketing, because the short term rate of return was much higher there. Within a few years, the cumulative impact of this misallocation led to a growing gap in the technological and general professional level of management and labour. To put this right requires investment which, as in the case of plant and equipment, is hard to justify given the high cost of the capital involved, and the very high tax rates on any profits that might accrue.

The moves made by the government during 1986 to open up the capital market to private sector borrowing failed to do more than scratch the surface of the true needs of industry and commerce. Much of what the government made available was directed specifically to sectors in severe financial distress, while the cost of funds was prohibitive for many firms that are profitable and would expand, if conditions were right. Thus the de facto nationalisation of the capital markets acts as a powerful brake on investment and so long as this situation is not radically changed, the sectors that need and could best use extra resources are starved of them.

The unemployment figures are misleadingly optimistic -

The moderate rise in unemployment that followed the implementation of the ESP was widely welcomed, because the rate of 7-8 per cent that developed was much better than the predictions of 10 per cent and more than had been expected. However, and as noted in previous chapters, the reasons put forward to explain this "achievement" are much less reassuring than the fact itself.

Thus, the small rise in measured unemployment is attributed to the cushion of West Bank and Gaza Strip Arabs employed in a wide range of low paying jobs, who act as Israel's gastarbeiter. Their dismissal does not show up in unemployment figures, and many of them are simply absorbed back into their family farms and other enterprises, particularly in the West Bank. Secondly, the firing process of tenured employees is exceptionally difficult and costly in Israel, because of the protection provided by social security and labour laws. Therefore, unless and until the employer is convinced that the crisis affecting his business is more than a temporary affair, he will retain rather than dismiss his employees. This explains why the main reductions in employment have been in sectors such as construction and financial services, where the long term trends have clearly changed, or in high technology sectors, where personal contracts are widespread and hiring and firing is less difficult.

- because of measures that can only be temporary

A half way house between retention of workers and their dismissal has been the encouragement of part time working, especially in service industries. This saves the employer from paying dismissal compensation, reduces his current wage bill and gives the employee at least some security and some income. In this case, employment has decreased in terms of man hours, but the unemployment figures are unaffected.

Conversely, since most of those dismissed are in the lower echelons of the economy, including Arabs from the occupied areas and workers in factories in development towns, their chances of finding new employment are poor, and when the period of their unemployment benefits expires - for those who have them - they tend to become discouraged and drop out of the work force entirely. Finally, for those with skills that are in demand, failure to find employment in Israel often leads to a job search overseas and subsequent emigration. Particularly in upper level jobs, and especially in the technology sector, unemployment has been exported, and this represents a long term loss that the country can ill afford.

To sum up, the true picture of unemployment is much grimmer than the gross statistics make it appear. If the economy fails to grow, the temporary panaceas such as holding on to workers, or having them work less than full time, will be given up in favour of dismissing them and realising the long term savings of a reduced labour force. Even if discouragement and emigration increase, total unemployment will rise and, what is far more relevant, total employment will fall.

A vicious circle of decline already exists

The real economic variables of production, employment and growth, as distinct from the nominal variables of inflation and devaluation, have settled into a longer term pattern of decline. If nothing is done, this situation will deteriorate along fixed lines. That is to say: high personal and corporate tax rates and high capital costs will force net capital formation steadily lower, the labour force and its equipment will become steadily more obsolete, resources will seek alternative employment elsewhere, lower production and employment will keep exports from growing, this in turn will worsen the trade deficit and reduce government tax revenues, necessitating measures that will further discourage investment, and so on. This is the vicious circle of decline that is already in place and that must be broken. If the status quo in these areas is maintained, a negative scenario must be an almost self-fulfilling prediction, because the downward momentum exists. It has been partially checked by the improvement of 1985-86, and this has created the opportunity to reverse these trends decisively through basic structural reforms. That opportunity was missed in 1986 and another must be sought in the future. If that opportunity is also not seized, the underlying negative trends, rooted in 15 years of slow, low, and no growth, will inevitably reassert themselves.

THE DEBT THREAT

Internal debt repayments are a major headache

The general election that must take place by November 1988 is one of two major events whose deadlines fall close together. The other is the bank share redemption, scheduled for October 30, 1988. The commitment to redeem the bank shares, undertaken in October 1983 to stave off an imminent financial collapse, represents the sharp edge of what is, in the opinion of many economists, the single greatest problem that the Israeli economy faces in the second half of the 1980s - namely, the size of the country's internal debt.

