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Israel: Poised For Take-Off?

by Augusto Lopez-Claros

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

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

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

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

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

Selected Economic Indicators 1/

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

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

Low Inflation and Weak Growth: A False Dichotomy?

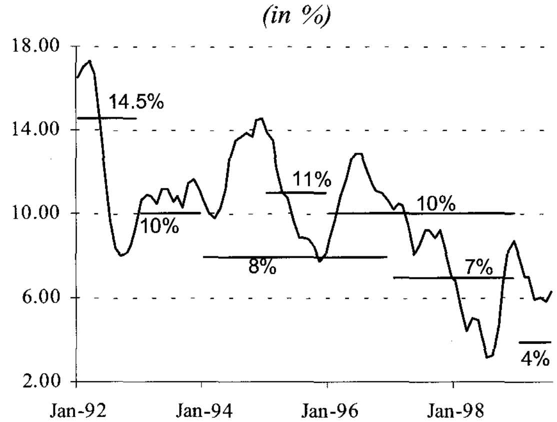
Although inflation targeting was introduced in late 1991, it was only by the mid-1990s, as the band for the exchange rate was widened, that attaining the annual inflation target became a central objective of monetary policy. Indeed, both targets were missed in 1993 and 1994, the latter by a large margin.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

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

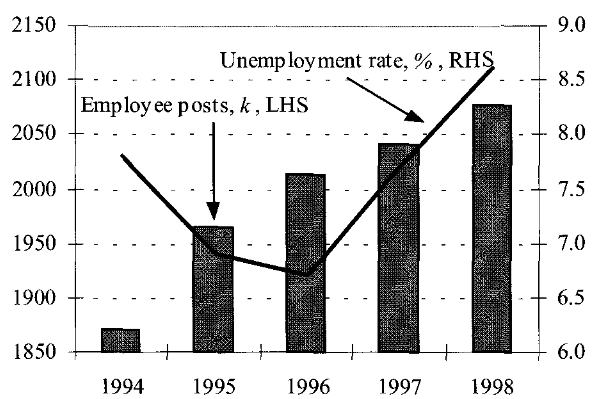
- **The "Strong Growth" School.** The Bank of Israel is unduly focussed on inflation control and is not particularly sensitive to the weakening of output seen in recent years and the concomitant rise in the rate of unemployment. Inflation cannot be brought down to average EU/OECD levels because nearly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

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

(in %)



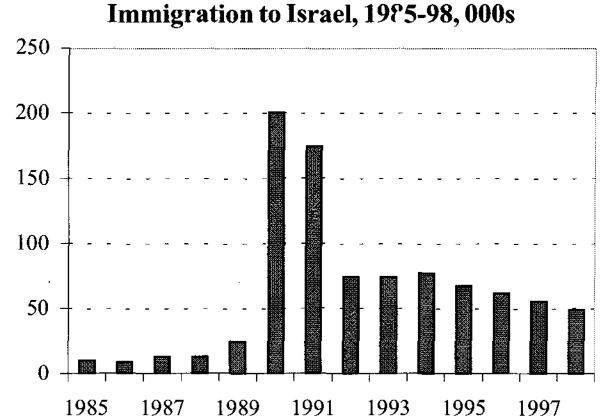
Employment and unemployment rate



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

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

Immigration to Israel, 1985-98, 000s



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

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

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

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

Recent inflation performance
(% change, end-year)

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

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

Interest Rate Volatility

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

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

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