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ECONOMIC REPORT ON ISRAEL

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Bureau for Near East
Agency for International Development

EXECUTIVE SUMMARY

Background to Israel's Current Economic Situation

Since the early 1970's, Israeli economic performance has deteriorated. Until 1971, Israel enjoyed high rates of economic growth and relative price stability. By the end of the 1970's, however, economic growth rates were much reduced, and the rate of inflation reached triple digit levels. An increasing proportion of national savings was channelled toward the financing of current government expenditures, and the level of gross domestic investment declined from 32% of GDP in 1972 to 21% in 1981. High levels of consumption were stimulated by deficit spending and by marked increases in real wages. The high levels of consumption coupled with growing defense requirements and the lessened ability of the Israeli economy to supply demanded goods and services because of decreasing investment led to growing goods and services deficits financed both by increased U.S. assistance flows and rising foreign borrowing. At the start of the 1970's, the civilian goods and services deficit was under $700 million; by the end of the decade, it exceeded $2 billion and has since increased to $4 billion.

Summary of U.S. Assistance

Commitments of AID economic assistance and military aid since FY 1978 are shown below:

Economic & Military Assistance Commitments
($ Millions)

	FY'78	FY'79	FY'80	FY'81	FY'82	FY'83	FY'84
AID Economic Assistance	785	785	785	764	806	785	910
Military Aid	1000	4000	1000	1400	1400	1700	1700
Total	1785	4785	1785	2164	2206	2485	2610

Grants comprise an increasing proportion of assistance commitments. Moreover, their value has been enhanced by providing the economic component as a cash transfer.

Developments in 1982

In recent years, exports have contributed some 40% to Israeli Gross Domestic Product. In 1982, exports of goods and services dropped causing a virtual halt in economic growth. The fall in export earnings resulted from both depressed conditions in the countries with which Israel trades and a purposeful slowing in the rate of the depreciation of the shekel against the currencies of major trading partners.

Both private and public consumption (excluding defense imports) rose substantially in 1982. High private consumption was made possible by a decrease in the rate of savings. It was motivated by both a positive wealth effect stemming from a stock exchange boom and the perception that, with the slowing of the rate of depreciation of the shekel, imports, compared to previous years, were a "good buy." Much of the public consumption increase reflected domestic spending for the Lebanon war.

To help finance war costs, the government levied a compulsory loan on Israeli citizens and introduced a number of other revenue measures, including an increase in the value added tax. As in prior years, however, revenues were insufficient to cover expenditures, and deficit financing was required.

Although the government had hoped that by slowing the rate of depreciation of the shekel, the rate of inflation would fall, consumer prices in 1982 rose by 132% vs. 102% in 1981.

The high consumption levels sustained by both the private and public sectors were reflected in increased imports. The volume of goods imports increased by 10%. Export earnings, on the other hand, fell. As a result, the civilian goods and services deficit rose by 48% from $2139 million to $3168 million. The combined civilian and military goods and services deficit expanded by $400 million to $4.7 billion. However, a high level of capital inflows (including U.S. assistance) enabled Israel to finance this deficit and to add over $300 million to international reserves. By year's end, Israel's total external debt totalled $20.9 billion, of which $13.2 billion was owed by the public sector.

Developments in 1983

Macroeconomic policies changed little in the first half of 1983. However, by mid-year, the continued deterioration in Israel's trade account and high inflation persuaded the government to abandon the failed policy of artificially slowing the rate of depreciation of the shekel. Nevertheless, the uncertainties about what economic policies would be followed after the resignation of Prime Minister Begin led to a loss of confidence in the shekel. Massive selling of shekel denominated assets caused a collapse in stock market prices. In response to the crisis, the shekel was devalued by 18% on October 11 and prices of most government subsidized commodites were raised by 50%. To curtail public consumption, the government also decided on additional revenue measures and cuts amounting to 2.5% of projected fiscal 1983 expenditures.

These corrective actions were too late to affect significantly the final economic outturn for 1983. In 1983, export earnings continued to fall and gross domestic product grew by less than 2%. Bolstered by an average rise in real wages of about 5%, private consumption rose by an estimated 6.5%, while public consumption (excluding defense imports) increased more than it did in 1982, 6.4% vs. 4.6%. Investment in fixed assets rose by 6.5%, encouraged by an exchange rate policy which made capital goods imports comparatively cheap.

