

Ronald Reagan Presidential Library

Digital Library Collections

This is a PDF of a folder from our textual collections.

Collection:

Green, Max: Files, 1985-1988

Folder Title:

[Israel] (1 of 4)

Box: Box 12

To see more digitized collections visit:

<https://www.reaganlibrary.gov/archives/digitized-textual-material>

To see all Ronald Reagan Presidential Library Inventories, visit:

<https://www.reaganlibrary.gov/archives/white-house-inventories>

Contact a reference archivist at: **reagan.library@nara.gov**

Citation Guidelines: <https://reaganlibrary.gov/archives/research-support/citation-guide>

National Archives Catalogue: <https://catalog.archives.gov/>

FOR
AGENDA

NEA/TAL

SM/86/85

CONTAINS CONFIDENTIAL
INFORMATION

April 23, 1986

201.85
Σ

To: Members of the Executive Board

From: The Secretary

Subject: Israel - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Israel. A draft decision appears on page 19.

This subject has been tentatively scheduled for discussion on Wednesday, May 21, 1986.

Mr. R. P. Hicks (ext. 7187) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

ISRAEL

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with Israel

Approved by Brian Rose and J.T. Boorman

April 22, 1986

I. Introduction

A staff team consisting of Messrs. de Fontenay (EUR), Kreis (FAD), Hicks (EUR), Nielsen (EUR), and Op de Beke (EP-EUR), with Ms. Adams (EUR) as secretary, held Article IV consultation discussions in Jerusalem and Tel Aviv during February 27-March 10, 1986. The Israeli representatives included officials of the Bank of Israel and the Ministries of Finance and Commerce and Industry. The mission had discussions with the Minister of Finance, Mr. Moday, the Governor of the Bank of Israel, Dr. Mandelbaum, and the Director General of the Ministry of Finance, Dr. Sharon. Meetings were also held with the Heads of the Manufacturers' Association, the Bankers' Association, and the Trade Union Federation (Histadrut). Mr. Polak, Executive Director for Israel, and Mr. Steinberg, Advisor to the Executive Director, attended some of the meetings.

Israel continues to avail itself of the transitional arrangements under Article XIV.

II. Background

Over the past decade, Israel has experienced a period of prolonged economic difficulties. While output and productivity stagnated, private and public consumption continued to expand, resulting in a rapid increase in foreign debt, recurrent balance of payments crises, and a steep decline in the share of investment in GDP. Inflation accelerated by stages reaching 445 percent (on a year-end basis) in 1984 (Chart 1). Unemployment remained generally low, with the public sector's share in the labor force rising from 20 percent to 30 percent during the past ten years. Priorities for economic policy shifted between the balance of payments and inflation, with attempts at solving one problem usually aggravating the other.

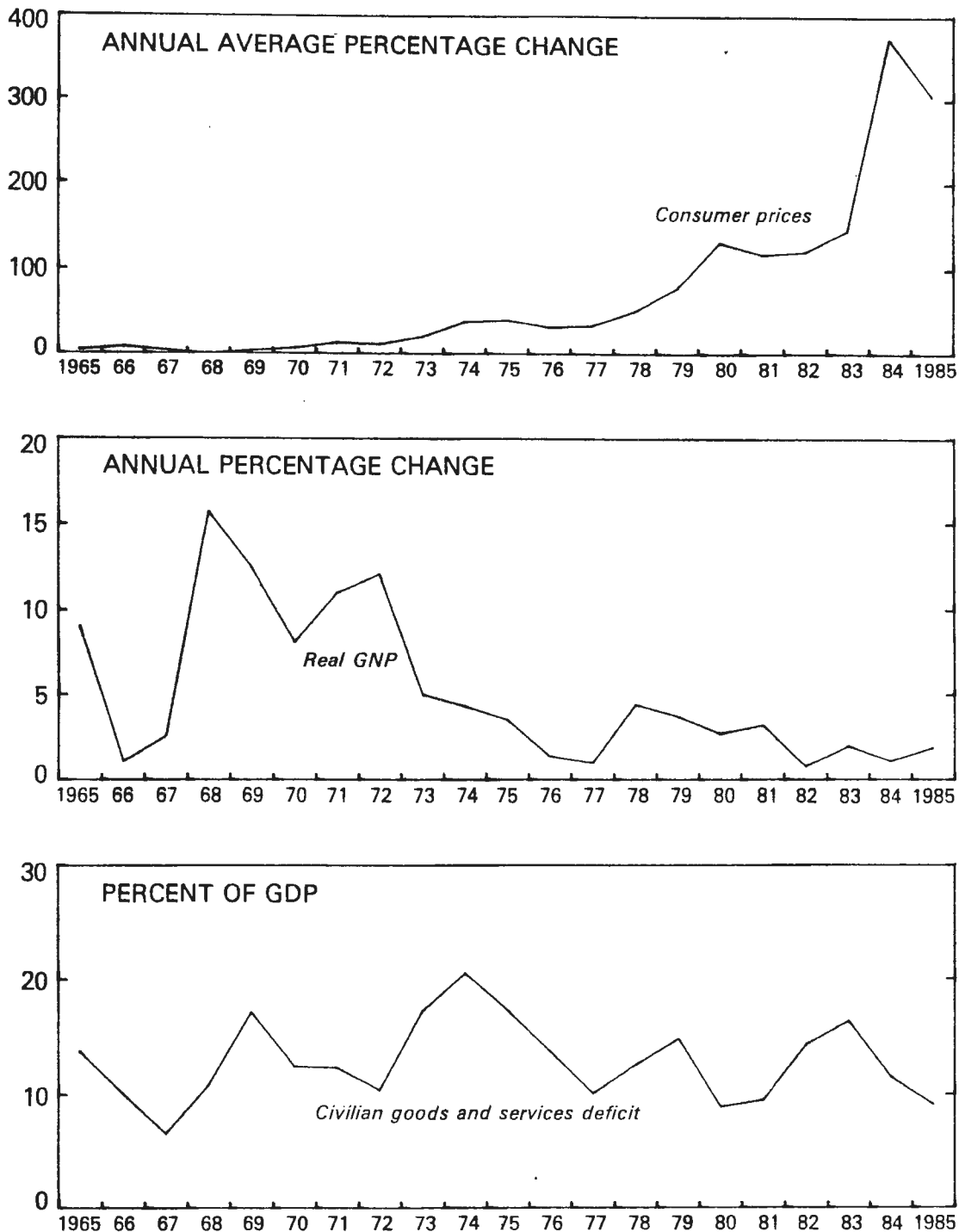
There is broad agreement over the main causes of Israel's poor economic performance. A large responsibility rests on the government budget deficits, related in part to defense needs and the desire to maintain full employment. Despite special incentives to encourage savings, the Government has had to borrow massively from the central bank, thereby precipitating losses of official reserves and fueling inflation. Attempts at reducing the budget deficit by cutting subsidies or raising taxes, or the balance of payments deficit by devaluing, resulted in sharply higher rates of inflation as indexation of wages speeded up the transmission of such price shocks through the economy and indexation of financial assets implied automatic accommodation of the money supply to the higher prices.

The Israeli representatives said the notion that the adverse effects of inflation could be adequately countered by widespread indexation had been abandoned. Inflation was now seen as largely responsible for the decline in productivity and the overexpansion of financial services. Business decisions, and in particular the monitoring of costs and relative prices, had become exceptionally difficult.

As discussed in last year's Staff Report (SM/85/118), Israel suffers from structural problems which have also contributed to the deteriorating performance of the economy: a high tax burden (although inflation bursts temporarily reduce revenue as tax receipts lag behind incomes and prices), a bloated public sector, and an excessive degree of interference by the Government in the economy, in the form of various regulations, subsidies and taxes which distort resource allocation.

On the occasion of the 1985 Article IV consultation with Israel Directors observed that the continuing failure to deal with the underlying imbalances in the economy, reflected especially in large and expanding fiscal deficits, had contributed importantly to the major economic problems that had emerged. They expressed serious doubts about the realism of a gradualist approach, given the dimensions of the economic problem, and emphasized the need for substantial, comprehensive and immediate adjustment measures. Directors underlined the critical role of fiscal policy in the stabilization effort, strongly supported the policy of maintaining high real interest rates, and expressed the view that real wage restraint should form an important part of a stabilization program in Israel. Directors also noted the exchange restrictions and multiple exchange rate practices recently introduced and regretted the extensive system of import restrictions and export subsidies.

CHART 1
ISRAEL
INFLATION, GROWTH, AND CIVILIAN GOODS
AND SERVICES DEFICIT, 1965-85



Sources: Central Bureau of Statistics; *Monthly Bulletin of Statistics*; IMF, International Financial Statistics; and staff calculations.

III. The Stabilization Program

1. Economic developments in the period preceding the program

Economic policy shifted in late 1983 toward the improvement of the balance of payments. The sheqel was devalued by 19 percent in October 1983 and again by 8 percent in September 1984, and the prices of subsidized products were raised. Domestic demand, which had expanded rapidly in 1981-83, declined in 1984 partly due to the erosion of financial wealth associated with the stock market collapse of 1983 (Table 1). The budget had an expansionary effect as the deficit rose because of a sharp drop in revenue associated with the acceleration of inflation. The foreign trade account improved but the inflation rate soared to an average monthly rate of 23 percent in September-October 1984. Fears of hyperinflation prompted the coalition Government formed in September 1984, the Histadrut and the employers' organization to sign an agreement (which became known as the "first package deal") providing inter alia for a three-month price freeze, cuts in the budget deficit, and payments to wage earners of only two-thirds of the normal cost of living adjustment over the three months' period, which lowered the monthly rate of inflation to 4 1/2 percent by December-January. However, this success was short-lived. The continued depreciation of the sheqel, delayed wage adjustments for past increases in the cost of living, and the rising budget deficit (due to lower tax receipts and higher spending on subsidies to keep the price of subsidized products unchanged) created pressures to raise prices. At the end of January 1985, the Government raised controlled prices and negotiated with the Histadrut and the employers a "second package deal" which provided for controlled increases in prices of nonsubsidized products and continuation of the partial indexation of wages. Prices, however, rose by 13 percent a month in February and March 1985. A third package deal reimposed a price freeze for four months as of April 1, after immediate price increases which pushed prices up by 19 percent in April, and a second adjustment at the end of May which led to a 15 percent increase in prices in June. The increasing ineffectiveness of the "package deal" approach and the decision of the employers' federation to exercise its option to withdraw from the agreement led the Government to adopt in early July a comprehensive plan for economic stabilization.

Despite the intended reduction in the budget deficit for FY 1985/86 (beginning on April 1, 1985) equivalent to about 7 percent of GNP (excluding foreign grants), the deficit remained high during the first half of 1985. Implementation of some of the expenditure cuts and additional revenue measures approved in the budget was postponed and overruns were registered in subsidies and other spending items. As a result, the government deficit in relation to GNP remained in the first half of 1985 not much below the level recorded in the comparable period of 1984.

The wide fluctuations in the rate of inflation made the conduct of monetary and exchange rate policies particularly difficult. On balance,

monetary policy remained accommodative and total credit to the private sector expanded by 2 percent in real terms during the first half of 1985, while the real effective exchange rate appreciated by about 5 percent. Domestic demand and GDP expanded in the first half of 1985, mainly due to the recovery of private consumption. Despite an improvement in the balance on civilian goods and services in the first six months of 1985, reserves declined, partly due to speculative capital outflows, and the premium on the dollar in the parallel market rose to a peak in excess of 30 percent by June 1985.

The Israeli authorities concluded from the experience of the package deals that the balance of payments and inflation problems had to be tackled simultaneously and that price and incomes measures, though useful in contributing toward a rapid deceleration of inflation, had no chance of lasting success unless they were buttressed by restrictive financial policies. It was also considered that exchange rate stability relative to the U.S. dollar would need to be an essential element of a stabilization plan.

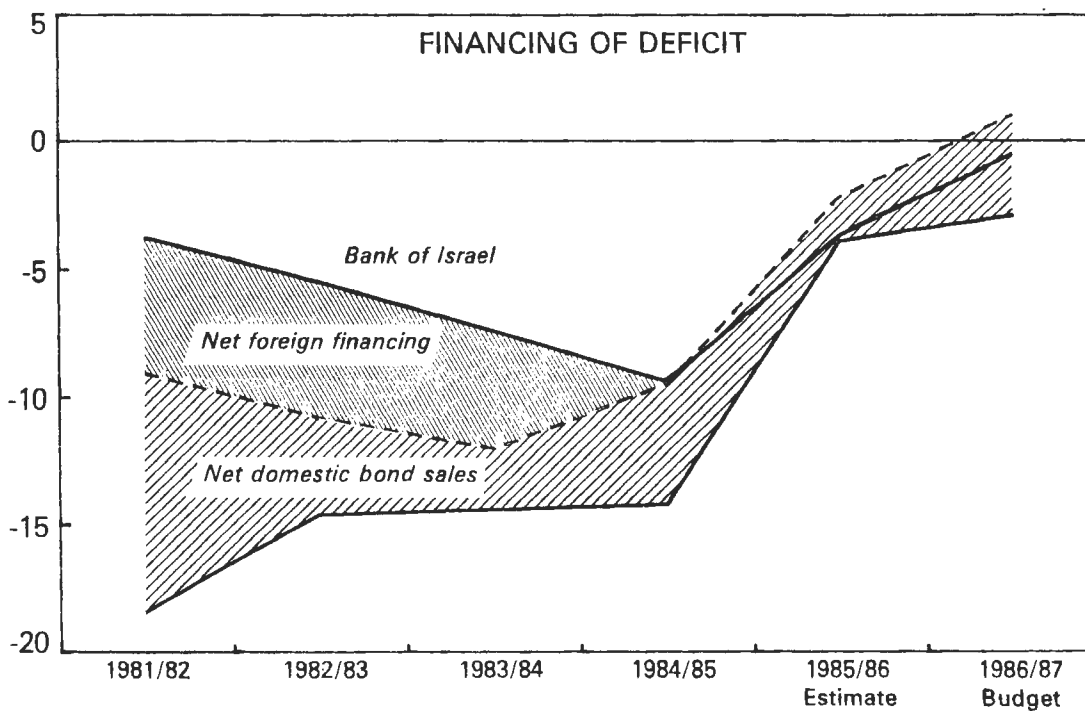
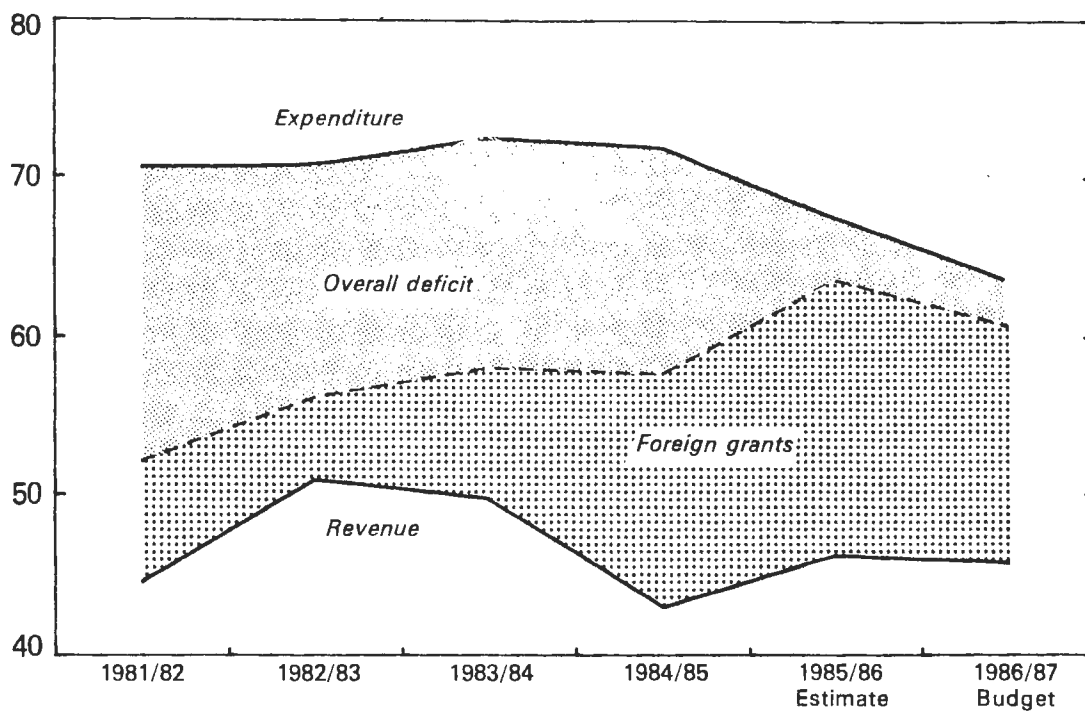
2. The Stabilization Program ^{1/}

The aim of the July 1985 Economic Stabilization Program was to reduce inflation rapidly by a combination of restrictive financial policies and of measures to limit drastically inflation inertia, i.e., the effect of past increases in costs and prices on the current rate of inflation either through the indexation mechanism or through other channels. A further improvement in the balance of payments was another important goal.