Table 33

Public Debt, 1975-85
(% of GNP in current prices)

	1975-85	1980	1981	1982	1983	1984	1985
Internal debt[a]	111	112	114	123	118	123	143
External debt	43	37	38	40	40	51	60

a Excluding bank shares.

Source: Bank of Israel.

External debt is long term and intergovernmental -

Table 33 shows the remorseless growth of both internal and external debt levels over the decade to 1985 in proportion to GNP. The external debt is measured in dollars, and its sharp rise in 1984-85 is an accounting distortion resulting from the relative rates of change of the shekel/dollar exchange rate and the consumer price index. In 1982-83 the former was repressed to a slower pace than the latter, while in 1984-85, on an annual average basis, the opposite was the case. The true extent of the public external debt becomes clear from the fact that it stood at some $15.5 bn at the end of 1985, equal to 70 per cent of GNP of approximately $22 bn. But this debt, large as it is, does not represent a pressing concern, because, as Table 34 makes clear, almost all of it is long term, with repayments in the coming years not exceeding $850 mn a year, and the bulk of the debt is owed to the US government.

Table 34

Foreign Debt Repayment Schedule, 1986-90 and Beyond

	Short term credit	Medium and long term credit					
		Balance of debt[a]	1987	1988	1989	1990	1991 & beyond
Public sector	-	15,727	882	962	830	905	11,929
of which: US government	-	9,903	164	207	293	367	8,823
Non-financial private sector	1,164	2,705	666	627	374	204	623
Net obligations of banking system	2,254	2,587	826	609	378	247	320
Total overseas obligations	3,418	21,019	2,374	2,198	1,582	1,356	12,872

a September 30, 1986.

Source: Bank of Israel.

- and the burden of heavy interest payments can be eased

In this context, it may be pointed out that the onus of the foreign debt is in the interest payments which, according to Table 35, will exceed the capital repayments for every one of the years in the forecast period. However, these amounts have already been partially lowered by the reduction in interest rates worldwide. Moreover, as forecast above, the interest due to the US government is a burden which will be eased either by increased direct grants, as occurred in 1984-86 (see Table 13), or by cutting the rate of interest on outstanding loans from the high market rates that existed in the late 1970s and early 1980s, when they were taken, to current market rates that are on average about half as high.

Table 35

Projected Interest Payments on Existing Foreign Debt[a], 1986-91

	1986	1987	1988	1989	1990	1991
Public sector	1,314	1,284	1,233	1,174	1,111	1,038
of which:						
US government	940	945	940	929	905	872
Non-financial private sector	197	188	134	89	63	43
Net obligations of banking system (est)	206	326	100	63	35	108
Total projected interest payments[b]	1,717	1,798	1,467	1,326	1,209	1,189

a As per original terms of loans; interest on floating rate loans calculated as per euromarket rates at end 1985. b Excluding interest payments on suppliers' trade credit.

Source: Bank of Israel.

The internal debt is much larger, with "bunched" repayments -

Turning, then, from the external to the internal debt, it may be seen that this, too, jumped in 1985, reflecting the fact that it is mostly linked to the CPI, and that inflation as measured by the CPI rose faster in 1985 than the growth in GNP measured at factor prices, because the subsidy cuts that pushed the CPI up were not fully reflected in factor prices. For example, doubling the price of bread had a great effect on the CPI, but wages and other inputs were eroded in "real", or CPI linked, terms. This is not mere accountancy, as were the changes in the ratio of external debt to GNP, because the terms of the internal debt require the government to repay it fully linked to the CPI. However, this was a one off effect, caused by realignments of relative prices. What should be noted is that even the size of the internal debt as given in Table 33 is not its full extent, nor does it indicate how "threatening" that debt is.

The government's self-imposed obligation to redeem the bank shares at their full value prior to the October 1983 crash, represents an additional $5 bn of debt that must be added to the internal debt, and which would bring its total proportion of GNP to about 170 per cent. Furthermore, the fact that the bank shares have to be paid in two very large sums, particularly that of October 1988, makes that obligation much more onerous than would the same amount spread more evenly over a longer period. From the very outset of the arrangement under which the Treasury promised to redeem the bank shares, there has been a large measure of scepticism as to its ability actually to carry out its promise. The bank shares, which have traded as dollar linked bonds since October 1983, have consistently traded at a yield level far higher than other government dollar linked bonds, even those with more distant maturity dates. This has been taken as a measure of the public's lack of credulity regarding the government's ability to meet the terms it set itself.