The devaluation and price increases in subsidized commodities in the latter part of the year raised the rate of inflation from 132% in 1982 to 191% in 1983.

The continued high consumption levels led to a $800-900 million increase in the civilian goods and services deficit. Estimated at $3950 million, the deficit was equivalent to a record 17.7% of GDP as compared to 13.9% of GDP in 1982. The main contributors to the growth in the deficit were increased merchandise imports (up 6% in terms of current dollars), continued stagnation in merchandise exports, and a $250 million fall in interest and dividend income. The combined civilian and military goods and services deficit rose by $400 million to an estimated $5150 million.

Net medium and long-term capital inflows increased by $300 million in 1983. Nevertheless, Israel's international reserves declined by approximately $120 million. Total external debt rose by $2.2 billion in 1983 to $23.1 billion.

Outlook for the Israeli Economy

This is AID's fifth report on the Israeli economy. With Israel's growing external imbalance and deepening domestic economic problems over the past several years, this report, like its predecessors, highlights how critical Israeli economic policy measures are to successful achievement of Israeli objectives for the economy. Regardless of aid levels voted by Congress, implementation of appropriate economic policies must continue to be the principal mechanism for redressing Israel's economic imbalances.

Major internal and external imbalances are present in the Israeli economy. The indexation system makes reduction in inflation difficult. Labor unions are, however, strongly opposed to change in the wage indexation system. Public support for austerity measures is not high. The new government formed after Prime Minister Begin's resignation has yet to announce a comprehensive stabilization program.

First priority has been given to improving Israel's balance of payments position, and the new exchange rate policy is aimed at making Israeli exports competitive. Cutting inflation has been assigned a lower priority, and no major reform of the indexation system is contemplated. The government has called for a decline in real wages in 1984, but has not specified the strategy by which this is to be achieved. For fiscal 1984, the government has proposed some cuts in public expenditures. However, it seems likely that deficit financing of about $2 billion will still be necessary.

Economic expansion in countries with which Israel trades coupled with exchange rate policy changes should spur some recovery in Israeli exports in 1984. Given the current incompleteness and uncertainty of implementation of the government's economic plans, the extent and success of domestic policy measures in curbing consumption and imports cannot be readily predicted. In these circumstances, it would be imprudent to expect more than a modest reduction in the civilian goods and services deficit from the record 1983 level of $3950 million.

Longer term prospects are even more difficult to discern. Clearly Israel needs to reduce deficit financing of government expenditures, contain private consumption, and encourage increased savings and investment -- particularly in export industries. A comprehensive, long-term program to realize these objectives has not yet emerged.

ISRAEL
SUMMARY ECONOMIC STATISTICS

Gross National Product (1981 dollars)	$20.4 billion
Per Capita GNP (1981 dollars)	$5160
Population (mid-1983)	3.96 million
Population Growth Rate	1.7%

	1980	1981	1982	Estimated 1983
GDP & Employment				
Real increase in GDP (%)	3.1	3.4	1.2	1.8
Real Increase in Uses of Total Resources Available (%) *	-1.8	4.9	4.8	4.8
Private Consumption	-2.7	11.0	7.5	6.5
Public Consumption	3.5	0.7	4.6	6.4
Gross Domestic Investment	-16.3	-5.4	13.7**	4.8
Exports	6.3	4.4	-2.6	1.3
Rate of Unemployment	4.8	5.1	5.0	4.4
Money & Prices				
Money Supply (billions of shekels)				
M_1	7.0	12.5	26.8	53.4 (Oct)
M_2	84.7	189.3	469.4	1078.2 (Oct)
Consumer Price Rises (Dec. to Dec.)	133	102	132	191

* Excluding defense imports
** Mainly inventory accumulation. Gross investment in plant and equipment increased by 4.7%.