A key element of the program was the reduction of the budget deficit (before grants) for 1985/86 by US\$1.5 billion (7.5 percent of GNP) below the level for 1984/85 (Chart 2). This implied, in addition to full implementation of the deficit reducing measures included in the 1985/86 budget, new temporary tax measures and expenditure cuts amounting to about US\$750 million on an annual basis, or US\$560 million for the remainder (July-March) of the 1985/86 fiscal year. The new revenue measures included a one-year income tax surcharge of 10 percent on the self-employed and corporations. Expenditure cuts consisted mostly of a further reduction in subsidies, loans, selected categories of transfer payments, and purchases of goods and services, including wages. Prices of subsidized consumer goods and services and of other goods whose prices are controlled were raised by between 30 percent and 100 percent immediately and the amounts spent on price subsidies were frozen in real terms. Monetary policy was also severely tightened in order to achieve within one month a 10 percent reduction in real terms in bank credit outstanding. The exchange rate of the sheqel was devalued by 16 percent

^{1/} See Appendix II for a comparison of the main features of the stabilization programs adopted by Argentina, Brazil and Israel in 1985 and 1986.

CHART 2
ISRAEL
CENTRAL GOVERNMENT OPERATIONS
(As a percentage of GNP¹)



Source: Data provided by the Ministry of Finance.
¹ GNP data adjusted to fiscal year (April-March) basis.

and the sheqel-U.S. dollar rate was stabilized (though this was declared to be conditional on wage developments). Prices of nonsubsidized products were frozen after an initial increase of about 17 percent and the indexation arrangement for wages was temporarily suspended. The wage agreements subsequently negotiated provided for full compensation by March 1986 for the erosion of real wages in the business sector during the first months of the program, while real wages in the public sector were to be eroded over the period by 5 percent (Chart 3). Finally, although the indexation of long-term financial assets was maintained, its scope was narrowed for foreign-exchange-linked (PATAM) deposits; henceforth new deposits of less than 12 months' maturity could no longer be effected in sheqalim, and the share of tradable government bonds issued by tender was to be raised gradually. The program was supported by US\$1.5 billion in emergency grant assistance from the United States, of which half was disbursed in 1985 and the other half was expected to be received in 1986.

Some compromises had to be accepted by the authors ^{1/} of the program to gain its acceptance by the Government. The reduction in the deficit was smaller than needed to stabilize public debt in real terms and only 20 percent of the reduction in the deficit was to come from a reduction in public consumption. The size of the devaluation was smaller than what would have been required for a total abolition of export incentives (about 30 percent), largely because it was feared that the wage erosion that would have resulted from the inflationary effect of such a large devaluation--given the temporary suspension of the indexation arrangements--would have been unacceptable. Finally, the wage agreement signed in August by the Histadrut and the employers' association provided for the reintroduction of indexation and enhanced its extent by lowering the cumulated CPI increase that would trigger an adjustment from 12 percent to 4 percent and reducing the minimum period between adjustments from six to three months.

3. The first results

In the eight months following its introduction, the stabilization program has been a success. After an initial burst of 27.5 percent in July, resulting from a correction of prices, the rate of inflation declined to an average monthly rate of 2.7 percent in the rest of the year and virtual price stability in the first two months of 1986 (Chart 4). The Israeli representatives discounted the role of price controls in maintaining price stability, emphasizing instead the contraction of demand and the relative stability of the exchange rate with respect to the U.S. dollar, and pointing to the absence of shortages. By the beginning of March 1986, items accounting for 46 percent of the CPI were no longer controlled while, of the remainder, roughly one half

^{1/} A team of economists from the Government, the Bank of Israel and universities, headed by the Director General of the Ministry of Finance, Dr. E. Sharon.

consisted of goods and services normally controlled, such as utility rates and monopoly prices, and the other half is to be freed by the summer.

The overall fiscal performance improved substantially in 1985/86 compared with the outturn in the previous years as well as with the budget estimates (Table 2). The government deficit (before grants) is estimated to have been cut relative to GNP by 7.5 percentage points, and the financing requirement (deficit after grants) by over 10 percentage points, as foreign grants have risen by almost 3 percentage points of GNP. Because of an exceptionally large amortization of domestic debt, principally the redemption of about US\$700 million worth of bank shares held by senior citizens and guaranteed by the Government, there was a sharp drop in net domestic bond financing, and net financing from the Bank of Israel remained high (3.7 percent of GNP), although much below the level authorized in the budget and substantially less than in 1984/85.

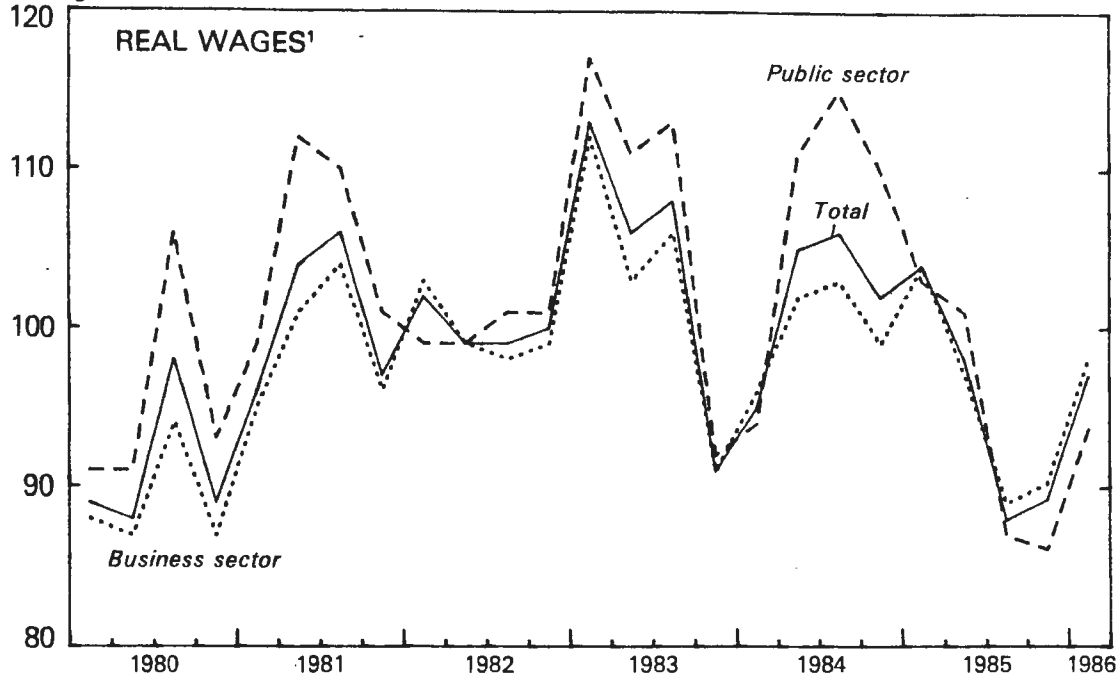
The improvement in the budget outturn for 1985/86 was due to an estimated increase in revenue equivalent to 3.2 percent of GNP and cuts in expenditure estimated at 4.3 percent of GNP. The increase in revenues reflected the positive impact of decelerating inflation on tax collections, the elimination of various tax benefits previously enjoyed by corporations, and other measures introduced in the budget in mid-year. Expenditure cuts occurred through sharp reductions in subsidies for basic products and lower payments for interest, wages and salaries, and defense outlays. At the same time, transfer payments--including those for export promotion--increased markedly during the fiscal year.

Monetary policy was tightened severely. The average cost of sheqel overdraft credit which had been 17 1/2 percent per month in the first half of 1985 initially declined only modestly despite the sharp drop in the inflation rate, thus putting pressure on firms to reduce their inventories. The high interest rates and stable exchange rate relative to the U.S. dollar prompted a shift from linked to nonlinked assets (Chart 5). As the reserve requirements on the latter are lower, the Bank of Israel had to raise them sharply in order to neutralize the potential for monetary expansion. "Directed credits" for exports were denominated from July entirely in U.S. dollars at an interest rate equivalent to 2 percentage points over LIBOR; the stability of the exchange rate implied a large gap between the cost of such credit and that of local currency loans. The introduction of a tax on capital inflows was considered but administrative regulations continued to be used to limit the use of foreign currency loans.

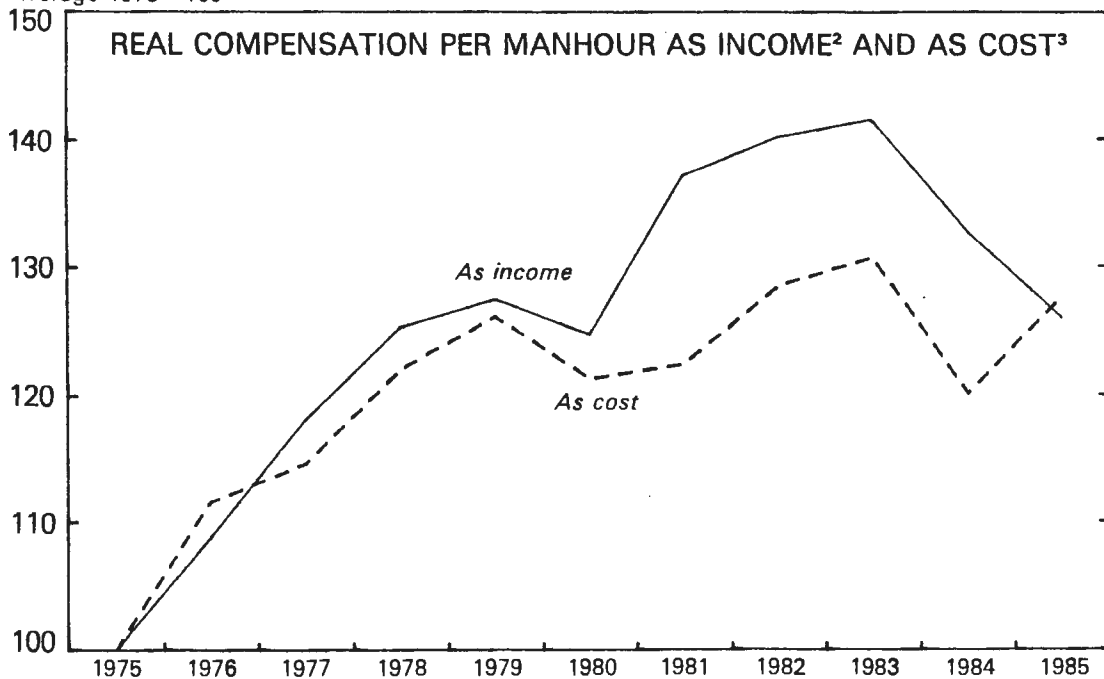
Interest rates were lowered gradually: by mid-March 1986, the average monthly cost of sheqel overdraft credit had fallen to 3.4 percent, compared with official expectations of a rate of inflation continuing at 1 1/2-2 percent a month (Chart 6). Total short-term bank

CHART 3 ISRAEL WAGE DEVELOPMENTS

Average 1982 = 100



Average 1975 = 100



Source: Data provided by the Bank of Israel.

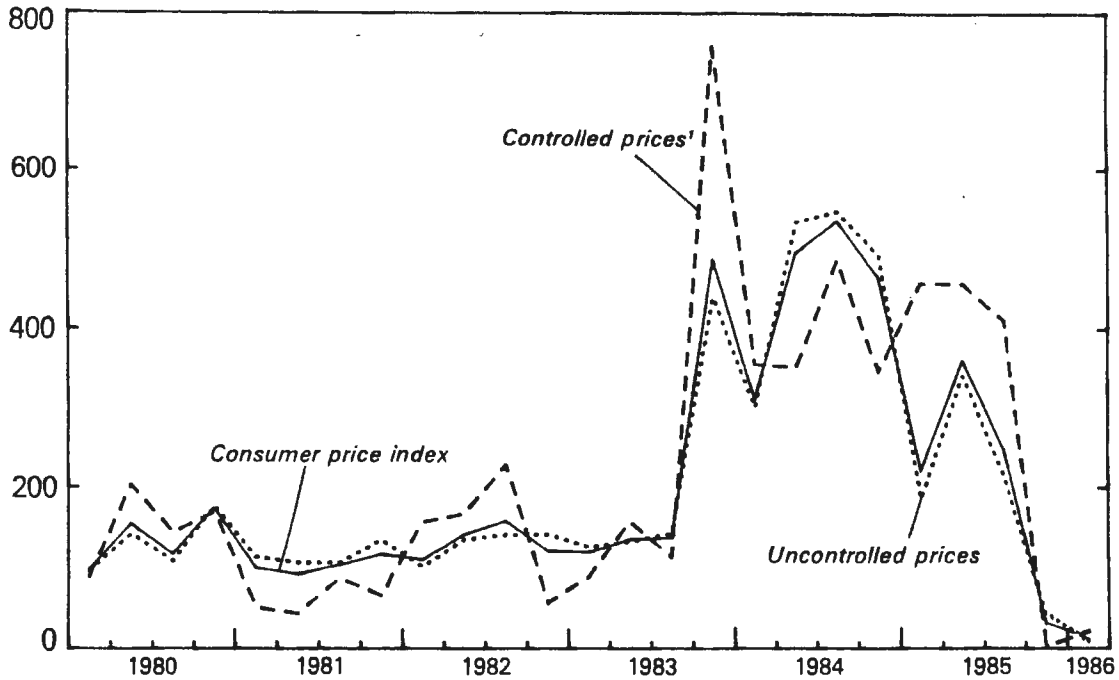
¹ Average monthly wage per employee post at constant prices.

² Gross; including nonwage compensation; deflated by CPI.

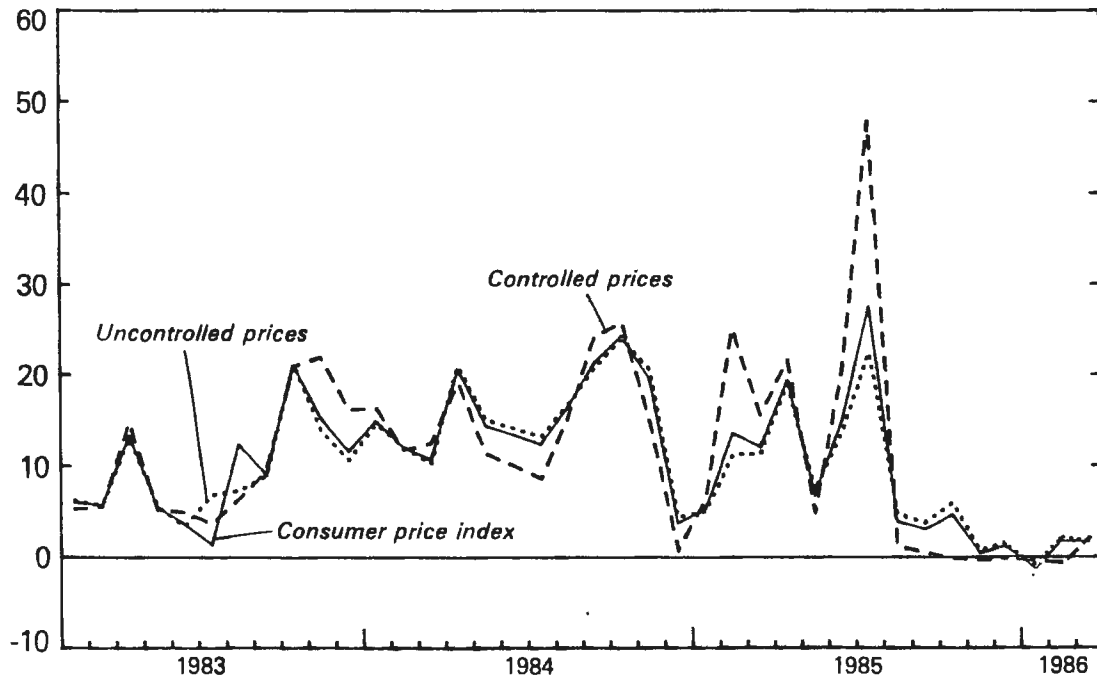
³ As indicated in footnote 2 but deflated by the implicit price index of business sector net domestic product.

CHART 4
ISRAEL
CONSUMER PRICES

Percent change through the quarter at annual rate



Percent change from previous month



Source: Central Bureau of Statistics, *Monthly Bulletin of Statistics*.

¹Controlled prices (20 percent of the CPI) are prices traditionally fixed directly by the Government.