- and is highly liquid, making it more dangerous

The danger inherent in the internal debt, however, is rooted not so much in its absolute size, but in its liquidity. Although held in savings schemes and provident funds as well as in traded bonds, a large proportion of the internal debt has reached the point where it can be withdrawn by its holders on demand, and is therefore "hot money". It may be argued that the relatively small level of withdrawals, even at the height of the hyperinflation and loss of confidence in the government in 1984-85, demonstrates the solidity of the debt holders. Yet the threat of a flood of liquid funds pouring in to the economy still remains, and the events of June-October 1983, when the public fled from bank shares to foreign currency investments, demonstrates the vulnerability of the economy to such sharp changes in investors' tastes.

Table 36

Internal Debt Repayment Schedule, 1986-90
($ mn, fiscal years)

	1986/87	1987/88	1988/89	1989/90
State loans	566	390	1,256	1,124
Deposits of funds from share issues	1,317	900	1,556	1,226
Savings schemes	180	729	662	351
Compulsory loans	280	100	280	660
Bank shares	-	1,100	3,800[a]	-
Total	2,343	3,219	7,554	3,361

a Including shares held by banks.

Source: Treasury.

In terms of the general economic stability, therefore, it will be seen that the size and liquidity of the internal debt represents a constant threat hanging over the economy, for any signs of the breakdown of stability might cause the mountain of hot money to begin to move in undesirable directions, such as into cash dollars and hence out of the economic system altogether. The general history of financial panics, and the Israeli experience in 1983 in particular, are sufficient to illustrate that once such a process begins, for whatever reson, it often becomes an unstoppable avalanche. For this reason, the government will treat the whole issue of the internal debt with the greatest delicacy, and will not be able to relax until the October 1988 bank share redemption is behind it. Indeed, the redemption may only be achieved by recycling most of the obligation into longer term debts with a better balanced maturity pattern.

CHAPTER 10
ALTERNATIVE INTERNATIONAL SCENARIOS

Externally administered shocks cannot be ruled out

The alternative domestic forecast examined in Chapter 9 was based on relaxing some of the domestic assumptions made in Chapter 7. These assumptions included the existence of sufficient political strength and cohesion to implement austerity measures and, eventually, a reform programme, as well as the maintenance of confidence in the shekel and hence the ability of the government to recycle its internal debt and to avoid a renewed foreign exchange and balance of payments crisis.

In this chapter, a number of the external assumptions made in earlier chapters are relaxed, including some of those in the world forecast in Chapter 6, and their possible influence on the economy is examined. Among these assumptions were that the coming years would see no major hostilities with Syria, no general war between Israel and the Arab states, and conversely no peace treaty with Jordan or general peace with the Arab world. It was likewise assumed that there would be no further dramatic changes in the real price of oil and other energy sources, relatively minor changes in the prices of other commodities and manufactures, no sharp swing to protectionism in the industrialised world, no major population changes (such as would result from a renewed exodus of Russian Jews to Israel) and that Israel would benefit from increased net US aid.

LIMITED AND GENERAL HOSTILITIES

In an Arab-Israeli war, or a clash with Syria, Israel would win -

Israeli military planning continues to be based on worst case contingencies, including the possibility that a number of Arab countries could act together in any future war against Israel. Such a grouping is presumed in any case to include Syria, the most belligerent of the Arab states. Other participants might include Jordan, which could fight alongside Syria on the Golan Heights as in 1973, or even open a separate front as in 1967. A change of policy or a different government in Egypt could cause it to resume a militant posture. Iraq and/or Iran could become involved, depending on the outcome of the Gulf war and its aftermath. Also possible is some Saudi, Kuwaiti, Moroccan and - much more likely - Libyan and Algerian participation, especially by the air and naval forces of these countries. But the major threat is assumed to come from Syria alone, and the possibility of that country opening a limited offensive against Israel, either on the Golan Heights front alone, or in conjunction with a move along the Lebanese frontier, is considered quite high, despite - or, in the view of some, because of - the economic crisis in Syria and the isolation of the Assad regime at home and abroad.

The consensus among Israeli and Western military observers is that Israel would emerge victorious from a clash with Syria, although at a high price in terms of men and material, and that it could more than hold its own against any conceivable combination of Arab states. It may also be assumed that the more clear cut the Arab aggression, the swifter and greater would be the US diplomatic and material support extended to Israel. Table 37 summarises the military balance between Israel and Syria and between Israel and a full Arab coalition.