External Balance Indicators ($ Millions)

	1980	1981	1982	Estimated 1983
Balance of Payments				
Merchandise Exports	5798	5903	5573	5520
Civilian Merchandise Imports (c.i.f.)	-7776	-7823	-7932	-8400
Trade Balance	-1970	-1920	-2359	-2880
Interest & Dividends Payments	-1966	-2320	-2757	-2750
Interest & Dividends Receipts	1052	1485	1657	1400
Tourism Receipts	896	970	893	950
Other Services, net	-88	-354	-600	-670
Civilian Goods & Services Deficit	-2084	-2139	-3168	-3950
Military Imports	-1692	-2190	-1552	-1260
Civilian & Military Goods & Services Deficit	-3776	-4329	-4720	-5150
Unilateral Transfers	2970	2938	2622	2575
Medium & Long-term Capital				
Israeli Bonds	450	518	557	580
U.S. Government Loans	1368	1111	1086	1090
Other Loans	397	728	643	750
Principal Payments	-957	-1119	-1053	-970
Foreign Investment, net	-149	-95	12	100
Medium & Long-term Capital, net	1109	1143	1245	1550
Short-term Capital[1]	126	748	1690	na
Overall Balance	429	500	837	na
Reserves	3404	3546	3881	
Foreign Exchange (incl. SDRs)	3351	3497	3839	
Gold	53	49	42	
External Debt				
External Public Debt	10692	12252	13159	14635
Total External Debt[2]	16517	18230	20920	23120
Exchange Rate				
Shekels per $; end of year	7.55	15.60	33.65	107.70

[1] Includes errors and omissions.
[2] Includes private debt, including a portion of the liabilities (that is deposits) of the overseas branches of Israeli commercial banks.

BACKGROUND TO ISRAEL'S CURRENT ECONOMIC SITUATION

Israel's economic achievements in the first 25 years of its existence were remarkable in view of its very limited natural resources. Fueled by very high levels of investment (frequently reaching 30% of GDP), Israel's real GDP rose at an average annual rate of 9% between 1952 and 1972. At the same time price levels were relatively stable; until 1970 consumer prices increased at an average annual rate of 7%.

Since the early 1970's, Israeli economic performance has deteriorated. Price instability began with expansionary monetary policy in 1971 which resulted in not only high GDP growth --11% in 1971 and 12% in 1972 -- but also a sharp increase in inflation to 13% in 1971 and 12% in 1972. Following the global oil price shock of 1973, inflation accelerated, reaching 56% in 1974. At the same time Israel's civilian goods and services deficit increased dramatically from under $700 million in 1972 to $2.1 billion in 1974. Reductions in domestic military expenditures and in the rate of investment moderated aggregate demand pressures between 1975 and 1977. As a consequence, GDP growth was reduced to 2% annually between 1975 and 1977, and inflation decelerated to an average annual rate of 34%. In addition the deficit on the civilian goods and services account declined from the peak $2.1 billion registered in 1974 and 1975 to $1.4 billion in 1977.

Over the period 1977-1979, sharp increases in real wages coupled with a rise in government expenditures and deficit financing stimulated aggregate demand. GDP expanded by 4% in 1978 and 1979, and the civilian goods and services deficit climbed from 10.2% of GDP in 1977 to 16.3% of GDP in 1979. The rate of inflation accelerated from 43% (on a year end to year end basis) in 1977 to 111% in 1979.

In 1980 and 1981, government expenditures and reliance on deficit financing continued to rise, further bolstering inflationary pressures. Private consumption expenditures, however, fell in 1980, reflecting a decline in real wages in that year. GDP growth in 1980 thus moderated from 5.0% to 3.1% while the civilian goods and services deficit declined from $2.5 billion to $2.1 billion (7.5% of GDP). In 1981, real wages increased by over 10%., and the rate of GDP growth increased from 3.1% to 3.4%, while the civilian goods and services deficit remained at $2.1 billion. Inflation continued at triple digit levels: 133% in 1980 and 102% in 1981.