CHART 5
ISRAEL
LIQUID FINANCIAL ASSETS OF THE PUBLIC

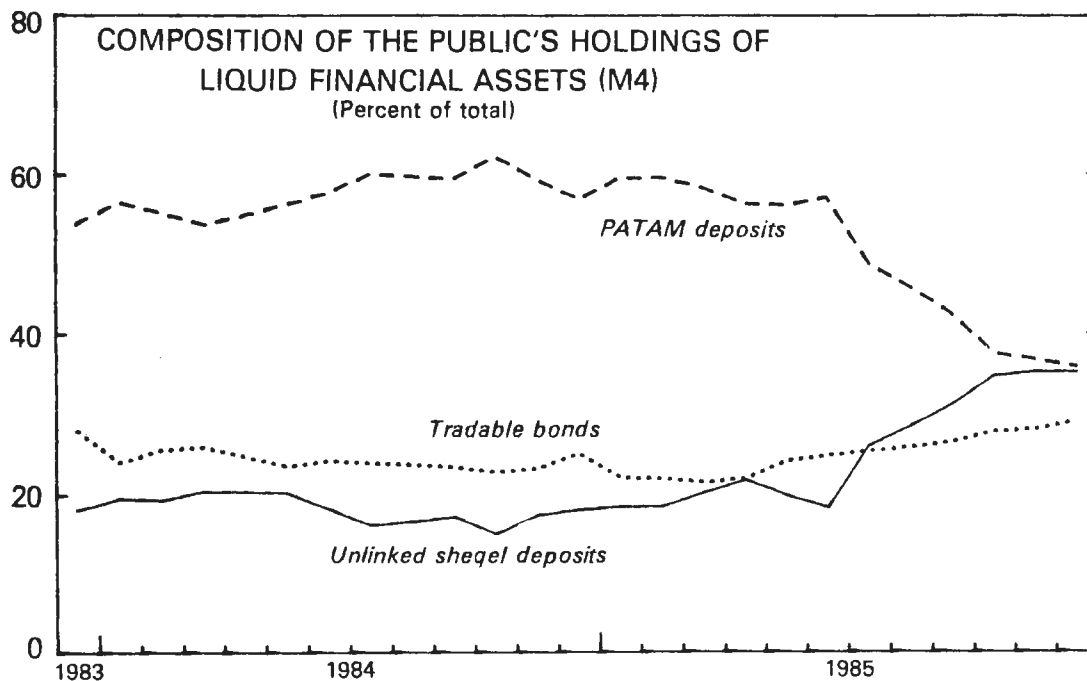
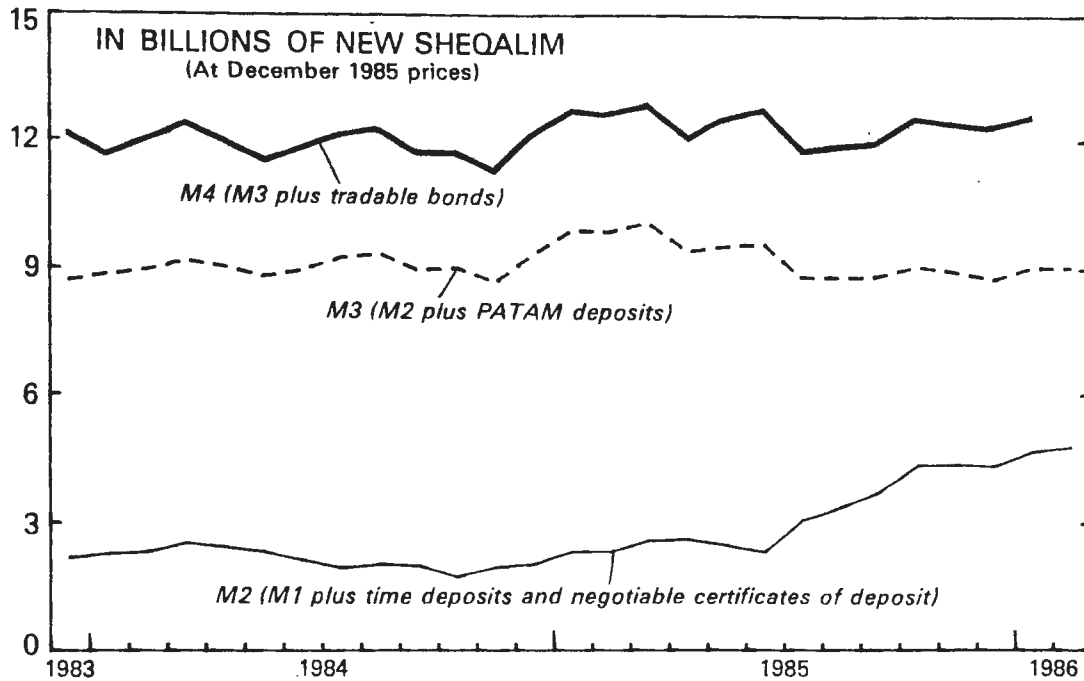
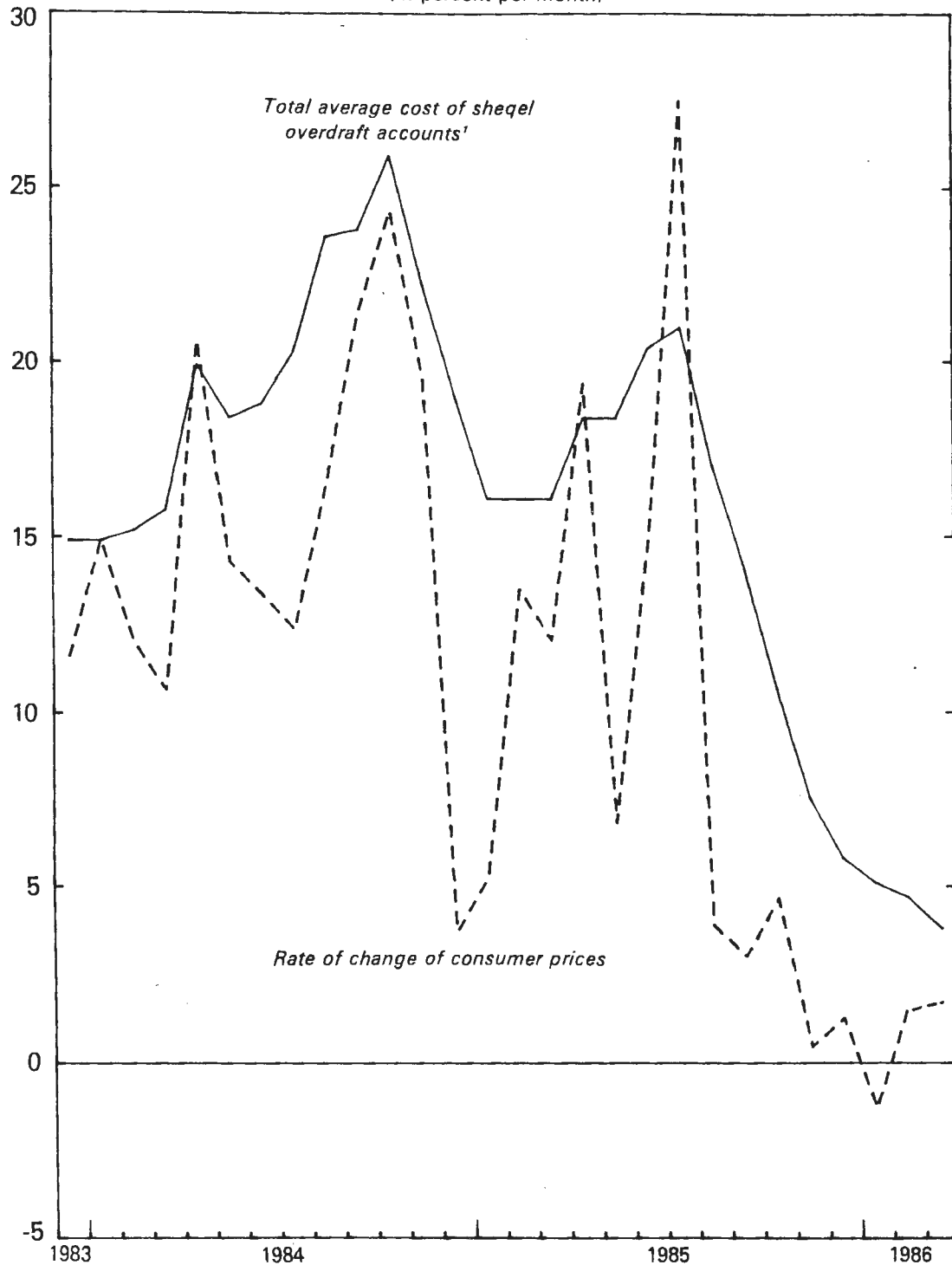


CHART 6
ISRAEL
SHEQEL OVERDRAFT RATE AND
CONSUMER PRICES, 1983-86
(In percent per month)



Sources: Bank of Israel, Research Department, *Recent Economic Developments*; and data provided by the Bank of Israel.

¹ Includes allocation fee and risk premium.

credit to the private sector fell by 7 percent in real terms in the second half of 1985, but began to pick up again in the first two months of 1986 (Chart 7).

The tightening of financial policies and the decline in real wages combined to reduce domestic demand in the second half of 1985 by 8 1/2 percent in real terms (after seasonal adjustment). Although real disposable income continued to fall sharply, private consumption declined by only 3 1/2 percent as households reduced their savings, while public consumption fell by 9 percent (largely due to lower domestic defense spending related to the withdrawal from Lebanon); fixed investment declined by nearly 7 percent, while stocks fell sharply. Real GDP declined by 5 percent in the second half but increased on average by 2 percent for the year as a whole. The rise in unemployment proved less serious than had been feared. The unemployment rate (seasonally adjusted) peaked at 7.8 percent in the third quarter, then fell to 6.6 percent in the fourth quarter, and in February 1986 stood at less than 6 percent (Chart 8). Demand and activity seem to have recovered from the final quarter of the year: retail sales and imports of consumer durables rose strongly due in part to the resurgence in real wages.

The improvement in the civilian goods and services account of the balance of payments continued in 1985 (Table 3). The effect of the weakening of foreign demand on the trade account was offset by the decline in domestic demand and improvement in the terms of trade. Despite an increase in defense imports, the overall goods and services deficit declined by about US\$500 million in 1985 (Chart 9). The large increase in public transfers received from the United States (due both to emergency economic assistance and a shift from loans to grants) resulted in a current account surplus for the first time since 1954. The weakening in the capital account reflected the shift from loans to grants in U.S. assistance and the repayment of debt by the private sector. Speculative purchases of foreign exchange increased in the second quarter of 1985 on expectations of a devaluation and concern about a possible impairment of financial assets (through a tax on savings or reduced indexation); however, there was a shift to net sales of foreign exchange by the private sector in the third quarter. Strict capital controls limited the inflow of registered capital, but the Israeli representatives attributed the large positive errors and omissions account to the high domestic interest rates that attracted unregistered capital into the country. The authorities intend to use the U.S. emergency assistance to rebuild net reserves and this was largely achieved in 1985. Net reserves of the Bank of Israel rose by \$590 million in 1985 to US\$3.2 billion, equivalent to about three months of imports. Total net external debt (defined as gross debt minus banks' foreign assets) stabilized in 1985, despite an unfavorable valuation adjustment resulting from the appreciation of nondollar liabilities.

IV. The Problems Ahead

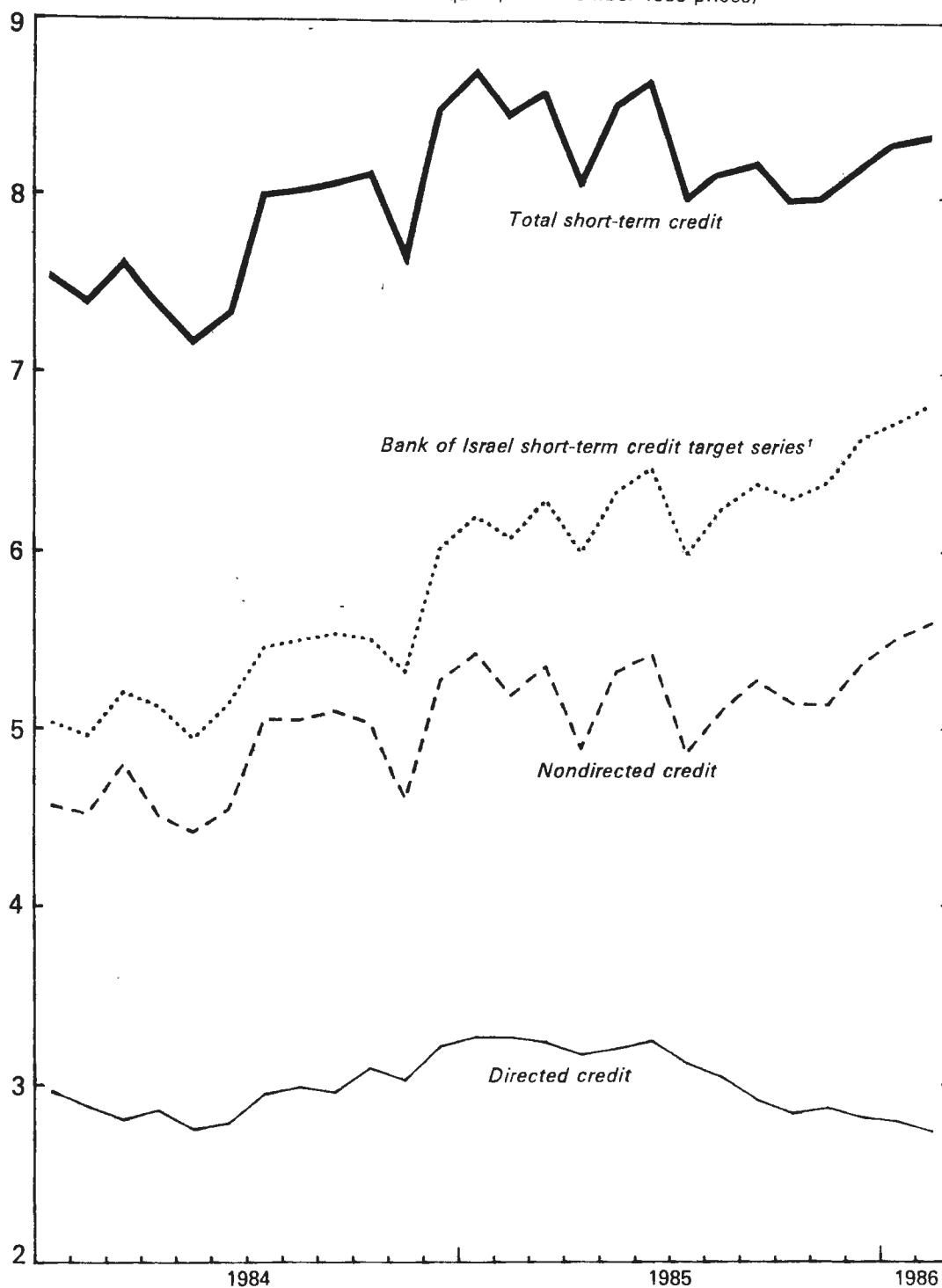
The Israeli representatives agreed that the stabilization program could be regarded as truly successful only if it had lasting effects on inflation and the balance of payments and in particular reduced reliance on foreign assistance which would be significantly lower by 1987. They recognized that the fall in the price of oil and the depreciation of the U.S. dollar had helped the program. Stability of the sheqel in terms of the U.S. dollar had advantages because of the high visibility of this rate, and the large share of imports denominated in that currency. At the same time, the depreciation of the U.S. dollar against major currencies, and hence the effective depreciation of the sheqel, prevented an erosion of export competitiveness and the real effective exchange rate of the sheqel depreciated modestly in the latter part of 1985. The rise in unemployment and the financial difficulties experienced by some companies had stiffened resistance against the stabilization effort, however, and the Prime Minister had recently stated that the emphasis should again be on economic growth. While confidence in the program, appeared high, as measured by inflationary expectations and the modest premium on the dollar in the parallel market, the Israeli representatives acknowledged that changes could take place very rapidly. Most unlinked financial assets, bank deposits, and Treasury bills have a maturity of no more than two months and might be converted again into foreign exchange or linked assets although the scope for such transfers has been reduced in part since deposits in PATAM accounts of less than one year can no longer be made in sheqalim. The authorities saw the main problems ahead in the areas of wage determination, the 1986 budget, and monetary and exchange rate policies.

1. Wages

The wage agreement expired on March 31, 1986 and negotiations between the Histadrut and the employers' association on a new agreement are to commence soon. These negotiations are seen as crucial both for inflation and for employment. The Government has warned the Histadrut that a large settlement would be promptly followed by a depreciation of the sheqel in order to maintain competitiveness, thereby eroding some of the gain in purchasing power that workers might seek. It is also considering the possibility of reducing the employers' payroll tax to offset partly the effect of the wage increase on labor costs. However, the staff mission pointed out that, if such a tax cut were to be financed by increases in indirect taxes or cuts in subsidies which would be shifted to business through the indexation mechanism, firms would not receive any real relief.