Table 37

Military Balance

	Personnel ('000)	Armoured divisions	Tanks	Guns & mortars	Combat aircraft	Helicopters	MFPB[a]
Israel-Syria							
Israel	540	12	3,800	1,000	645	190	24 + 2 hydrofoils
Syria	840	5	4,100	2,300	650	235	20
Arab[b]-Israel							
Arab coalition	1,942.5	11	8,445	5,650	1,508	495	75
Israel	540	12	3,800	1,000	645	190	24 + 2 hydrofoils
Ratio, 1985	3.6:1	1:1	2.2:1	5.7:1	2.3:1	2.6:1	2.9:1

a MFPB - Missile Fast Patrol Boats. b Full Arab coalition comprising Syria, Jordan, Egypt, units from Libya, Morocco, Saudi Arabia, Kuwait and Algeria.

Source: Middle East Military Balance 1985. Reprinted with permission from the Jaffee Centre for Strategic Studies.

- but would certainly suffer damage to its economy -

However, any hostilities would have a detrimental effect on the Israeli economy, and the wider their scope and the longer their duration, the more significant this effect would be. Israeli strategy is based on achieving a rapid resolution of the fighting, because mobilising its reserves creates major dislocations in the civilian economy. This doctrine of attack, however, perforce increases the casualty rate suffered in the fighting. The likely financing of any war would include the following factors, as past experience has shown.

- Emergency taxes levied on the Israeli public, mainly on a temporary basis (one to two years), but probably resulting in a permanent increase in the tax level.

- Increased government borrowing at home and abroad, forcing interest rates up and probably involving a lengthening of average maturities to avoid bunching.

- Special US aid.

- Increased aid from world Jewry.

The extent of US aid would be the crucial factor, since Table 4 indicates that Diaspora Jewish support, though reliable and responsive to emergencies, is limited and could under no circumstances be expected significantly to exceed $1.2-1.5 bn in a given year. The 1973 total of $742 mn remains the highest single annual total, in both nominal and real terms.

- although there could be long term positive effects

In the medium term, the budget structure would obviously change as well, with defence taking a larger proportion, presumably at the cost of welfare and of transfer payments, since it is no longer possible to maintain borrowing on a large scale for very long. The need to cut welfare and transfer payments might well provide a hefty impetus to rationalisation of the budget, which would be effected more rapidly than would be possible in the more normal political environment envisaged in Chapter 8.

Finally, and perhaps most importantly, even an Israeli victory, were it to involve high casualties, would strengthen the position of those demanding a new defence doctrine based on a defensive strategy and a smaller army reliant on sophisticated weapons to smash attacks. In the long run, therefore, the next war - if it comes - could cause a reduction in total defence spending.

PEACE IN THE MIDDLE EAST

Peace might have little short run effect on the economy -

The peace process has made only marginal progress in recent years. Nevertheless, the possibility exists of direct talks with Jordan and some mutually agreed group of Palestinian representatives, and could result in a diplomatic breakthrough in the course of the forecast period. However, and despite the obvious desirability of such a development, it is difficult to perceive any immediate or dramatic impact on the economy of even a full peace treaty with one or more Arab states in addition to the existing one with Egypt. In fact, the Egyptian treaty illustrates that any such expectations are liable to prove false for, despite the importance of the withdrawal of the largest Arab country from the circle of confrontation, Israeli military spending could not be massively cut. The inherent instability of the Arab countries and their policies force Israel to be prepared to cover all contingencies. This would certainly continue to be the case if a peace treaty were signed with Jordan, although some reductions, especially in the amount of reserve duty needed, would presumably result. Only a genuine winding down of the arms race, which would have to encompass all, or at least most, of its potential enemies, could enable Israel to make long term reductions in its order of battle.

- since scope for trade is limited -

In the context of trade, too, the Egyptian treaty has been a disappointment. Although joint efforts in the tourist industry would be possible for Israel with both Egypt and Jordan, and agricultural cooperation would be likely, including joint development of water resources, these are relatively marginal issues. No significant trade in goods has developed or seems likely to develop with Egypt, with the important exception of oil imports, nor would it with Jordan, whose economy is structured towards the Gulf states. The main effects would therefore be indirect, including the removal of some of the factors militating against investment in Israel, such as the Arab boycott affecting companies involved in Israel and the general threat of war. Israel's credit standing would improve, but it has already been noted that the country's economic performance has been the primary factor determining its creditworthiness, not its security situation.