During the course of the 1970's, an increasing proportion of national savings was channelled toward the financing of current government expenditures, while productive investment declined because of the uncertainty of the magnitude of real returns under conditions of high inflation as against the certainty of positive real returns on securities issued by the government to help finance its own consumption expenditures and transfers. The level of gross domestic investment declined from 32% of GDP in 1972 to 21% in 1981. The incomes of Israeli consumers, on the other hand, were largely protected against the erosive forces of inflation by an increasingly widespread system of indexing wages, welfare payments, interest income, and income tax brackets to rises in consumer prices and related exchange rate movements. Relatively high levels of consumption were stimulated by deficit spending and marked increases in real wages. Over the 1971-1981 period, labor market conditions were tight as reflected in an unemployment rate of less than 3%, and Israeli real wages increased at an average annual rate of 3.3%. The high levels of consumption coupled with growing defense requirements and a lessened ability of the Israeli economy to supply demanded goods and services because of decreasing investment led to growing current account deficits, financed both by increased U.S. assistance flows and rising foreign borrowing. The deficit on civilian goods and services account increased from $1.4 billion in 1977 to $2.5 billion in 1979 and remained above $2 billion in 1980 and 1981. External foreign debt (including short-term and private debt) rose from $11.1 billion in 1977 to $18.2 billion in 1981.

SUMMARY OF U.S. ASSISTANCE

U.S. commitments of economic and military assistance to Israel since FY 1978 and the Camp David summit are shown in the table below:

U.S. Assistance to Israel
($ millions)

	FY'78	FY'79	FY'80	FY'81	FY'82	FY'83	FY'84
AID Assistance	785	785	785	764	806	785	910
Grants	525	525	525	764	806	785	910
Loans	260	260	260	-	-	-	-
Military Aid	1000	4000*	1000	1400	1400	1700	1700
Grants	500	1300	500	500	550	750	850
Loans	500	2700	500	900	850	950	850
TOTAL	1785	4785	1785	2164	2206	2485	2610

* Includes $3.2 billion to cover costs for redeploying Israeli forces following withdrawal from the Sinai.

As the table shows, total assistance has increased year by year since FY 1980. The value of that assistance has also increased because the proportion provided as grants has been raised substantially from 57% in FY 1978 to 67% in FY 1984. In addition, since 1979, economic assistance has been provided entirely as a cash transfer and in FY 1984 was disbursed in a lump sum early in the fiscal year rather than in periodic payments.

DEVELOPMENTS IN 1982

As the value of the dollar rose in international currency markets in 1982, the real value of the shekel appreciated against European currencies. In addition, in an attempt to slow the rise in the domestic price of imported goods, the Israeli government in 1982 purposefully slowed the depreciation rate of the Israeli shekel against the dollar. The relative appreciation of the shekel against most major currencies together with the worldwide recession lowered demand for Israeli exports. On a national accounts basis, Israeli exports of goods and services declined by an estimated 2.6% in 1982. Since exports typically comprise over 40% of Israel's GDP, the drop in exports contributed to a considerable slowing down in GDP growth, from 3% in both 1980 and 1981 to 1.2% in 1982.

After a 10% increase in real wages per employee in 1981, real wages fell by 0.5% in 1982. Nonetheless, total private consumption expenditures continued to rise very substantially, increasing by 7.5% in 1982 following a 11.0% increase in 1981. Maintenance of high private consumption levels was made possible by a decrease in the rate of savings. It was motivated by both a positive wealth effect from the very sharp rise in share prices on the Israeli stock exchange and the perception that, with the slowing of the rate of depreciation of the shekel, imports, compared to previous years, were a "good buy." Reductions in taxes on imported consumption goods further stimulated the demand for imports. Reflecting these developments, the dollar value of car imports in 1982, for example, increased by 38%.

The domestic expenditure requirements of conducting the war in Lebanon caused real public consumption expenditures (excluding defense imports) to rise at a higher rate in 1982 than in 1981 (4.6% vs. 0.7%). Military expenditures for domestic goods and services rose by 9.0%, while civilian public consumption increased but marginally (0.1%) over the level of 1981.

To help finance these larger expenditures, the government introduced a number of revenue raising measures. Specifically, a compulsory twelve year loan equivalent, on average, to 4% of personal income was levied on Israeli citizens. Also, in June 1982, the Value Added Tax (VAT) rate was increased from 12% to 15%, a 2% turnover tax on stock exchange share sales was introduced, a 2% levy on imports and a 1% tax on foreign currency purchases was enacted, and a travel tax of 600 shekels was imposed. These tax measures raised domestic government revenues by 6.6% over what they would otherwise have been for the fiscal year beginning in April 1982. In 1982 the share of gross taxes reached 49% of GNP, a ten year record. Despite these larger collections, the inflationary impact of government finances in 1982 was greater than in 1981. Borrowing from the general public to finance the government deficit was far less in 1982. As a consequence, greater recourse to advances from the Bank of Israel (the central bank) was necessary.