The Israeli authorities hoped that real wages in the business sector could be contained at their March 1986 level which, though unchanged relative to the period immediately preceding introduction of the stabilization plan, was about 4 percent below the average level for 1984 (and equivalent to the 1981 average); for public sector employees, the decline was larger. The staff noted, however, that labor

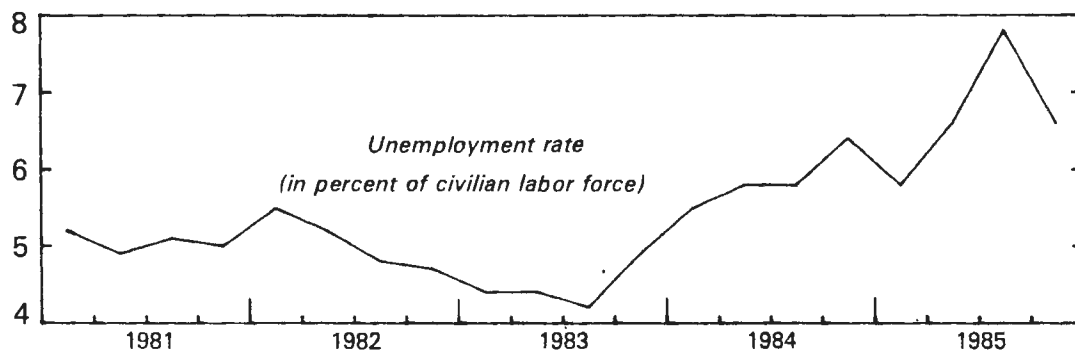
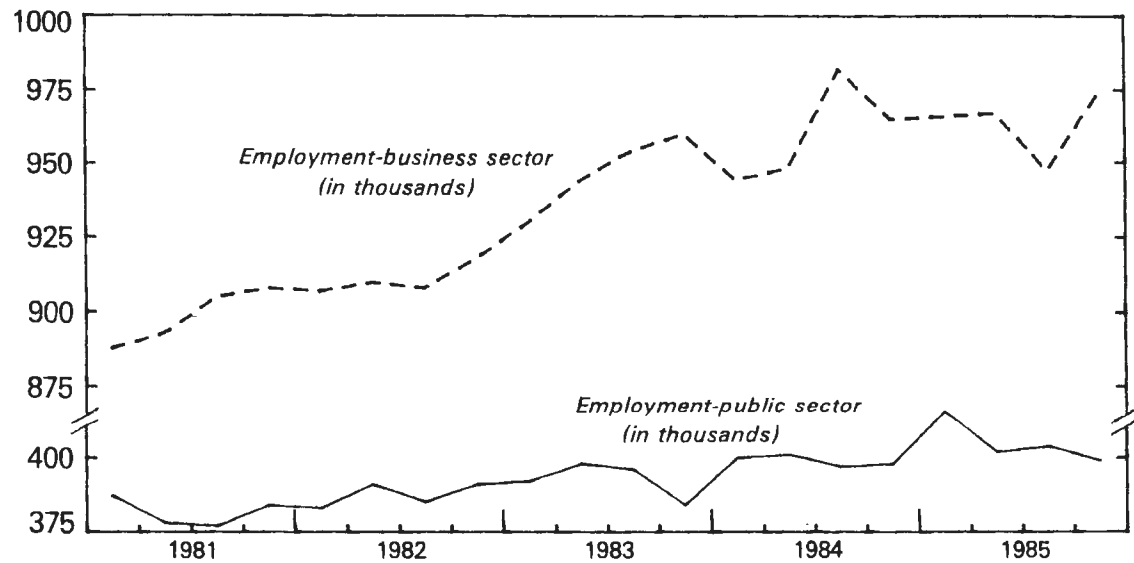
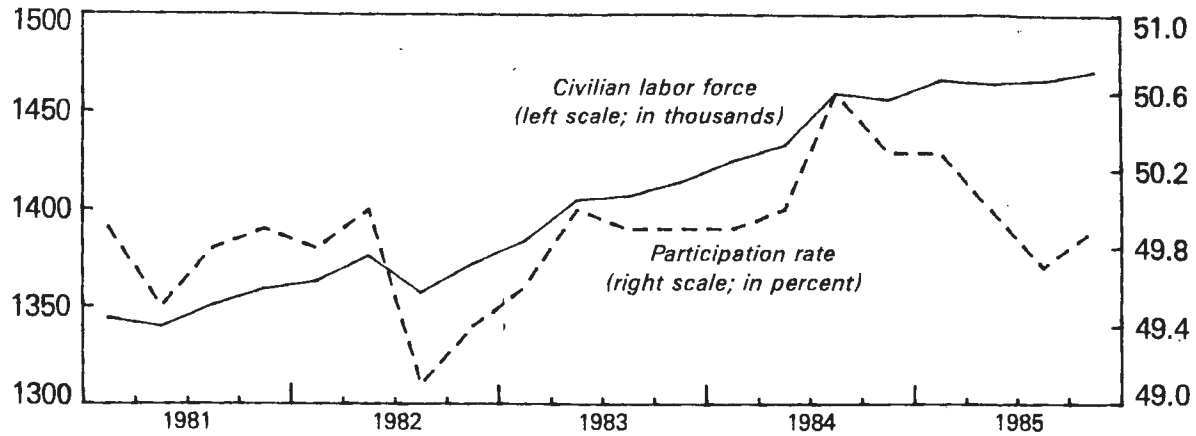
CHART 7
ISRAEL
SHORT-TERM BANK CREDIT TO THE PUBLIC, 1984-86
(In billions of new sheqalim; at December 1985 prices)



Sources: Bank of Israel, Research Department, *Recent Economic Developments*; and data provided by the Bank of Israel.
¹ Excludes credit for savings schemes, fuel, diamonds, and shipping and aviation industries.

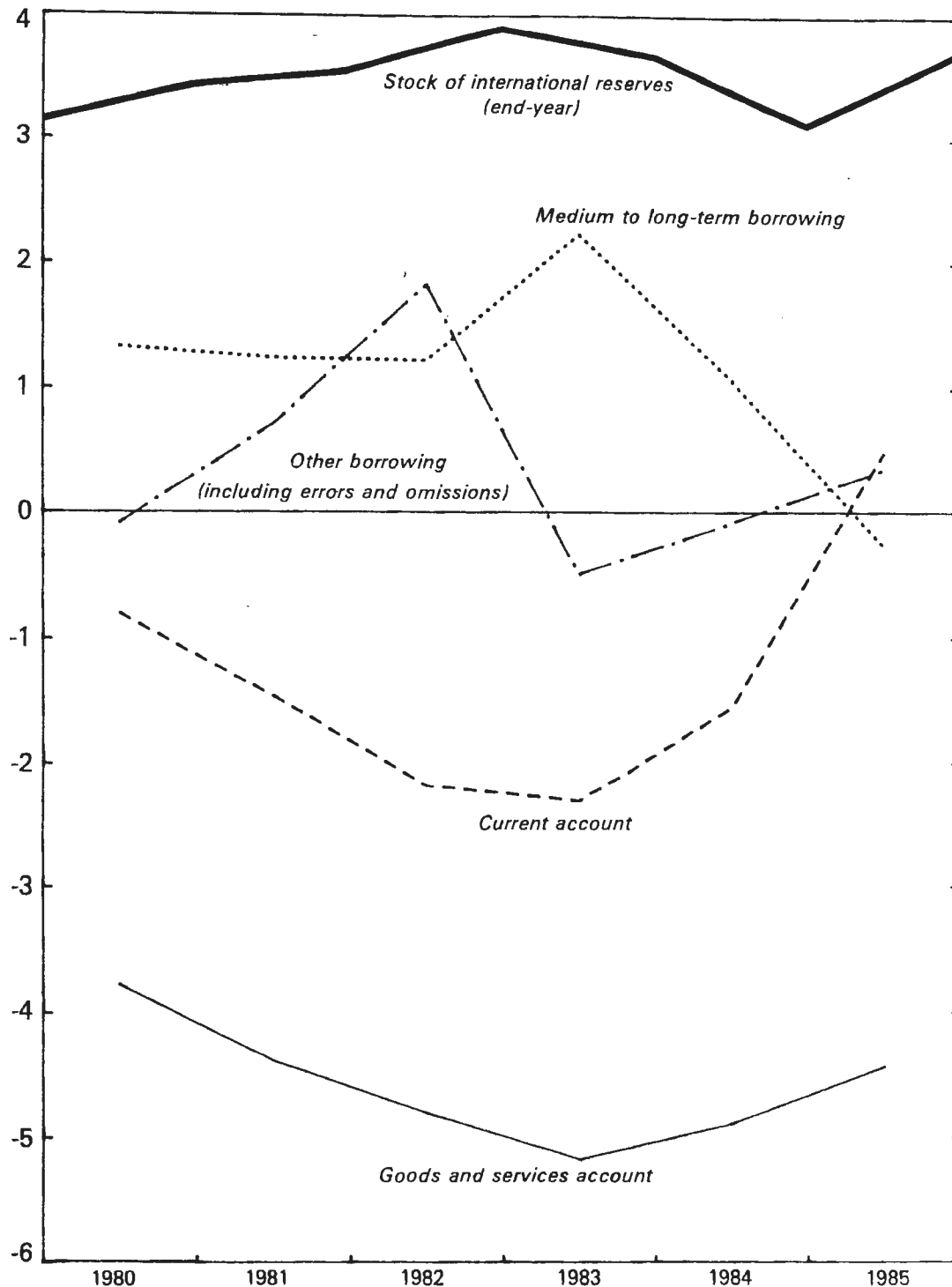
CHART 8
ISRAEL
LABOR MARKET INDICATORS, 1981-85

(Seasonally adjusted)



Source: Central Bureau of Statistics, *Monthly Bulletin of Statistics*.

CHART 9
ISRAEL
BALANCE OF PAYMENTS INDICATORS, 1980-85
(In billions of U.S. dollars)



Sources: Israel, Central Bureau of Statistics, *Monthly Bulletin of Statistics*; Bank of Israel, *Annual Report 1984*; and data provided by the Bank of Israel.

productivity had declined since 1981 and that full employment had been maintained in recent years in part by expanding public sector employment. This suggested that real wages, after their rapid increases since the mid-1970s, remained too high to achieve full employment with internal and external equilibrium.

2. The 1986/87 Budget

The 1986/87 proposed budget provides for a further reduction in the deficit (before foreign grants) equivalent to 3 1/2 percent of GNP, to about 18 percent of GNP (Table 2). As foreign grants are expected to decline by about 2 1/2 percentage points of GNP compared with 1985/86, (due in part to the phasing of military assistance), the financing requirement for the 1986/87 budget is to be cut by 1 percentage point to 3 percent of GNP. Total revenue is projected to decline slightly (in relation to GNP) because of an expected decline in nontax revenue. Tax revenues are expected to increase marginally, mostly due to a new education tax. All other tax revenues are projected to remain unchanged in relation to GNP, as the expected revenue gains in real terms resulting from the deceleration in inflation and the recovery of economic activity have been offset by adjustments in tax brackets, and because many of the tax measures introduced last year had only a one-time impact on revenue.

On the expenditure side, the 1986/87 budget proposes cuts amounting to about 4 percentage points of GNP, principally in subsidies and transfer payments and defense purchases abroad, and to a lesser extent in investment outlays. Excluding direct defense import expenditure, ^{1/} all other proposed cuts amount to less than 1 1/2 percent of GNP. Furthermore, the proposed level of expenditure, especially for education and health, is conditional on the Knesset authorizing the imposition of new fees and charges to finance a portion of these expenditures.

Although the total financing requirement is forecast to decline to less than 3 percent of GNP, domestic borrowing requirements are projected to remain at about 4 1/2 percent of GNP because net amortization of foreign debt is expected to amount to 1 1/2 percent of GNP. Net domestic borrowing from the nonbank public is projected to increase to almost 4 percent of GNP so that net financing from the Bank of Israel is programmed to decline sharply to less than 1/2 percent of GNP.

The Israeli representatives acknowledged that the planned reduction in the deficit remained below what was needed to eliminate completely liquidity injection on account of government operations and to avoid an increase in the overall public debt. They noted, however, that given Israel's special needs for defense and security in particular, the

^{1/} Defense-related imports are almost entirely financed by foreign grants and subject to large annual fluctuation due to the timing of their arrival in the country. A corresponding change is also registered in the inflow of foreign grants.

desirable was not always the feasible and a reduction in the tax burden remained an objective. The budget situation for FY 1986/87 has been further complicated by a recent decision of the Government's Interministerial Committee for Economic Affairs to add US\$300 million to the US\$150 million already included in the budget for assistance to enterprises in financial difficulties. The Israeli representatives explained that the decision may not affect the budget directly: the intention was to permit those enterprises to raise funds, with bank guarantees, on the capital market, which so far has been reserved exclusively for government issues. This was likely, however, to raise the cost of government borrowing.

The reduction in final purchases of goods and services by the public sector will be relatively small so that the direct pressure on domestic resources is expected to abate only slightly. The staff noted that workers' after-tax income was higher in March 1986 than it had been when the stabilization program was introduced due to adjustments in tax brackets, and that welfare and pension recipients, as well as holders of government securities, were fully protected against inflation; consequently, the burden of the cut in subsidies and the increase in taxes must have been largely shifted to the business sector. If this should be repeated in 1986, the prospects for a soundly based economic recovery would be impaired.

The very high and volatile rates of inflation and the current practice of presenting the budget in constant prices and the subsequent quarterly adjustment of the figures according to various indices result not only in a validation of inflation, but make it very difficult to determine the level of expenditure commitments. The data available on fiscal operations are on a cash basis and for very broad categories of expenditure. The authorities stressed that major efforts have been made in recent months to improve budgetary management and this objective will be pursued with vigor in the coming year.

3. Monetary and exchange rate policies

The conduct of both monetary and exchange rate policies will be delicate in 1986. Monetary policy must accommodate the increased demand for money resulting from the reduction of inflation, but must at the same time continue to provide support for the other stabilization measures. The Bank of Israel viewed further relaxation of credit policy as conditional on developments in wages, the budget and the balance of payments, but was forced by the Government to implement a further reduction in interest rates in mid-March. It was also concerned by continuing restrictions on the private sector's access to medium- and long-term financing in the capital market and at the consequent need to resort to the "grey" market where interest rates on such credit are especially high. A more liberal access to the capital market was seen as a way of encouraging investment and growth.

Even if the reduction in velocity experienced in the last quarter of 1985 were to be maintained throughout 1986, the balance of payments surplus, together with continued government borrowing from the Bank of Israel, would result in an expansion of money and credit not apparently consistent with the inflation target. The Israeli representatives believed that these financial savings would be adequate in 1986 to allow the public sector to sell more debt and reduce further, if necessary, borrowing by the Treasury from the Central Bank. They acknowledged, however, that such a plan was not in line with the Government's intention to stabilize public debt (including accrued interest) in relation to GDP and that room would need to be made in the capital market for the US\$450 million earmarked for assistance to enterprises in difficulties. Pressures on interest rates were likely and entailed the risk of capital inflows which would cause a further expansion of liquid assets. Basically, the monetary authorities were concerned by the excessive burden placed on monetary policy if the stabilization program was to continue to restrain inflation. They believed that a lower budget deficit, with greater emphasis on demand reducing measures, would ease their task.

Exchange rate policy will need to steer a cautious course between the need to contribute to price stability and avoidance of an unacceptable real appreciation that would rekindle speculation against the sheqel. The Israeli representatives agreed that the stated policy of fully adjusting the exchange rate to compensate exporters for increases in wages, while useful in convincing unions that it would be futile to aim at large settlements, provided insufficient inducement to employers to resist wage claims and could not be strictly followed. At the same time, the experience of the past showed that anticipation of a devaluation whenever the exchange rate became overvalued was translated rapidly into speculative capital outflows and shifts of financial assets into either imported goods or foreign-exchange linked securities. So far, the competitive position remained favorable and the depreciation of the U.S. dollar relative to major currencies obviated the need for changing its relationship to the sheqel (Chart 10). There was, however, a risk in maintaining for too long the present rate of NIS 1.5=US\$1 as it would create a psychological barrier for future rate changes the longer it remained unchanged. The mission suggested that somewhat wider fluctuations around that rate could reduce such a risk.

V. Prospects

1. Short term

The Israeli representatives emphasized that developments in 1986 would depend on the outcome of the forthcoming wage negotiations and the budget discussion in the Knesset. Assuming that wage increases after March would be limited to cost-of-living adjustments and that the budget would be approved as presented by the Government, they expected a moderate economic expansion in 1986, with GDP increasing by 1.6 percent in

real terms, supported by a fairly strong recovery of domestic demand (projected to increase by 2.3 percent). Although public consumption would decline further, both investment and private consumption were expected to recover. After a sharp decline in 1985, personal disposable income is expected to grow by 0.5 percent in real terms in 1986, largely due to the pattern of wage payments which implies an average increase of real wages in 1986 even assuming no further increase in real terms after March. The savings ratio is assumed to stay roughly unchanged from 1985 though still well below the 1975-81 average. Pent-up demand for imported goods, especially durables, would account for a major part of the strength in private consumption. The projected recovery of investment is to come from the rebuilding of inventories with total gross fixed investment remaining unchanged and residential construction continuing to decline in response to demographic developments and trends in personal incomes and interest rates.