- but its long term effects would be strongly beneficial

In short, peace would be a positive factor to Israel's economy, but its concrete contributions would only be felt in the medium and long term, when the peace was seen to be lasting and confidence had built up. Willingness to trade with and invest in Israel would certainly grow, and immigration trends could only benefit.

ENERGY AND COMMODITY CONSIDERATIONS

Price rises in energy and other commodities would be harmful -

The extremely negative effects of the oil shocks of the 1970s and, conversely, the strong positive impact of the oil price slump of 1986, have been noted in earlier chapters. Despite having spent some $250 mn between 1975 and 1985 searching for oil, Israel remains almost devoid of domestic energy sources. In 1986, oil exploration ground to a near total halt, although the exploration group headed by Armand Hammer continued its seismic studies in preparation for future drilling. Therefore any recovery in oil prices, beyond that assumed in Chapter 6, will lead directly to a worsening of Israel's trade deficit.

Similarly, any general recovery in primary commodity prices relative to prices of manufactured goods, will undermine the significant improvement in its terms of trade that Israel experienced in recent years. The only commodity that Israel produces on any major scale is citrus fruit, and that is far outweighed by its manufactured exports. Thus the general influence of the direction of energy and commodity prices for the Israeli economy can be summed up in the simple formula: down is good, up is bad. There is no reason to assume any change in this basic fact in the forecast period.

- although oil dependency has lessened -

However, the structure of the country's energy economy has changed considerably since 1973. By 1985 oil to coal conversion programmes had made coal the supplier of 17 per cent of primary energy supplies. The electricity generating industry had led this switch and had, by 1984, passed the halfway mark in coal fired production, with plans to reach 70 per cent by 1990. This drive has since slowed, because coal became more expensive than oil, but it can easily be renewed. Coal is a more congenial fuel for Israel, because its supply is far freer of political constraints. Oil is purchased primarily from Eygpt and Mexico, as well as on the spot market, but the potential threat of supply difficulties is always there for a commodity whose main reserves lie in the Arab world. By contrast, no such problems were encountered regarding coal purchases from Australia, Colombia and the UK. In the worst case Israel has a treaty with the USA whereby that country will act as oil supplier of the last resort if no other sources are available.

The development of alternative energy sources is further advanced in Israel than in most other countries. In particular, Israel is a world leader in the use of solar energy, with 800,000 families - 70 per cent of all households - using roof top solar collectors for water heating. This reduces the nation's electricity requirement by an estimated 6 per cent. Nevertheless, total per caput energy requirements rose by 1.5-2.5 per cent per annum in the 1980s while GNP per caput was stagnant. Any renewed and prolonged rise in energy prices would therefore require, and probably receive, tougher pricing policies than was the case in previous energy crises, and a renewed and more determined effort to reduce the strategically dangerous dependence on imported oil, which will centre on coal and include solar and wind generated power. The plan to construct a nuclear power station is still making slow headway, and represents a further path for diversification, although public awareness in the wake of the Chernobyl nuclear disaster in 1986 will certainly cause additional delays.

Overall, therefore, the Israeli economy will remain vulnerable to price rises in both energy and general commodity prices, but will continue to improve its supply position by diversification.

- and shale oil would benefit from major oil price rise

Ironically, a worst case scenario, in which oil prices rise passed $30/b, would become a major positive factor for Israel. The country's Negev desert contains proven reserves of low grade oil shale sufficient to supply current requirements for 80 years, and pilot plants indicate that existing technology could make these commercially worth exploiting at oil prices of around $31/b, while exploiting byproducts such as sulphur and ammonia could lower this cost. Furthermore, underneath the shale oil layers are rich phosphate deposits. Although oil market developments have reduced interest in this area of development, oil shale represents a trump card in reserve and would seem to put a firm cap on Israel's potential loss from high energy prices.

A SWING TO PROTECTIONISM

Free trade agreements will provide some shelter from protectionism -

Any economy in which imports and exports together are larger than GNP is clearly vulnerable to protectionist moves that would reduce trade flows. However, the relative degree of vulnerability of the Israeli economy is lessened by two factors. In the first place, Israel is uniquely placed in having free trade agreements with both the European Community and the USA. These areas comprise the country's main trading partners, as has been seen. It must be considered highly unlikely that either of these treaties would be curtailed, much less abrogated, as part of any conceivable US-European trade war, or US/European-Far Eastern trade war.

Furthermore, Israel's trade balance with both the EC and the USA is firmly

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