Despite the slowing in the rate of the depreciation of the shekel and restraint in passing on cost increases in the price of government controlled commodities, the pace of Israel's inflation rose in 1982. On a year end to year end basis, consumer prices rose by 132% in 1982 vs. 102% in 1981.

Maintenance of high levels of consumption was reflected in increased imports. The volume of goods imports rose by an estimated 10% in 1982 vs. 4% in 1981. In dollar terms however, the increase was far less (1.4%) due to the strength of the dollar against the currencies of Israel's chief import suppliers -- the countries of the EEC -- plus soft prices for oil imports. As mentioned above, export earnings dropped in 1982. Specifically, merchandise exports decreased by $330 million. The rise in imports and fall in exports combined to widen the civilian trade deficit by $400 million over 1981. The deficit on civilian goods and services account rose by 48% from $2139 million in 1981 to $3168 million in 1982. Aside from the deterioration in the merchandise trade balance, the increase in the deficit was due to a $77 million decrease in receipts from tourism, a $437 million increase in interest and investment income payments, and a $216 million increase in net expenditures for such invisibles as shipping, foreign travel, insurance, and other services.

Military imports, which, except for an annual amount of some $250 million, are entirely financed by U.S. military assistance, decreased by $640 million in 1982. The combined deficit on civilian and military goods and services increased by about $400 million in 1982 to $4.7 billion. Unilateral transfers decreased by over $300 million in 1982, partly reflecting a reduction in transfers from Jewish overseas institutions to Israel. However, higher bond sales, a reduction in amortization payments on medium and long-term debt, and a $100 million improvement in net foreign investment caused medium and long-term capital inflows, net of amortization payments, to rise by $102 million in 1982 to $1245 million.

Short-term capital flows rose by nearly $1 billion in 1982 to $1.7 billion. These combined with the $2.6 billion in unilateral transfers and $1.3 billion in medium and long-term capital inflows more than offset the $4.7 billion deficit on civilian and military goods and services. Israel thus ended 1982 with an overall surplus. As had been the case in every year since 1976, additions were made to international reserves, and, in 1982, total reserves increased from $3546 million to $3881 million. Reflecting the financing requirements for the current account deficit, Israel's total external debt outstanding expanded by $2.7 billion from $18.2 billion to $20.9 billion. Of this amount, public external debt reached $13.2 billion at year's end.

DEVELOPMENTS IN 1983

In the first half of 1983, the macroeconomic policy environment was little changed . The rate of depreciation of the shekel continued to be held below that of domestic inflation. The government also continued to raise prices of government controlled basic commodities (e.g. bread, milk, edible oils, eggs, margarine, frozen meat, gasoline) by an average of 5% on a monthly basis, which, because the increase was low, relative to rising costs, tended to increase the level of government subsidization of private consumption. Fiscal policy as embodied in the initial budget for the 1983/1984 fiscal year remained basically unchanged. The temporary levy on imports instituted to finance the costs of the Lebanon war was continued.

By mid-year, a slowing in the rate of inflation was still not evident; to the contrary, consumer prices in the first half of 1983 had risen at an annual rate of some 130%. Moreover, the imbalance in external accounts continued to widen; the merchandise trade deficit expanded by $300 million in the first half of 1983 as compared to the first half of 1982.

To reduce expenditures on imports, the government announced in June the institution of import deposits primarily on the importation of consumer durables. The new requirement stipulated that shekels equivalent to 15% of the value of the good to be imported must be deposited with the government at the time of order; the unlinked deposit is returned, without interest, after one year.

In August the government devalued the shekel by 7%, abandoning the failed policy of slowing the rate of shekel depreciation. In addition, a combination of expenditure cuts and revenue measures totalling some 55 billion shekels -- roughly equal to 5% of initially budgeted expenditures -- was proposed. The Israeli cabinet met and was reported to have approved a number of the proposed measures. Action on these decisions was, however, deferred upon Prime Minister Begin's resignation and the formation of a new government.