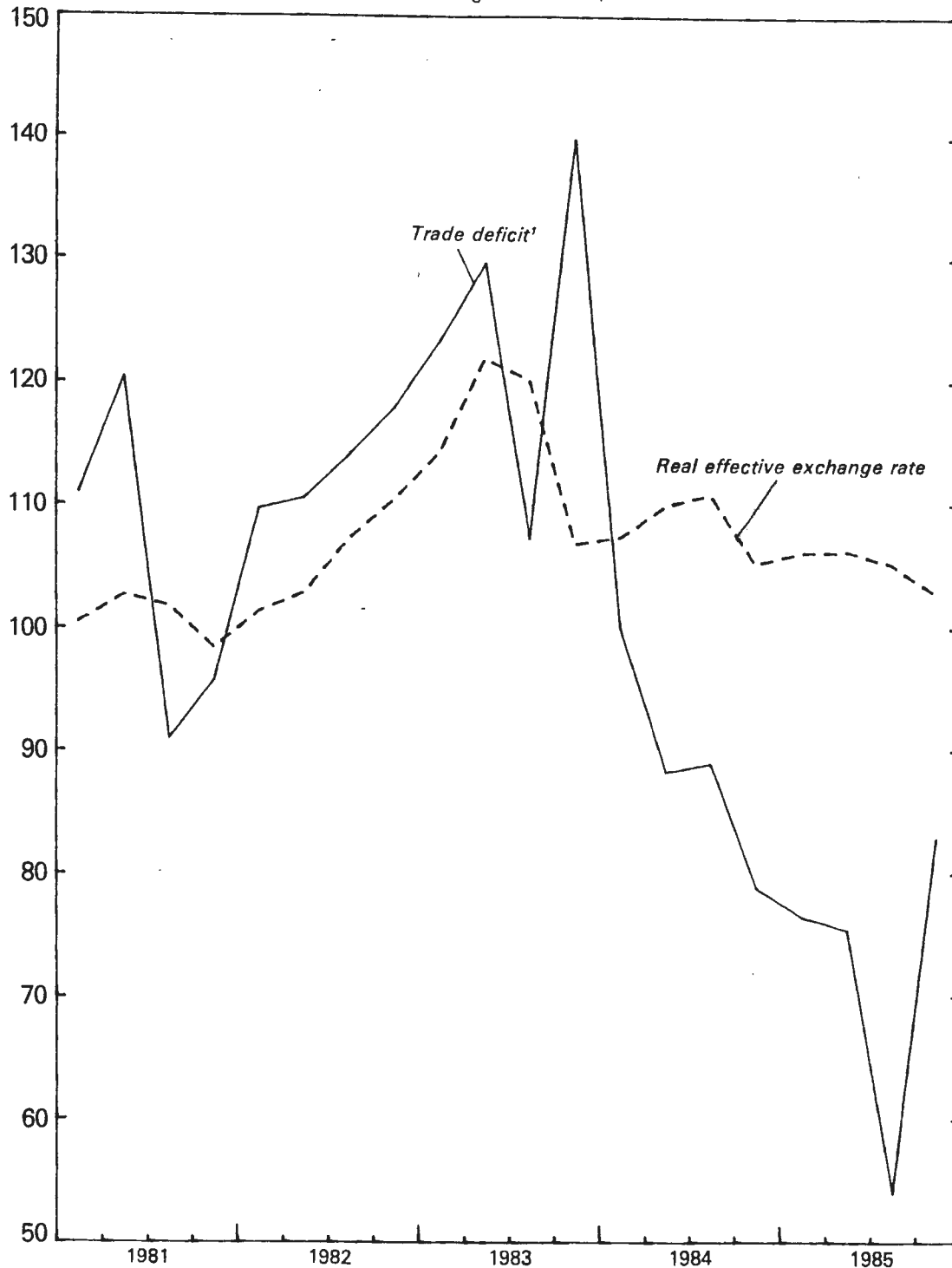
The Israeli representatives were confident that, unless the wage settlements were excessive, prices could continue to rise by less than 2 percent per month in 1986. The reduction in the price of oil was a favorable factor and, unless the competitive position became seriously impaired by higher labor costs, there would be no need for a large depreciation of the exchange rate. A moderate rise in unemployment is expected in 1986 despite a recovery of employment.

The balance of payments should remain strong in 1986. The combination of lower oil prices and the second tranche of emergency assistance from the United States should result in a current account surplus about the same size as in 1985, in spite of a pick-up in imports, and an increase in reserves. The Israeli representatives expected the volume of civilian merchandise imports to increase by 7 percent in 1986 (compared with less than 1 percent in 1985). Payments on invisibles, especially tourism, are also projected to show a marked increase compared with a steep decline in 1985; restrictions on imports and foreign travel were seen as having only a temporary effect and foreign exchange payments for those items were expected to revert to their trend in 1986. Another sizable increase in the volume of merchandise exports is projected in 1986 (8 percent compared with 9.4 percent in 1985) implying further gains in market share. The continued slack in the domestic market would remain a major factor in inducing firms to seek markets abroad. Receipts from invisibles (excluding transfers) are also expected to increase faster than in 1985.

2. Medium term

Medium-term projections by the Ministry of Finance feature a sharp upward shift in the trend of productivity in 1987 and beyond. The Israeli representatives explained that they expected the slower pace of inflation and the projected resumption of investment activity to have a positive effect on productivity. The staff team agreed that a much reduced rate of inflation was likely to raise the level of productivity but cautioned that it may be some time before greater price stability

CHART 10
ISRAEL
REAL EFFECTIVE EXCHANGE RATE AND
TRADE DEFICIT, 1981-85
(Average 1980=100)



Source: Standard developed in connection with the Fund's Information Notice System (based on consumer prices); and Bank of Israel, Recent Economic Developments.

¹ Seasonally adjusted, excluding diamonds, ships, and aircraft.

could be reflected in productivity gains. Furthermore, a faster growth rate for the Israeli economy called for a number of structural changes, and a higher investment ratio also required that the public sector allowed firms to tap medium- and long-term savings in the capital market from which they are presently excluded.

The authorities restated their major goals for the medium term as a continuous reduction in inflation, a current account deficit of the balance of payments that could be financed with long-term capital inflows, while keeping net international reserves at an adequate level, and sustained economic growth. To achieve these goals, the authorities intend to reduce public consumption through further cuts in government expenditure and change the basic employment structure of the economy by reducing the number of employees in the public sector and transferring workers to sectors which are producing for export. Also, to prevent a continuous increase in the public debt with budget deficits and interest payments reinforcing each other, the Government has stated that the deficit should be cut to permit a reduction of the public debt, first in relation to GNP, then in absolute terms.

The fiscal projections in Table 4 suggest that even on relatively favorable assumptions, ^{1/} the budget financing requirement, in relation to GNP, would increase from 3 percent in 1986/87 to 4 percent in 1987/88 and 4 1/2 percent in the following years. This adverse trend reflects the phasing out of the special economic assistance from the United States (equivalent to about 3 percent of GNP annually) provided in both FY 1985/86 and 1986/87 and a projected moderate decline--relative to GNP--of economic and military assistance from the United States. The ratio of total government debt to GNP, which averaged about 215 percent in recent years, is expected to decline to about 190 percent by the end of this decade. Since such debt continues to increase in nominal terms, the cost of government interest payments as a proportion of GNP remains high and the burden of cutting the deficit necessarily falls disproportionately on noninterest expenditure. To achieve the stated long-term goal and reduce public debt not only relative to GNP but also in real terms, the budget will have to be cut by even larger amounts in coming years.

Under two alternative scenarios, which assume only a partial implementation of 1986/87 budget, the financing requirement increases rapidly to an unsustainable level. The Government would find it

^{1/} The "adjustment" scenario assumes that all the measures taken in July 1985 with the introduction of the economic stabilization plan, and the fiscal policies announced in the 1986/87 budget, will be implemented fully and on time. Furthermore, additional measures will be taken to cut government expenditure by about 2 percentage points of GNP annually, while tax reform is enacted in order to reduce the heavy tax burden and rationalize the tax system.

difficult, if not impossible, to finance such a requirement through the placement of bonds and would have to revert to borrowing from the Bank of Israel.

Medium-term balance of payments and external debt projections are given in Table 5. Under the "adjustment scenario," the current account would stabilize at a small surplus, and permit a marked decline in the debt service ratio. With moderately lower export growth rates (Scenario II), the civilian goods and services account would deteriorate marginally but the debt service ratio would still decline through the period. When the slower export growth is combined with a somewhat faster import growth rate due to less restrictive domestic demand policies (Scenario III), the civilian goods and services deficit increases by about one fourth during the scenario period, leading to a relatively fast increase in external debt and to a modest decrease in debt relative to GNP and the debt service ratio.

VI. Trade Policies and Exchange Restrictions

Although most restrictions on payments and transfers for current international transactions and multiple currency practices were eliminated in 1977, the authorities have from 1982 attempted to check capital outflows and protect reserves by introducing various trade and exchange restrictions as well as multiple currency practices. The exchange and trade measures pertaining to current international transactions include a 2 percent import levy, a 1 percent levy on the purchase of foreign exchange by the public, and a noninterest-bearing import deposit requirement. The exchange measures which give rise to exchange restrictions subject to approval by the Fund under Article VIII, Section 2(a), 1/ are the following:

- (a) the suspension of residents' allowance for foreign transfers for support payments and gifts to the extent the suspension pertains to moderate remittance for family living expenses;
- (b) the foreign currency travel allowance for Israeli citizens traveling abroad; the allowance was lowered from US\$1,000 to US\$800 per person per trip in May 1985. Higher allowances apply for business travel abroad;
- (c) the requirement of a specific authorization from the Controller of Foreign Exchange for an Israeli employer to make wage payments in foreign currency to an Israeli citizen working abroad; and

1/ The staff is in the process of examining whether the imposition of a foreign travel tax represents a precondition on the making of current payments.

(d) the limitation on the right of a tourist to buy foreign currency against documents showing the conversion of foreign currency into Israeli currency in amounts in excess of US\$5,000 for a person over 18 years of age and to US\$2,000 for a person under 18 years.

The exchange measures that give rise to a multiple currency practice subject to approval by the Fund under Article VIII, Section 3 are:

- (a) The imposition of a 15 percent tax on import of services levied at the time of the foreign exchange transaction; and
- (b) The operation of the exchange rate insurance scheme.

The exchange rate insurance scheme has resulted in exchange transactions being conducted at effective exchange rates differing by more than 2 percent from the otherwise applicable exchange rate. Losses from the exchange rate insurance scheme--which increased to about US\$500 million in fiscal year 1985/86--have been fully met from the government budget, and from July 1985 liability was limited to 11 percent of value added in exports and 10 percent for the fiscal year beginning April 1, 1986.

As part of the plan for economic stabilization, and as a step toward unifying effective exchange rates, the authorities moved toward some liberalization of the trade and payments system in July 1985. Specifically, the import deposit requirement was eliminated except for luxury goods, where it was significantly reduced and then lowered in steps to the current level of 15 percent; furthermore, export subsidies were cut by requiring--as mentioned earlier--that directed credit for exports would henceforth be denominated entirely in U.S. dollars, and no longer permitted in sheqalim as previously. Against this more recent liberalizing trend, a levy of 15 percent on foreign investment abroad was imposed in November 1985, which the authorities explained as essentially the closing of a loophole to ensure that enterprises could no longer avoid the tax on imported services by investing abroad.

The authorities reaffirmed that their policy toward strengthening the balance of payments rested on expansion of exports rather than restrictions on imports. This commitment was reflected in the importance attached to the Free Trade Agreement with the United States that came into operation in September 1985. The present trade and payments restrictions, partly aimed at boosting budget revenues, were therefore to be seen as temporary measures, even though--in a number of cases--specific termination dates had not been set.

VII. Staff Appraisal

Israel's economic performance since the mid-1970s has been marked by weak growth of output and productivity, recurrent balance of payments crises, and accelerating inflation. In late 1983 and in 1984 the authorities attempted to improve the balance of payments through large devaluations of the sheqel which, in the absence of an adequate tightening of financial policies, sent prices soaring. They then coped with the risks of hyperinflation by freezing prices and wages but, in the absence of measures dealing with the underlying causes of the problems, and in particular the large budget deficit, relief was only temporary.

In July 1985, the Israeli Government introduced a comprehensive stabilization program. Again, a temporary price freeze and suspension of indexation for wages and the stabilization of the exchange rate, following a substantial devaluation, were intended to reduce the rate of inflation rapidly but, in contrast with previous attempts, the adjustment effort was supported by severely restrictive fiscal and monetary policies. Money creation was curbed by reducing bank credit and the Treasury's borrowing from the Bank of Israel. Interest rates rose to very high levels in real terms and the budget deficit for FY 1985/86 is estimated to have declined (before grants) by the equivalent of 7.5 percent of GNP. Against this background, domestic demand contracted sharply in the second half of 1985.

The results of the stabilization program have thus far been rewarding. Inflation, after a spurt in July associated with a 16 percent devaluation of the sheqel and initial price adjustments, has averaged 0.5 percent per month from October to February. The improvement in the external position initiated in 1984 has been extended and speculative capital outflows have given way to inflows. The cost of the program in terms of unemployment and bankruptcies has been significant, but by the end of 1985 economic activity was strengthening and the rate of unemployment had declined from its third quarter peak by one percentage point. At the same time, the potential effectiveness of monetary policy has been raised by reducing the indexation of short-term financial assets and by increasing the share of tradable government securities in new public debt issues.

The staff urges the Israeli authorities to persevere with the stabilization program and to consolidate the results achieved so far, as a failure would make it more difficult to repeat the efforts made to put the Israeli economy back on a sound basis. Over the medium term the staff sees no conflict between the stabilization effort and the prospects for faster growth, as Israel's experience in the past ten years suggests that resumption of growth requires a more stable environment than has been present until recently. Growth also requires further progress in reducing the fiscal deficit, which would allow a lowering of interest rates and greater room for enterprises to raise funds in the capital market. The widespread use of grants, transfers, and subsidies to influence investment, production and exports should, the staff

believes, also be phased out, especially when they are channeled to firms whose viability is questionable: a more neutral and transparent policy toward business would be more conducive to growth.

The reduction in the budget deficit expected in FY 1985/86 has been impressive, and a further decline is projected for FY 1986/87, although it is dependent on parliamentary approval of various fiscal measures and on further strengthening of expenditure control procedures. Taking the two fiscal years 1985/86 and 1986/87 together, the deficit (before grants) would be reduced by the equivalent of 11 percent of GNP, thereby diminishing the need to borrow from the central bank and to increase the public debt. But even if the new budget is approved as presented and implemented as approved, the staff regards the deficit as still too high in terms of its impact on aggregate demand and the need to avoid recourse to monetary financing and a further increase in public debt. Recent legislation is now restricting borrowing from the central bank, which has been a major source of inflation, but use of the counterpart of U.S. emergency assistance is tantamount to monetary financing, and it is taking place at a time when the reduced balance of payments deficit has a smaller moderating impact on the expansion of the money supply. At the same time, it is undesirable to increase government borrowing in the capital market, as the size of the debt is such that interest charges and the size of the deficit now reinforce each other continuously. As all government securities are indexed, inflation does not reduce the burden of debt, and there is therefore no choice but to reduce the deficit further to alleviate the debt problem.

In the view of the staff, the emphasis should be placed on curtailing expenditure in order not only to reduce the public sector deficit but also to allow over time a reduction in the tax burden, which would improve the prospect for faster growth. The heavy burden of corporate taxation inhibits investment activity and the high marginal rates of personal taxation discourage individual effort and encourage emigration of technicians and skilled workers. The large wedge between take-home pay and labor costs to the employers also prevents greater differentiation of remuneration as to skills and productivity. Although it appears that in 1985 the burden of the cut in subsidies was largely shifted to the business sector, leaving disposable income and private consumption little changed, complete elimination of subsidies remains desirable. The staff hopes, nevertheless, that efforts to reduce the budget deficit will also concentrate on the Government's purchases of goods and services in order to release real resources for use by the private sector.

The outcome of the wage negotiations which are about to begin will be crucial for the success or failure of the stabilization program. A large settlement, with the present cost-of-living adjustment provisions, would push up costs and prices both directly and through the exchange rate devaluation that would be required to avoid serious losses in competitiveness. After a temporary decline, real wages in the business sector have been fully restored to their level before the introduction

of the stabilization program. That level, though somewhat lower than the average of 1984, remains excessive in view of the large real wage gains well above productivity advances in recent years and cannot be maintained without a risk of increasing unemployment, or of inflationary pressures and external disequilibrium. Restraint on public sector wages also remains necessary in order to encourage a shift of manpower back to private industry.

The conduct of monetary and exchange rate policies will be delicate in 1986. Monetary expansion must accommodate the higher demand for unindexed assets associated with the decline in inflation and the stabilization of the exchange rate. At the same time it must avoid fueling a reacceleration of inflation. In view of the present uncertainties as to the 1986/87 budget, the effect of the lifting of price controls, and the forthcoming wage negotiations, the staff believes that the monetary authorities should maintain a cautious attitude and allow interest rates to decline further only if monetary policy can be given support in the stabilization effort from fiscal and incomes policies. There is also a potential conflict between the benefits of a stable exchange rate for price developments and the risks of allowing a real effective appreciation of the exchange rate which, on the basis of past experience, could rapidly trigger massive capital outflows. Some flexibility is therefore desirable, although a commitment to adjust the exchange rate automatically to offset the differential in labor cost increases between Israel and its main trading partners should not be made, so as to put pressure on both employers and labor to reach moderate wage settlements. The staff believes that the adoption of strict inflation targets to be used as mutually consistent guidelines for monetary and exchange rate policies, as well as for the budget (which should no longer be presented in real terms), would in current circumstances greatly improve the prospects for a permanent reduction of the rate of inflation, especially if they should be accompanied by a further limitation on the scope of indexation in the Israeli economy.

Although the Israeli authorities have reaffirmed their commitment to a liberal trade and payments system, they maintain various exchange restrictions and multiple currency practices. However, since introduction of the economic stabilization program in July 1985, the authorities have taken some steps toward liberalizing the restrictive system. In the absence of a comprehensive plan to remove the remaining restrictions and multiple currency practices, Executive Board approval of these restrictions and practices is not being proposed. The staff is of the view that such a plan should be part of the adjustment effort and permit a return to a liberal exchange system.

It is recommended that the next Article IV consultation with Israel be held on the standard 12-month cycle.

VIII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Israel's exchange measures subject to Article VIII, Sections 2(a) and 3 in concluding the 1986 Article XIV consultation with Israel and in light of the 1986 Article IV consultation with Israel conducted under Decision No. 5392 - (77/63), adopted April 24, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions and multiple currency practices maintained by Israel are subject to approval under Article VIII, Sections 2(a) and 3. The Fund notes the complexity of Israel's exchange system, and the need to simplify it. The Fund hopes that efforts will be made to remove these restrictions and practices in the near future.

Table 1. Israel: Demand and Supply

	1981	1982	1983	1984	1985	Official Forecast 1986
(Percentage change at constant prices)						
Private consumption	10.8	7.4	7.5	-6.3	-0.1	2.5
Government consumption <u>1/</u>	1.3	3.1	1.7	0.2	-4.1	-2.3
Domestic defense expenditure	(2.4)	(5.3)	(-0.1)	(0.5)	(-7.1)	(-3.5)
Other	(0.9)	(0.7)	(0.6)	(-0.1)	(-0.1)	(-0.7)
Gross domestic investment	-5.7	14.5	10.1	-13.9	-14.7	5.7
Gross domestic expenditure <u>1/</u>	5.0	7.8	6.8	-6.6	-3.8	2.3
Exports of goods and services	4.3	-3.2	2.1	14.5	6.7	7.0
Aggregate demand <u>1/</u>	4.8	4.5	5.5	-0.9	-0.5	3.7
Imports of goods and services <u>1/</u>	7.8	11.2	11.2	-3.8	-4.5	7.0
GDP at market prices	3.2	0.8	2.0	1.1	1.9	1.6
(In percent of GDP at current prices)						
Gross domestic expenditure <u>1/</u>	<u>107</u>	<u>114</u>	<u>115</u>	<u>108</u>	<u>106</u>	...
Private consumption	<u>61</u>	<u>63</u>	<u>65</u>	<u>61</u>	<u>64</u>	...
Domestic defense expenditure	14	15	15	14	13	...
Other government consumption	12	12	11	12	11	...
Gross domestic investment	22	24	24	21	18	...
Foreign balance <u>1/</u>	-7	-14	-15	-8	-6	...
Exports of goods and services	<u>45</u>	<u>41</u>	<u>38</u>	<u>45</u>	<u>48</u>	...
Imports of goods and services <u>1/</u>	52	54	53	53	53	...

Sources: Central Bureau of Statistics; and official estimates and forecast.

1/ Excludes direct defense imports, purchases of which are very closely associated with the receipt of intergovernmental transfers and loans.

Table 2. Israel: Developments in Summary Budget Transactions,
1981/82-1986/87

(In percent of GNP)

	1981/82	1982/83	1983/84	1984/85	Budget 1/ 1985/86	Estimated Outturn 1985/86	Proposed Budget 1986/87
Total revenue	44.6	50.9	49.7	43.0	47.9	46.2	45.7
Tax revenue	36.7	40.3	39.1	35.8	39.6	38.2	38.6
Nontax revenue 2/	7.9	10.6	10.6	7.2	8.3	8.0	7.1
Total expenditure and net lending	70.5	70.7	72.4	71.8	69.3	67.5	63.6
Transfers and subsidies	21.9	20.4	19.6	19.1	17.5	18.0	15.1
Interest payments 3/	9.5	11.7	12.1	15.4	15.0	13.9	14.1
Defense	22.4	21.2	21.9	22.3	18.9	21.5	18.6
Domestic expenditure	(13.2)	(14.9)	(12.3)	(11.5)	(10.5)	(11.2)	(11.0)
Purchases abroad	(9.2)	(6.3)	(9.6)	(10.8)	(8.4)	(10.3)	(7.6)
Other current expenditure	8.2	9.0	8.7	8.5	8.3	7.3	7.5
Capital expenditure 4/	8.5	8.4	10.1	6.5	6.6	6.6	5.4
Unallocated	—	—	—	—	2.9	0.2	2.9
Budget balance	-25.9	-19.8	-22.7	-28.8	-21.4	-21.3	-17.9
Foreign grants	7.5	5.2	8.3	14.6	12.3	17.4	15.0
Defense grants	...	...	2.9	8.6	6.6	8.8	7.2
Economic grants	...	...	5.4	6.0	5.7	8.6	7.8
Financing requirement	-18.4	-14.6	-14.4	-14.2	-9.1	-3.9	-2.9
Foreign borrowing (net)	5.3	5.3	4.6	0.1	-1.6	-1.5	-1.5
Domestic bond issue (net) 5/	9.3	3.8	2.4	4.7	2.0	1.7	3.9
Net credit from Bank of Israel 6/	3.8	5.5	7.4	9.4	8.7	3.7	0.5

Sources: Ministry of Finance; and Fund staff estimates from information provided by the Israeli authorities.

- 1/ Calculated at first quarter (April-June) 1985/86 prices.
- 2/ Excludes Bank of Israel profits and sales of bonds to the National Insurance Institute.
- 3/ Excludes computed interest payments to the Bank of Israel.
- 4/ Includes support purchases of bank shares in 1983/84.
- 5/ Includes sales of bonds to the National Insurance Institute.
- 6/ Credit and change in deposits in the banking system.

Table 3. Israel: Summary Balance of Payments

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985	1986 ^{1/}
Exports	5,906	5,561	5,538	6,198	6,575	7,528
Nondefense imports	-7,275	-7,355	-7,798	-7,412	-7,280	-8,336
Civilian trade balance	-1,369	-1,794	-2,260	-1,214	-705	-807
Net services	-854	-1,533	-1,893	-2,215	-1,870	-1,737
Civilian goods and services	-2,223	-3,327	-4,153	-3,429	-2,575	-2,544
In percent of GNP	(-10.5)	(-15.1)	(-16.7)	(-15.2)	(-12.2)	(-10.8)
Direct defense imports	-2,165	-1,476	-1,025	-1,464	-1,860	-1,750
Intergovernmental transfers	1,349	1,199	1,556	2,210	3,817	3,680
Private and other transfers	1,583	1,419	1,303	1,134	1,100	1,118
Current account	-1,455	-2,186	-2,319	-1,549	482	504
In percent of GNP	(-6.8)	(-9.9)	(-9.3)	(-6.9)	(2.3)	(2.1)
Medium- and long-term capital (net)	1,234	1,218	2,228	1,068	-280	-132
Official	(1,273)	(1,215)	(1,267)	(1,025)	(-60)	(-132)
Private (nonbanks)	(-39)	(3)	(961)	(44)	(-220)	(--)
Commercial banks (net)	762	1,627	236	-167	340	...
Short-term capital (net)	385	312	-235	231	-400	...
Official	(413)	(151)	(-347)	(377)	(-50)	(...)
Private	(-28)	(161)	(112)	(-146)	(-350)	(...)
Errors and omissions	-431	-115	-501	-148	403	...
Overall balance	494	857	-591	-564	545	...

Sources: Central Bureau of Statistics; Bank of Israel; and official estimates and forecasts.

^{1/} Staff estimates.

Table 4. Israel: Medium-Term Central Government Operations Scenarios,
1985/86-1990/91 1/2/

(In percent of GNP, unless otherwise indicated)

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
I. "Adjustment" Scenario						
Assumptions						
Revenue	46.2	45.7	45.0	44.0	43.5	43.0
Expenditure	67.5	63.6	61.0	59.0	57.0	55.5
Budget balance (deficit (-))	-21.3	-17.9	-16.0	-15.0	-13.5	-12.5
Foreign grants	17.4	15.0	12.1	10.6	9.0	7.9
Overall deficit <u>3/</u>	-3.9	-2.9	-3.9	-4.4	-4.5	-4.6
Net foreign financing	-1.5	-1.5	-1.2	-1.1	-1.0	-1.0
Net domestic bond sales <u>4/</u>	1.7	3.9	4.6	5.2	5.5	5.6
Net credit from Bank of Israel	3.7	0.5	0.5	0.3	--	--
Average real rate of interest on government debt (percent)						
Foreign	10.5	9.6	7.8	8.0	8.3	8.5
Domestic	6.0	6.1	6.3	6.3	6.5	6.5
Changes in real GNP (percent)	0.4	2.0	5.0	5.0	5.0	5.0
Results						
Government interest payments <u>5/</u>	13.9	14.1	14.3	14.0	14.0	13.9
Other government expenditure	53.6	49.5	47.7	47.0	46.0	46.1
Government debt <u>6/</u>	216.0	213.0	214.0	206.0	198.5	191.5
II. "Partial Adjustment" Scenario						
Revenue		45.7	45.0	44.5	44.0	44.0
Expenditure		65.0	63.0	61.0	60.0	60.0
Overall deficit <u>3/</u>		-4.3	-6.0	-5.9	-7.0	-8.1
Government interest payments <u>5/</u>		14.1	14.4	14.2	14.1	14.0
Other government expenditure		50.9	48.6	46.8	45.9	46.0
Government debt		214.0	216.0	208.5	202.0	196.5
III. "No Adjustment" Scenario						
Revenue		45.7	45.0	45.0	45.0	45.0
Expenditure		65.0	65.0	64.0	64.0	63.0
Overall deficit <u>3/</u>		-4.3	-7.9	-8.4	-10.0	-10.1
Government interest payments <u>5/</u>		14.1	14.4	14.4	14.3	14.2
Other government expenditure		50.9	50.6	49.6	49.7	48.8
Government debt		214.0	217.0	216.0	217.0	217.0

Source: IMF staff.

1/ In all scenarios, foreign financing of the budget is assumed to be the same. Financing from domestic resources would thus be substantially higher in Scenarios II and III than in Scenario I. It is further assumed that a sizeable part of such higher levels of financing would be met from sales of bonds to nonbank public and the Bank of Israel would reduce its share of financing to zero after 1988/89.

2/ Starting with fiscal year 1987/88 all projections are made at 1986/87 projected prices.

3/ Deficits after accounting for foreign grants.

4/ Includes purchases of bonds by the National Institute.

5/ Interest due during the year, including interest payments on medium- and long-term bonds tied to savings schemes, which are paid only at maturity.

6/ Excluding debt to Bank of Israel and PATAM, but including the debt resulting from converting commercial bank shares to government bonds.

Table 5. Israel: Medium-Term External Debt Scenarios 1/

(In billions of U.S. dollars, except where noted)

	1985	1986	1987	1988	1989
I. "Adjustment Scenario"					
Civilian goods and services account	-2.6	-2.5	-2.3	-2.1	-1.9
Defense imports	-1.9	-1.8	-1.8	-1.7	-1.6
Total transfers	4.9	4.8	4.3	4.1	3.8
Current account	0.5	0.6	0.3	0.3	0.3
Net medium- and long-term capital	-0.3	-0.1	-0.1	-0.1	-0.2
Short-term borrowing (including commercial banks)	-0.1	-0.3	-0.1	-0.2	-0.1
Increase in international reserves	0.5	-0.2	--	--	--
External debt 2/ (end-year)	23.8	23.5	23.2	22.9	22.6
Short-term debt	3.5	3.2	3.1	2.9	2.8
Medium- to long-term debt	20.4	20.2	20.1	20.0	19.8
Debt in percent of GNP	113	99	95	89	83
Short-term debt in percent of GNP	16	14	13	11	10
Debt service in percent of exports of goods and services 2/	42	42	33	33	28
II. "Sluggish Export Growth"					
Civilian goods and services account	-2.6	-2.6	-2.6	-2.7	-2.8
Debt in percent of GNP	113	100	97	93	90
Short-term debt in percent of GNP	16	14	15	16	17
Debt service in percent of exports of goods and services 3/	42	42	35	35	31
III. "Domestic Expansion"					
Civilian goods and services account	-2.6	-2.6	-2.8	-3.0	-3.3
Debt in percent of GNP	113	100	98	95	94
Short-term debt in percent of GNP	16	14	15	17	21
Debt service in percent of exports of goods and services 3/	42	42	35	35	32

Source: IMF staff.

1/ Main assumptions underlying Scenario I are: an annual average growth of GNP in 1985-88 around 2 percent, export growth around 5 percent, and import growth around 3 percent. United States aid to Israel (excluding emergency aid) is assumed to decline slightly toward the end of the projection period. Private medium- and long-term loans falling due are rolled over while there is a moderate net redemption of public medium- to long-term loans every year; reserves are unchanged in nominal terms. In Scenario II, annual average growth of exports is around 3 percent, while Scenario III combines the lower export growth with higher civilian import growth (4 percent per annum on average in 1985-88).

2/ Gross external debt minus foreign assets of commercial banks.

3/ Excluding investment income.

Israel: Fund Relations

(As of March 31, 1986)

I. Membership Status

(a) Date of membership: July 12, 1954

(b) Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account]

(a) Quota: SDR 446.6 million

(b) Total Fund holdings of new Israel shekels: SDR 446.6 million (100 percent of quota)

III. Stand-By Arrangements approved since 1974

(i) One year stand-by arrangement for SDR 32.5 million (25 percent of quota) approved on November 8, 1974. Fully disbursed; cancelled on February 14, 1975.

(ii) One year stand-by arrangement for further SDR 32.5 million (25 percent of quota) approved on February 14, 1975. Fully disbursed.

(iii) One year stand-by arrangement for SDR 29.25 million (22.5 percent of quota) approved on October 20, 1976. Utilization: SDR 12 million.

IV. SDR Department

(a) Net cumulative allocation: SDR 106.36 million

(b) Holdings: SDR 25,475 (0.02 percent of net cumulative allocation).

(B) Nonfinancial Relations

V. Exchange arrangement: flexibly managed floating rate based on a currency basket reflecting the composition of foreign trade.

VI. The Board concluded the 1985 Article IV Consultation on May 24, 1985 with the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Israel, in the light of the 1985 Article IV Consultation with Israel conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Israel maintains restrictions on payments and transfers for current international transactions and restrictive currency practices as described in SM/85/129. The Fund encourages Israel to eliminate these restrictive practices and return to a liberal exchange and trade system.

Israel is on the standard 12-month consultation cycle.

Main Features of Stabilization Programs in Argentina, Brazil and Israel

	<u>Argentina</u>	<u>Brazil</u>	<u>Israel</u>
1. Date of program introduction	June 1985	February 1986	July 1985
2. Price policy	Freeze for unspecified period, to be followed by a move toward market determined prices.	Freeze for unspecified period.	Freeze, to be lifted gradually.
3. Wage policy	Freeze for unspecified period; eventually, a general wage increase was decreed by the Government at the beginning of January 1986.	Wages were adjusted to reflect their average real value in the previous six months, with both increases or decreases in nominal terms. The resulting amount was increased by 8 percent.	Temporary cut in real wages, followed by return to pre-program level in the business sector but lower in public sector.
4. Indexation	Interest on deposits and loans made before the reform were converted to the new currency unit according to a conversion table that was designed to offset the inflation premium implicit in contracts agreed prior to the reform.	Interest on non-indexed deposits and loans made before the reform were converted to the new currency unit according to a conversion table that was designed to offset the inflation premium implicit in contracts agreed prior to the reform. Indexation of financial instruments with maturities of less than one year was limited to savings and loan deposits and certain assets in pension funds. Wages would be partially indexed at the time of annual wage negotiations. In addition, full indexation would apply whenever the cumulative price increase since the preceding annual wage negotiation reached 20 percent.	Temporary suspension of wage indexation. Discontinuation of indexation for short-term (less than one year) bank deposits.
5. Exchange rate	Fixed in terms of the U.S. dollar, following a real effective depreciation of 36 1/2 percent from September 1984 to June 1985.	Fixed in terms of U.S. dollar at the rate prevailing on February 28, 1986.	Fixed in terms of U.S. dollar after 16 percent devaluation.
6. Monetary policy	There was to be no central bank financing of the public sector (except for the on-lending of money borrowed abroad by the Central Bank), and essentially no expansion of central bank credit to the rest of the economy; in the second half of 1985, interest rates were well above the observed rates of price increase.	The authorities intend to lower real interest rates from the earlier high levels that reflected a large risk premium in circumstances of high inflation.	An initial 7 percent decline in real bank credit; high real interest rates.
7. Fiscal policy	The combined public sector deficit was reduced from 12 3/4 percent of GDP in the first half of 1985 to 4 1/4 percent of GDP in the second half of the year.	The public sector budgets for 1986 are currently being revised.	Budget deficit was reduced by 7.5 percent of GNP in current FY to 21 percent of GNP (before grants and to 4 percent of GNP after grants).