Uncertainties surrounding the likely economic policies of the new government, continued adverse developments in both domestic inflation and exports, and rumors of impending devaluations led in late September and early October to a flight from shekel denominated financial assets, including Israeli stock shares. The large volume of sales of Israeli stock shares led to a collapse in share prices. In response to the crisis, the Government on October 11 devalued the shekel by 18% and announced a 50% increase in the price of government controlled basic commodities.

The size of the devaluation was intended to restore confidence in the shekel and enhance the competitiveness of Israeli exports. The rise in prices of government controlled commodities above that of the devaluation represented a shift in government policy on subsidies. The devaluation as well as the subsequent sharp price increases of government controlled basic commodities reduced real incomes and caused a surge in the inflation rate. In turn this generated demands for an advance on the scheduled quarterly cost of living adjustment (COLA) of wages due on January salaries. Agreement was reached in mid-December among the Histadrut (the Israeli labor federation), employers, and the Finance Ministry to pay on December 25th an advance on the COLA to compensate for 85% of October's consumer price index rise of 21%. Under the same agreement, employees were paid on February 1st for 85% of the 28.6% increase in consumer prices in November and December. Although these adjustments raised real incomes, they were not restored to their pre-devaluation level.

As noted, the devaluation and the subsequent increases in prices of subsidized commodities raised the rate of inflation for 1983 substantially. The increase in consumer prices on a year end to year end basis reached 191% in 1983, compared to 132% in 1982 and 102% in 1981. In other areas, the measures were undertaken too late to affect overall economic results for 1983.

For 1983 as a whole gross domestic product is estimated to have increased but modestly -- 1.8% -- a rate of growth very little changed from that of 1982. On a national accounts basis, exports of goods and services expanded by an estimated 1.3%, an increase which was insufficient to make up for the 2.6% decrease in export earnings in 1982. While export earnings were virtually stagnant, domestic consumption and investment expanded at a brisk pace. Private consumption increased by an estimated 6.5%, bolstered by an average rise in real wages in 1983 of about 5%. Public consumption of domestic goods and services increased more than in 1982, 6.4% vs. 4.6%.

Investment in fixed assets evidenced a larger increase than in 1982, 6.5% vs. 4.7%. The continued relative cheapness of imports resulting from the slowing in the rate of the depreciation of the shekel and the public expectation of an ultimate substantial shekel devaluation encouraged firms as well as individual consumers to advance their purchases of consumer durables and investment goods. Thus, imports of automobiles, after rising by 38% in dollar terms in 1982, increased by a further 36% in 1983. Imports of capital machinery and equipment rose by 32% in 1983 after a 23% increase in 1982.

In fiscal policy, the only significant revenue measures introduced in the 1983 fiscal year were the aformentioned import desposit system and the August enactment of a 10% increase in the rate of the purchase tax. An estimated $270 million in added revenues were expected from these two measures for the fiscal year ending in March 1984. Other revenue measures that have been enacted or are still being considered for introduction this fiscal year or next include an income tax on child allowances, an increase in the witholding tax, the raising of the highest income tax bracket to 66%, and increased fees for education and health services. These measures would bring in very little added revenues this fiscal year even if they were introduced immediately, but could yield $175-200 million in the fiscal year beginning April 1, 1984 if in effect for the full year. By comparison, the revenue measures introduced in the 1982 fiscal year were projected to raise about $900 million in collections in fiscal year 1983.

With respect to government expenditures, the policy followed for most of the year of restraining increases in the prices of government subsidized products to 5% per month had the effect of raising total subsidy expenditures by an estimated 6% in real terms in 1983 and of increasing the share of subsidies in the government budget from 4.8% to 5.4%. In October 1983, a series of budget cuts were agreed upon. These were forecast to total 33.5 billion shekels or 2.5% of budgeted expenditures. The most salient of the savings result from the devaluation and the reduction in subsidization. These policy changes are projected to cut subsidy and exchange rate insurance expenditures by 19.5 billion shekels. An additional 8.5 billion shekels was to be saved by cutting planned defense expenditures, while 5.5 billion shekel in expenditure reductions were planned for other government departments and development loans.