Note: This comparison of the main features of stabilization programs in Argentina, Brazil and Israel is of necessity incomplete and does not do justice to the complexities and specifics of the individual countries' programs.

Israel - Statistical Issues

1. Outstanding Statistical Issues

a. Financial statistics

The mission discussed with the authorities problems encountered in reconciling national source data on the deposit money banks with data for these institutions published in IFS. The authorities indicated that they would welcome a Fund technical assistance mission to resolve this issue.

b. Government finance

Data in IFS correspond to the time series reported in the GFS Yearbook. IFS includes only annual data on government finance; debt data are available only through 1978.

The presentation for Israel in the 1985 Yearbook includes data in the statistical and derivation tables for the consolidated central government through fiscal year 1983 and data on outstanding debt through 1978. Data for local government operations are available through 1982, with the exception of data on local government outstanding debt.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Israel in the April 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Israel which, during the past year, have been provided on a timely basis.

Status of IFS Data

		<u>Latest Data in April 1986 IFS</u>
Real Sector	- National Accounts	Q4 1984
	- Prices: Consumer	January 1986
	Industrial Products	January 1986
	- Production: Industrial (seasonally adjusted)	October 1985
	- Employment: Industrial	October 1985
	- Earnings: Wages (daily earnings)	October 1985
Government Finance	- Deficit/Surplus	1983/84 1/
	- Financing	1983/84 1/
	- Debt	1983/84 1/
Monetary Accounts	- Monetary Authorities	November 1985
	- Deposit Money Banks	October 1985
	- Other Financial Institutions	n.a.

External Sector	- Merchandise Trade: Values: Exports	January 1986
	Imports	Sept. 1985 <u>2/</u>
	Unit Values	Q3 1985
	- Balance of Payments	Q3 1985
	- International Reserves	January 1986
	- Exchange Rates	February 1986

1/ Fiscal year ending March 31.

2/ Data on imports (excluding military goods) are published through January 1986.

Israel--Basic Data

Population (end-year estimate 1985):	4.3 million
GNP in 1985 (market prices):	NIS 24,788 million (US\$21,028 million)
GNP per capita in 1985:	US\$4,890
Origin of GDP in 1985 (at factor cost)	(In percent of GNP)
Agriculture, forestry and fishing	10
Industry, mining and quarrying	30
Construction	10
Public utilities	4
Transportation and communications	14
Finance, trade, and services	31
GDP of the business sector	100

	1981	1982	1983	1984	1985 1/	Official Forecasts 1986
(Annual percentage change)						
National accounts (at constant prices)						
GDP	3.2	0.8	2.0	1.1	1.9	1.6
Gross domestic expenditure 2/	5.0	7.8	6.8	-6.6	-3.8	2.3
Private consumption	10.8	7.4	7.5	-6.3	-0.1	2.5
Government consumption 2/	1.3	3.1	1.7	0.2	-4.1	-2.3
Gross domestic investment	-5.7	14.5	10.1	-13.9	-14.7	5.7
Prices, wages, and employment						
Consumer prices (end-year)	101	131	191	445	185	...
Wholesale prices (yearly average)	123	126	144	397	266	...
Real compensation per man-hour 3/	10.0	2.2	1.0	-6.3	-5.0	...
Unemployment rate (in percent)	5.1	5.0	4.5	5.9	6.8	7.4
(In percent of GNP)						
Budget aggregates (fiscal years)						
Expenditures and net lending	70.5	70.7	72.4	71.8	67.5	63.6
Of which:						
Defense	22.4	21.3	21.9	22.3	21.5	18.6
Interest payments	9.5	11.7	12.1	15.4	13.9	14.1
Revenues	44.6	50.9	49.7	43.0	46.2	45.7
Foreign grants	7.5	5.2	8.3	14.6	17.4	15.0
Financing requirement	18.4	14.6	14.4	14.2	3.9	2.9
(Real percentage change; 4/ end of period)						
Monetary developments						
Liquid financial assets (M4)	-3.3	0.1	8.4	1.2	1.4	...
Total financial assets of public	15.4	37.3	-32.0	15.0	-2.7	...
Bank credit to private sector	-8.2	0.5	-17.6	10.7	-3.6	...
(Annual percentage change)						
External sector						
Exports, f.o.b. (in U.S. dollars)	1.9	-5.8	-0.4	11.9	6.1	12.3
Imports, f.o.b. (in U.S. dollars)	4.8	-6.5	-0.1	0.6	3.0	6.4
Of which:						
Nondefense	-1.0	1.1	6.0	-4.9	-1.8	9.6
Export volume	5.1	-0.9	1.1	17.2	9.4	8.0
Import volume 2/	2.8	10.9	11.2	-3.4	0.8	7.1
Terms of trade 2/	-1.1	3.3	1.6	-1.7	0.6	—
Nominal effective exchange rate 5/	-47.0	-47.2	-61.6	-81.2	-66.1	...
Real effective exchange rate 5/	-2.5	12.2	-3.2	-1.5	-2.1	...
(In percent of GNP)						
Current account balance	-6.8	-9.9	-9.3	-6.9	2.3	2.8
External debt outstanding 6/	115.3	127.4	120.2	134.2	139.0	...
Gross official reserves, end-year (in months of total imports)	2.9	3.1	3.0	2.5	3.0	...
Gross debt service (as a percentage of exports of goods and services)	37.3	42.4	40.5	42.1	42.7	...

1/ Provisional estimates.

2/ Excluding direct defense imports.

3/ Including nonwage employee compensation; deflated by consumer price index.

4/ Deflated by consumer price index.

5/ Based on the standard index (using consumer prices) developed in connection with the Information Notice System; fourth quarter over fourth quarter; increase means appreciation.

6/ Gross external liabilities.

*Isaiah's
coming*

EXPORT-LED GROWTH STRATEGY FOR ISRAEL

EXECUTIVE SUMMARY

PREPARED BY:

**JIM - JERUSALEM INSTITUTE OF MANAGEMENT
TELESIS - CONSULTANT
DR. S. TILLES - CONSULTANT**

FUNDED BY:

**JIM - JERUSALEM INSTITUTE OF MANAGEMENT
ISRAEL MANUFACTURER'S ASSOCIATION
OPERATION INDEPENDENCE
HISTADRUT/HEVRAT OVDIM**

THE MESSAGE OF THIS REPORT

Over the past 40 years, the public leadership of Israel has led the people of Israel on a series of successful quests which have required vision, determination, energy and intelligence to accomplish:

- The establishment in a hostile environment of the State of Israel from the ashes of the Holocaust;
- The creation of an impressive defense establishment to protect the state;
- The transformation of seemingly useless land into a garden of bountiful food and a source of useful minerals;
- The development of industry to bring self sufficiency in food, clothing, and shelter and the conveniences of modern day life to the people of Israel;
- The forging of an educational and research establishment unparalleled for a small nation.

All of these missions were accomplished by people who felt that they must be independent and self sufficient, for the non-Jewish world had often not been hospitable to the Jewish people.

After three decades of startling accomplishment, Israel's economy stagnated in the late 1970s and 1980s. The leaders of Israel had to borrow from abroad increasingly to maintain the living standards of the Israeli people, creating an uncomfortable dependence.

This report discusses a new quest which must be undertaken to assure Israel's economic prosperity. Israel has one of two choices for its economic future: dependence on or interdependence with the rest of the world. Israel is too small a country to be an independent economic island and still be prosperous. The scale required to develop, manufacture and market goods in today's world is too large. Israel must trade extensively and successfully.

Israel exports now, but unlike many small countries in Europe, its exports are not large and do not command a high value in the international economy. Achieving prosperity through increased high value exports is the quest addressed in this report.

This report is long and technical but it really has only four simple but powerful messages:

- The goal of increased exports must become a national priority;
- The strategy and culture of most Israeli firms needs to change from import substituter, defense supplier or raw material developer to focussed builder of international competitive advantage;

-
- Israelis must learn to market their products better;
 - The uneasy relationship which exists between the Israeli government and Israeli businesses must be modernized: the businesses must be allowed to function more independently.

This report is offered as a call to action. Its specific recommendations are presented with our firm belief that they can be of help to Israel in its quest. However, more important than adopting any one of the recommendations is the understanding by all concerned that Israel's future depends on achieving economic prosperity through increased high value added exports.

Israel's choice is between economic dependence and stagnation or economic interdependence and prosperity. The choice will be made soon.

EXECUTIVE SUMMARY

EXPORT LED GROWTH: AN ISRAELI IMPERATIVE

THE PROBLEM

Israel's economy has lost its capacity to grow and to increase the living standards of its people. Between 1960 and 1973, the gross domestic product per person in Israel grew by over 100%. Between 1973 and 1986 it grew by only 9%. Since 1980, it has increased by only 0.3% per year.

In 1986 Israel's GDP per person was only 37% that of the United States, down from 39% in 1970. Israel now has a lower GDP per person than Ireland and Singapore and is one of the only developed countries in the world to decline relative to the U.S. since 1970 (Exhibits 1 and 2).

The increase in living standards experienced by Israelis during the 1980s has been made possible by a massive increase in foreign borrowing. Foreign debt now is almost \$20 billion and 32% of Israel's exports go to pay the net debt servicing, up from 20% in 1979 (Exhibit 3).

THE NEED FOR EXPORT LED GROWTH

To increase living standards and reduce its foreign dependence, Israel must pursue export-led growth. Without exports the country cannot import the raw materials and industrial components needed for production. Moreover, Israel is too small to achieve efficient production scale in a wide variety of industries by serving its home market alone. Attempts to make these items for the local market alone would inevitably be inefficient. Israelis would have to pay high prices. The economy would be unproductive and would continue to stagnate.

Attempts to bring about growth through stimulating demand would result in greater inflation and a worse balance of international payments. Imports would increase, Israeli firms would divert product from export to the local market, and prices would rise in Israel.

The only solution to Israel's stagnation is increased exports.

THE EXPORT GOAL

The Jerusalem Institute of Management, using the economic model of the Israeli Finance Ministry, has projected the level of export growth which would be required to achieve a balance in Israel's external accounts (assuming a continuation of U.S. military assistance and private transfers from abroad) by 1995. Based on certain assumptions

about the growth of domestic consumption, the service sector, and exports to territories, the model indicates that exports of goods must increase at a rate of 8.9% per year in constant 1985 dollars. (This excludes exports to the territories of Judea, Samaria and Gaza).

If this growth rate can be achieved, the model projects that GDP will grow by an average of 5.0% per year and GDP per capita by an average of 3.1% per year. Assumptions and model relationships can be changed to produce many different results, but it is clear that improved living standards and an end to international dependence will require significant export growth.

Substantial productivity improvements will have to be made to achieve this goal. This will not be easy since Israel's productivity growth has stagnated during the 1980s (Exhibit 4).

While this goal may sound ambitious, it can be achieved if appropriate actions are taken by business and government. Israel currently exports a much lower amount per person than other small countries (Exhibit 5). The growth we have set as a goal would take Israel only to Ireland's current level of exports per person, by 1995.

WHERE WILL THE GROWTH COME FROM

In real 1985 dollars (U.S. GNP deflated), Israel's export of goods grew by 9.6% per year from 1960 to 1970 and by 13.5% per year from 1970 to 1980. However, between 1980 and 1985, it declined by 2.5% per year.

More than 20% of Israel's exports are made up of products based on natural endowments in agriculture (mainly citrus products, cotton and vegetables) and in minerals (mainly bromine, potash, phosphates and periclase).

Another 48% of its exports come in areas where Israel has some special advantage: 19% in defense products where Israel's government is a relatively large and sophisticated purchaser; 21% in diamonds where the emigration of Jews active in the diamond industry from Belgium in the 1940s transferred an established export industry to Israel; 2% in products sold to Marks & Spencer where Zionist sympathy provided the initial impetus; and 6% in products used in agriculture (for example for arid conditions) where Israel again has sophisticated purchasers.

Only 32% of Israel's exports originate in products where Israeli companies entered world markets based on advantages not due to local conditions.

¹ There are a number of ways to measure real export growth; no one is perfect. We have used dollars at average yearly exchange rates inflated with a U.S. GNP deflator to 1985 dollars. This has the advantage of making international comparisons possible, but the disadvantage of being affected by differences in the U.S. dollar exchange rate with other currencies. No matter which measure is used, the reality of export growth decline in the 1980s is clear.

During the 1970s all of these areas showed considerable export growth. In the 1980s exports of agricultural products and diamonds and most of the areas not based on a special Israeli advantage actually declined in real dollars and the growth in other areas slowed considerably.

The study team analyzed the future prospects of each of these export groups in depth. This was possible because Israel's exports are quite centralized with over 75% of exports coming from only 55 companies. By interviewing 150 companies in Israel and over 125 customers, partners, and competitors in the U.S. and Europe, it was possible to develop a view of growth prospects and impediments to growth.

The findings show that much of Israel's exports have reached a plateau. With the exception of agricultural technology markets, all other areas where Israel has some obvious advantage are unlikely to grow sufficiently to meet our growth targets.

Raw Materials Based Exports

Israel's agriculture is facing two constraints: increased competition from Brazil in citrus concentrate and from Spain, Portugal and Greece in various products as they enter the EEC; and a water constraint which limits the production potential of water intensive crops. Israel's farmers have been resourceful and have drawn international admiration for their success in developing Israel's arid land. Nevertheless, Israel's agricultural exports declined by 5.7% per year from 1980 to 1985. All of the ingenuity of Israel's farmers will be required to produce even a slight real growth during the next decade.

Israel has also shown great resourcefulness in developing its raw material based chemical industry. Extraction techniques are first rate, new technology has driven the development of downstream compounds to add value to the minerals, and bold marketing steps have been taken to secure distribution channels and customers in Europe and the U.S.

However, a changing competitive environment and evolving demand patterns threaten future prospects for growth. In potash the supply-demand balance is expected to be unfavorable for producers until the mid-1990s. Potash demand will grow only 1.3% per year in the U.S. and 1.0% in Europe. Meanwhile, new capacity is being planned or built in Africa, the Far East, South and North America, and Saudi Arabia. Growth of potassium nitrate, a major downstream product from potash, is also expected to be slow.

In phosphates Israel has maintained market share in Europe only by meeting prices which have declined by over 40% in the past five years. Substantial new capacity additions in Jordan and Tunisia will hinder a price recovery. Israel's production costs are not fully competitive in phosphates, and its deposits are of relatively low purity limiting downstream product opportunities.

Israel's bromine exports are also threatened by decreasing demand in ethylene dibromide and other end uses, although bromine exports overall

should continue to increase. Periclase, which has grown rapidly in the past five years, will face significant increased competition from Mexico and Japan.

Israel's raw materials based chemicals have grown at 4.4% during the 1980s. It will be difficult to maintain that growth rate in these products over the next decade.

[Special Market Exports

Diamonds experienced a price explosion in international markets in the 1970s. Prices collapsed in the early 1980s and total exports have still not recovered to 1980 levels. Over the last 40 years diamond trade in dollars has grown at a rate of 7% per year. Since the value added in Israel is only about 20% of total diamond exports, slight variations from this rate will not affect Israel's overall balance of payments.

Israel's exports to Marks & Spencer have grown by 6.6% during the past five years. Marks & Spencer imports only about 10% of its requirements, preferring to maintain as many British made goods in its stores as possible. Israeli goods now represent about 40% of its imports. Growth is likely to continue but will be constrained by overall store policies.

Israel's defense sector has grown in real terms between 1980 and 1985. Since our ability to study this sector was limited for national security reasons, it is hard for us to project potential future growth. We have projected two scenarios, one assuming a 3.7% growth rate into the future, and the other assuming an 8.9% growth (our target for all exports) as an optimistic assumption. Defense exports are subject to geopolitical factors and can often be volatile. Increasing the share of Israel's total exports accounted for by defense might entail considerable risk.

Of the special market based exports, only the agricultural technology based sector has no natural or externally imposed constraints. Nevertheless, exporters in this area face a number of challenges. Pesticides, which make up 33% of the sector's total exports, are facing severe price competition from Far East competitors, particularly Korea. Many of the other exports of this sector are plastic products which have low barriers to entry. It is common for purchasers of Israeli products from abroad to set up local sources of supply in their own countries to replace Israeli exports. Finally, kibbutzim are major exporters in this area. Ideological concerns about hiring outside labor sometimes restrict their growth.

Exhibit 6 shows the growth which can come from these constrained and special market export sectors (not including agricultural technology). It ranges from 4.8% to 6.5% per year, considerably lower than our goals. If the goals are to be achieved, other exporters including the agricultural technology sector must grow at 12.2% to 13.8% per year (Exhibit 7). How to accomplish this goal is the major focus of our study.