The shift in exchange rate policy in the last half of 1983 was too late to affect significantly overall export performance in 1983. For the year as a whole, merchandise exports, in dollar terms, fell by an estimated 1%. Merchandise imports had, in dollar terms, grown but little between 1980 and 1982. In 1983, however, they expanded by 6%, despite the import levies and deposit requirements and the sharper depreciation of the shekel in the latter part of 1983. The civilian trade deficit increased by more than $500 million. In the aggregate, developments in the services accounts in 1983 were also unfavorable. Interest and dividend payments remained constant at $2.8 billion, but receipts on interest and dividend income fell by about $250 million. Tourism receipts rose by an estimated $57 million to $950 million, a level which was still below that attained in 1981. Net expenditures for other services increased by an estimated $70 million, more than offsetting the increase in tourism earnings. In total, the deficit on civilian goods and services rose by nearly $800 million to $3950 million. Deliveries of military equipment and materiel declined by nearly $300 million in 1983, and the combined civilian and military goods and services deficit rose by $400 million to reach a record $5.2 billion.

Grant receipts and net inflows of medium and long-term financing increased in 1983 by an estimated $250 million. Specifically, inflows of medium and long-term loans increased by $134 million; at the same time, amortization payments due on past loans decreased by $80 million. While unilateral transfers fell by an estimated $47 million, net foreign financial and direct investment increased from $12 million to $100 million.

Complete data on short-term capital inflows in 1983 are not yet available. However, since Israeli international reserves fell by $120 million in 1983, it can be deduced that short-term inflows were somewhat below $1 billion (the sum of the civilian and military goods and services deficit, $5150 million, less the total of transfers, medium and long-term capital, $4125 million, and the decline in reserves).

In 1983, external public debt rose by over 10% or $1.5 billion, reaching $14.6 billion. Payments of interest and principal on external public debt, however, remained constant at $1.7 billion. Total debt, including short-term and private debt, rose from $20.9 billion to $23.1 billion. Total debt service payments, however, declined by $97 million from $3672 million in 1982 to $3575 million in 1983.

OUTLOOK FOR THE ISRAELI ECONOMY

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Israel has experienced high inflation for over a decade and triple digit inflation for the past five years. The Israeli consumer's standard of living has largely been protected against erosion from inflation by an increasingly pervasive system of indexing wages, interest income, and income tax brackets to consumer price and related exchange rate movements. (However, had there been no inflation, the level of investment would likely have been higher which would have translated into a still higher living standard.) In addition, transfer payments and subsidization of basic commodities by the government have tended to increase real disposable income. Government deficits have expanded stemming both from high levels of military expenditures and rising transfer, interest, and subsidy payments. Private consumption has grown, and investment has not kept pace. Moreover, with high inflation, the attractiveness of investing in real productive assets has declined relative to the holding of financial and other assets which provide good hedges against inflation but do not finance productive investment. The decline in fixed investment has ruled out major advances in labor productivity from increased capital per worker. At the same time, wage settlements, plus the system of wage indexation, have led to rise in labor costs that exceeded increases in productivity, thus eroding the competitiveness of Israeli goods and services.

The pattern of lucrative wage settlements, comprehensive indexation and high government deficit spending that has emerged over the past several years has led to rises in both public and private consumption which have exceeded the increases in the economy's productive capacity. As a result, Israel's deficit on civilian goods and services account has increased. While excessive aggregate demand pressures largely account for increased imports, a number of additional factors have been responsible for lagging export performance. Firstly, the global recession of 1980-1982 dampened world demand for exports of goods and services. Israel was adversely affected as were many other countries. Secondly, domestic wage costs have been increasing at a faster pace than those of foreign competitors (and, as already noted, at a faster pace than can be justified on the basis of increases in labor productivity), reducing the profit margins for Israeli exports. Lastly, the slowing in the rate of depreciation of the shekel in 1982/1983 made Israeli exports relatively more costly and further undermined the position of Israeli suppliers in export markets.

To finance the growing civilian goods and services deficit, Israel has relied on both continued flows of concessional economic assistance and expanded borrowing in foreign commercial capital markets. The interest and principal payments on Israel's external debt (including interest on short-term debt) absorb over 30% of Israel's earnings from the exports of goods and services. In addition, foreign debt service payments comprise an increasingly significant portion of government expenditures. Given the magnitude of commercial financing likely to be available, Israel clearly needs to take steps to reduce its financing requirements. A well thought out economic program which addresses both the problems of external and internal inbalances is needed irrespective of the level of assistance voted by the Congress.

If the major internal and external imbalances present in the Israeli economy are to be corrected and if Israel is to take advantage of the opportunity provided by Western economic recovery to revive exports, the government must find ways to restrain real wages, ensure that the exchange rate reflects market forces and reduce budget expenditures to curtail aggregate domestic demand and the monetary expansion associated with rising deficit spending. If aggregate domestic demand pressures could be reduced via fiscal policy measures, inflationary pressures would diminish. Moreover, a reduction in real labor costs in Israel could be expected to have positive impacts on both export competitiveness and profitability. Over the longer term, reduced inflation would tend to make investment in real, productive assets more attractive, while increased export profitability and lower wage costs would provide opportunities for investment in export oriented manufacturing and services.

The process of adjustment will not be an easy one. Labor remains strongly opposed to altering the wage indexation system. Moreover, political support for austerity measures is not high. When plans for austerity measures and reform of Israel's monetary system were made public in mid-October, the public outcry and lack of political support for the economic reform program forced the resignation of the Minister of Finance. Given that experience, the Israeli government since October 1983 has moved very deliberately and so far has announced only a gradual and incomplete stabilization program. First priority has been given to improving Israel's balance of payments position. To this end, exchange rate policy now reflects the government's intention to make Israeli exports competitive and to diminish incentives to import. In addition, the government has continued the 1% levy on foreign exchange purchases and the import deposit requirements.

Combatting inflation has been assigned a lower priority. No cohesive program to reduce it has been devised yet. The new government has called for a reduction in real wages in 1984. But it has not indicated how this is to be achieved in the face of pressures to further extend the system of wage indexation and reduce the lag between price increases and compensating adjustments in wages. The publicly announced target is to maintain real wages at the 1981 level, implying about a 5% decline from the average 1983 level. In fact, achievement of this target would allow for some growth in current wages since, in the last quarter of 1983, real wages dropped below the average 1981 level as a result of the lag in COLA adjustments to the very rapid rise in prices following the devaluation and subsidized commodity price increases. Whether the government's hoped for reduction in real wages and resulting decrease in private consumption materialize will depend on the outcome of wage negotiations which take place when the current wage agreement expires in April. Some moderation in private consumption may be expected from a carry-over into 1984 of the negative wealth effect experienced when Israeli stock prices fell steeply in late 1983.

With respect to fiscal policy, the government has eschewed major new revenue measures, but has proposed some reductions in government expenditures. For the 1984 fiscal year, the Israeli cabinet agreed on a government budget expenditure ceiling of 1.4 trillion shekels (in 1983 prices) approximately 4% less than the projected level for fiscal 1983. Hopefully, the bulk of the cut will be in procurement of domestic goods and services, thus directly reducing demand pressures. Subsidies and transfers will also be reduced. Over the medium term, it is expected that the level of subsidies will drop to no more than 25% of prices to the consumer. (By comparison, in January 1984, subsidies comprised between 41% and 128% of prices to consumers.) However, while cutting subsidies reduces the size of the government budget, it does much less to curtail aggregate demand since, under Israel's indexation system, the loss in income that cut in subsidies would normally imply is quickly offset by COLA adjustments. From information available at the time of writing -- and it needs to be stressed that the Knesset has not yet approved the new budget -- it does not appear that the proposed budgetary cuts will be sufficient to bring down inflation materially. Projected advances from the central bank to finance the deficit remain high, and no longer term plans have been formulated to reduce dependency on deficit financing. Moreover, if it proves difficult to realize the planned reductions, fiscal operations could further strengthen inflationary pressures.

Economic recovery in Western Europe and North America coupled with October's devaluation of the shekel and current exchange rate policy should spur some recovery in Israeli exports in 1984. The amount by which import growth will be curtailed and resources made available for exports and investment will depend greatly on levels of domestic consumption. Given the government's gradualist approach and the uncertain prospects for achieving even its modest goal in the areas of fiscal and wage policy, a marked reduction from the $5.2 billion deficit in goods and services registered in 1983 is unlikely.

Longer term prospects are even more difficult to discern. Clearly Israel needs to reduce deficit financing of government expenditures, contain private consumption, and encourage increased savings and investment -- particularly in export industries. A comprehensive, long-term program to realize these objectives has not yet emerged.