THE CHALLENGE OF GROWTH FOR OTHER EXPORTERS

Exports not based on the Israeli advantages, described above, accounted for about \$1.9 billion in 1985. These exports originated in two very different types of firms: those set up primarily as import substituters to serve the Israeli market and those set up primarily for export. Since it is in these businesses where Israel's future growth will be won or lost, the problems confronting these exporters deserve careful attention.

Import Substituters

The vast majority of Israel's exporters in this category exist to serve the domestic market. They are provincial rather than international in outlook. They export less than 30% of their production, regarding exports as a way either to sell surplus production (a surplus mentality) or to make some money when good deals can be found (an opportunistic mentality). In aggregate, these import substituters exported \$1.1 billion in 1985, down from \$1.9 billion in 1980.

Most of these companies have always operated behind import barriers without having to worry about international competitiveness. Because they are import substituters, these firms often have very broad product lines produced in small quantities.

The transition from import substituter to sustained exporter is a difficult one. Areas of specialization must be built, foreign commercial relationships must be established, and significant investments made in product development, production capacity, and distribution.

A company set up for export lives or dies in its international business. One that has a profitable home market may choose to export (especially if there are general government subsidies to do so), but will withdraw without too much hesitation if the markets become more competitive.

This happened extensively in the 1980s as companies that had developed export markets to sell surplus production in the 1970s, withdrew in the face of increased international competition and more attractive conditions at home. Israel has a large base of import substitution companies. For Israel to achieve the necessary real growth rates in exports, many of these will have to become more successful exporters.

Export Oriented Companies

Beginning in the late 1960s, a new breed of Israeli companies formed, many with a technology base, to serve international markets. Exports made up well over 70% of their production from the beginning and their success totally depended on

international markets. This group accounted for only \$20 million in exports in 1970, grew to \$342 million by 1980 and to \$870 million by 1985. Exhibit 8 lists some members of this group, a few of which are Israeli business legends.

Beginning in the mid-1980s, several of the best known of these companies began to experience difficulty maintaining growth and profitability. The near bankruptcy of Elscint and two years of losses for Scitex, the biggest exporters of this group, have raised questions about the ability of young Israeli firms to reach significant size.

Companies trying to grow to a large size from a small home base face a number of problems:

- These companies usually focus on a particular market niche. If the niche remains small, the company does too. If it grows large, it attracts large competitors who can make life difficult for the small competitors.
- Markets for products now develop almost simultaneously around the world. A growth oriented company must develop an international network in the business rapidly. Being small and remote from major markets makes it difficult to have the type of intensive customer interaction necessary for good product development and market adaptation.
- Product life cycles are growing shorter while new product generations are becoming increasingly expensive to develop. Risks have increased greatly.
- All companies make mistakes in growing businesses. Large companies take write-offs and keep going, small companies often stall or go bankrupt.

Almost all of Israel's exporting companies are small in international terms, with sales no higher than \$200 million each. Their typical pattern has been one of brilliant product development, good financial backing, rapid growth once a start-up phase has been passed, and then a flattening of growth due to some of the problems listed above.

Israel's export companies are aggressive and savvy. They must overcome the inherent problems of small home market base and small relative size, however, if they are to experience significant export growth.

The Marketing Problem

There is another problem which seems to plague many Israeli exporters, particularly the import substituters. It involves insufficient attention to and ability in international marketing.

There are many examples of Israeli firms which develop a leading product but lose its full commercial potential to competitors because they do not have the marketing, sales, or service network to support it adequately.

Our interviews often turned up extensive praise for Israeli products - from fashion clothing to electronic instruments - but strong disillusionment with the Israeli company's ability to promote and support the product.

Exhibit 9 lists quotes representative of many we heard from the roughly 125 market interviews conducted by Telesis. They graphically point to a serious problem of many Israeli companies - lack of marketing skill - which must be overcome if growth is to be achieved.

(Other Constraints

Our interviews with Israeli companies and their customers also turned up some other constraints hindering their ability to grow.

One problem was best expressed by the outside board director of one of Israel's major companies when he said:

"A major share of the time, energy, and attention of the chief executive and other top managers has had to be devoted to relationships with government ministries,

The Bank of Israel, and large commercial banks because of the critical importance of government approvals (foreign currency, etc.) and government aid... combined with these programs.

All this inevitably reduces the time and energy available for attention to competitive issues in the company's product markets..."

Problems with foreign exchange controls came up frequently in this regard.

Another issue often raised was the need to secure customers' finance for capital goods exports. Israel is sometimes not as generous as other countries in its provision of guarantees and thus competitive financing cannot be achieved.

(New Firms

We have examined the role of new companies in Israel's export growth. Start-up companies take a long time to become significant exporters. Only nine companies formed since 1970 are in Israel's top fifty exporters making up about 9% of total industrial exports.

|| Start-up companies are unlikely to provide the major share of export

growth in the next ten years, but they are crucial to Israel's long term economic development.

Israel has a healthy rate of start-ups. Moving from initial start-up to full commercialization is sometimes a problem, however. In a number of cases Israeli start-ups develop an innovation only to be beaten by a technological follower who is quicker to develop manufacturing and marketing capabilities and more professional management.

THE EXPORT TASK-SUMMARY

Israel must increase its exports of goods at 8.9% per year. Traditional sources of export growth in raw materials based industries, diamonds, defense, and Marks & Spencer will not provide the growth that is needed.

Most Israeli companies were formed behind import barriers to produce a small volume of a large number of goods to make Israel self sufficient. Others were formed to serve Israel's defense needs or to exploit raw materials. Very few were formed with international markets in mind and most of those which were are less than fifteen years old.

The transformation from import substituter, defense supplier and raw material developer to international exporter is very complex and difficult. The new breed of Israeli companies focussed on export also face serious constraints to growth due to the firms' small size, the small size of their home market and their remoteness from major customers. Most Israeli companies of all types lack marketing skills and must confront the difficulties of Israel as a business environment.

Building strong international companies that can export large quantities of high value products successfully is difficult from a small country base. It requires product focus and the building of long-term international price or cost advantage. Israel's firms will need to direct their efforts to this goal and change their corporate organizations and cultures to accomplish it.

RECOMMENDATIONS TO ISRAELI COMPANIES

Companies create exports, not countries. If Israel is to achieve the economic goals we have set, a large group of Israeli firms will have to change the way they do business and new export oriented firms will have to be established. Firms must think more strategically and define their international opportunities precisely.

Many will need to take risks far greater than they do now. Most will need to improve their marketing. Some must seek out partners abroad or look for ways to cooperate at home. All will need to know what makes for competitive advantage in their businesses.

The following recommendations, based on perceptions of the strengths

and weaknesses of Israel's companies, provide directions for Israeli firms to follow:

Seeking Competitive Advantage

1. Israeli companies should build exports based on long-term competitive advantage, not surplus capacity. It is necessary to identify clearly and pursue the basis for competitive advantage and adapt if it changes.
2. Israeli companies should seek to increase value added per employee by developing competitive advantages based on factors other than low wage labor costs.
3. Israeli companies should focus on specific market niches which are appropriate to their capabilities. These companies are small in world terms and even if they are technologically capable of entering large markets, they cannot survive there over the long-term.

Marketing

4. In businesses where marketing scale is important, Israeli companies should aim to build foreign marketing systems they can control. Joint marketing agreements or OEM supply can be interim steps to that goal but should not be end-points in themselves.
5. Israeli companies with brand opportunities should look for ways to cooperate and secure scale to reduce the high costs of establishing branded products.
6. Service investment is critical to sales success. The sale is the start of a long-term relationship which the customer must find satisfying. Entry to a new market must be accompanied by investment in service capability.
7. Israeli companies should invest much more heavily in developing marketing skills in their people. In some companies this should be a crash program.
8. Product development should start with the market, not with the product.
9. Israeli firms competing in applications engineering intensive businesses must invest to standardize applications engineering rather than customizing each order.
10. Israeli companies must recognize that product innovation, by itself, rarely secures competitive advantage. Attention must also be paid to investing in other sources of potential advantage in the early stages of business development.

-
11. In areas requiring large scale R&D and where Israel has some inherent world class capabilities, companies should actively cooperate in joint development.

Manufacturing

12. Israeli companies should place more emphasis on manufacturing basics like cost control, quality control, machine maintenance, higher machine utilization, efficient production scheduling and meeting delivery timetables, rather than focussing mainly on automation.

Gaining a Price Premium

13. Israeli companies must seek out and invest in opportunities for sustainable competitive advantages based on achieving price premiums for superior quality products.

Management Capability

14. Israeli firms must accelerate their investments in managerial skill development.

THE GOVERNMENT ROLE

The Israeli government has always been deeply involved with the economic development of the country. The nature of that involvement has changed substantially over the years, as new economic challenges or opportunities arose.

For example, direct government investment to develop the mineral resources of the Negev and agriculture in the early years of the state was followed by a policy of industrialization through import substitution in the late 1950s. This was followed by government efforts to broaden and enhance Israel's military industries in the 1960s.

Over the last three decades, the government has played a major role in directing the flow of funds in the economy. In recent years the government's role has included increased encouragement to business-related research and development and greater aid to exporters.

The pattern of these diverse government activities adds up to an industrial policy, but not a clearly defined one. Indeed, many of Israel's industrial policies have been developed with other priorities in mind - two of the most significant being frontier settlement and military self sufficiency.

Exhibits 10, 11, and 12 summarize funds allocated in the current budget to industry. Some of the allocations, such as the exchange rate insurance, are designed to compensate Israel's exporters for the fact that currency devaluations have not kept pace with local inflation, which is higher than that in major competing countries. The regional development program provides capital grants to exporters who invest in certain parts of the country. Other policies subsidize manufacturing, agriculture, and tourism with income and employers tax exemptions. Another set of programs provides funds for research and development. Two important areas of government assistance, that provided to military companies and to firms which are in difficulty, are not accurately reflected in the chart since their amounts are not public information.

One of the most important aspects of Israel's industrial policy has been the achievement of free trade treaties both with the EEC and the United States. Israel's industrial policies also include elaborate exchange controls, capital controls and merger laws.

ISRAELI INDUSTRIAL POLICIES IN PERSPECTIVE

A number of small countries have tried to accelerate their economic development since World War II with active government involvement. Ireland, Portugal, Greece, Singapore and Taiwan have all followed the path of aggressive government incentives to attract foreign investment to their countries. More recently Ireland and Singapore have also established programs to encourage research and development, skills development, new company start-ups, technology transfer, and the general development of indigenous companies. Israel stands alone in basing its development on indigenously-owned industry. (Exhibit 13). Countries which have based their export growth on foreign firms have found it hard to increase their value added beyond a certain point since higher value activities like R&D, automated production, marketing and such are rarely located locally.

Israel has the problem of being a small country trying to industrialize but has developed a much stronger base of local companies and a stronger technical base than other small newly industrializing countries. For this reason, problems like the ones Israeli firms are facing have more often been addressed by developed countries. Programs which are relevant to Israel include:

- Programs in Sweden, France, and Japan for risk sharing in new products and markets
 - Programs in Denmark and Germany to sponsor collaboration in marketing
 - Programs in Canada, France, and Japan to restructure import substituters for export
 - Programs in Germany, the U.S., and the U.K. to assist start-up firms
 - Programs in Japan, France, Germany, and Europe to encourage R&D collaboration
-

-
- Programs in Sweden and Japan to minimize the bureaucracy associated with controls

We have chosen a number of successful examples from these programs which we discuss in detail in the full report.

Most developed countries have a wide variety of industrial incentive programs. Some speak a rhetoric of opposition to government industrial policies, but all use these policies extensively. On paper most countries appear to address a similar list of competitive and structural problems. In practice, many programs are wasteful or mere public relations while others are successful. Most successful programs share common ingredients including:

- Continuity of programs despite changes in political leadership
- A pragmatic rather than ideological debate about policies
- Incentives toward industries involved in foreign trade, rather than sheltered ones
- Decentralized identification of market opportunities (companies rather than bureaucracy) except where government is the key purchaser
- A focus on international competitiveness as the driving discipline for actions
- A focus on incentives to invest on a matching basis rather than a pure subsidy to sales
- A structuring of incentives to focus on specific competitive leverage points

Israel's industrial policies, with the exception of its R&D and BIRD (U.S. - Israel Bilateral Research and Development Foundation) programs, lack many of these characteristics. They change frequently, they tend toward subsidy rather than incentive, and they are not focussed on competitiveness.

RECOMMENDATIONS FOR GOVERNMENT, HISTADRUT, AND THE OPERATION INDEPENDENCE TASK FORCE

Perhaps the two most important forms of support that any government can provide for industry are to secure a stable macroeconomic environment from which to operate and to provide good knowledge (educated people and a research base) and physical (transportation and communication) infrastructures.

Israel's government has recently had a poor record on the macroeconomic environment. Its record on infrastructure has been mixed: strength in the State's knowledge infrastructure (in terms of the populace's educational attainment and the worldwide standing of the scientific community -- see Exhibits 14 and 15) is balanced by

weaknesses in the physical infrastructure, most notably in the telecommunications system.

Many have studied the policies of Israel with regard to macroeconomics and infrastructure. We do not have much to add on these issues other than to indicate that a rekindling of the hyperinflation of recent years or an inability to improve the communications infrastructure will certainly jeopardize any growth program.

While these government roles are paramount, the government also has an important role to play in fostering industrial development in ways which specifically address the impediments to growth mentioned above. The Histadrut also has a crucial role to play in garnering public support for the importance of the export program and in helping implement it through its companies and its role in negotiating pay raises. The Operation Independence Task Force can play a catalyzing role as it is uniquely suited to mobilize commercial assistance for Israeli companies in export markets.

The roles of the government, the Histadrut, and the Task Force in achieving the goals set forth in this report have four parts: to create an export imperative in Israel; to assist in company restructuring by helping spread the risk of necessary investments; to assist in the effort to make Israel's firms better marketers; and to modernize the government/business relationship in Israel.

Creating an Export Imperative

Israel's economic prosperity depends upon dramatic growth in its exports. The government must take a leadership role in creating an export culture in Israel. Concretely, this means motivating companies to export and enhancing their capabilities to do so.

The motivation must come in order to stimulate companies with comfortable positions in the home market or in defense or raw materials businesses to turn to the difficult task of developing exports in products where there is no obvious or special home advantage. The motivation will also come from creating a national acceptance of the special importance of exports to the country. Nations with high living standards based on exports recognize exports as a national mission and subordinate other priorities to export success. This must happen in Israel.

Enhancing capabilities means assisting Israeli firms to overcome impediments to success which are rooted mainly in the small size of their home market, their relative infancy as international businesses, and the particular economic problems faced by Israel because of its geopolitical position.

Neither Adam Smith nor Karl Marx have much to say about this effort. Even in a purely free market world or a purely socialist world, Israeli firms would trade and would be at a competitive disadvantage because of the small home market. In the real world, not only is this true, but all nations try to assist their companies to enhance their capabilities to compete successfully. Israel must do this also.

To carry out these goals, we recommend that:

1. The government should ensure that adequate funds are available for export industry. Sufficient access to capital markets must be allowed to finance the needed growth. Export companies should not be penalized by having to pay higher rates for financing export activities than their international competitors.
2. The government and the Histadrut should promote a program to tie wage increases across the economy to productivity improvements in the export sector.
3. In keeping with the higher risks and cost of exporting, investments to create sustained competitive advantages in export markets should be assured a higher rate of profitability, if successful, than activities serving the local market. As a possible example, export firms could receive preferential depreciation schedules for capital investments for export and a sliding scale of tax credits for R&D and market related investments based on the proportion of sales they have in exports and their overseas export growth. This would penalize non-exporters and reward exporters, helping to motivate a sustained building of export positions. Any such set of incentives can be designed to be neutral in its revenue implications for the government.

The Restructuring of Industry - Spreading the Risk

We have said that a major restructuring must take place in Israel's industry. We have indicated that one of the biggest impediments to this process is the high risk for Israeli firms, which are small in international terms, to develop new products and markets. To encourage these investments by spreading the risks associated with them we recommend the following:

4. The government should establish a conditionally reimbursable loan fund which provides matching loans to companies for investment (capital, engineering, and marketing) in projects which involve entry into risky new products or markets for export. The loans the project -- no payback if the project fails and an above market payback if it succeeds. The fund should be administered by an independent agency (like the BIRD Foundation) outside of the government. Based on the experience of other countries, such a fund could be self-sustaining after its initial capitalization.
5. The government should continue the Chief Scientist and BIRD programs, increasing funding in relation to the expansion of the export economy. These programs have played a positive role in Israel's export development to date.
6. The government should license venture capital funds whose investors can receive tax incentives against personal income tax. Each fund would be required to invest at least 20% of its total capital as seed capital and would have to provide management assistance to companies it funds.

-
7. (Many of Israel's larger companies are government owned. They should be free to and even encouraged to seek export opportunities outside of their base businesses. While diversification has sometimes not been a successful path for companies abroad, in Israel's case it is a necessity. Some large companies in military and chemical industries have limited growth prospects and yet have the managerial capability and business base to enter new businesses and increase exports.
 8. (The mergers law should be loosened to remove the tax penalty for mergers of companies in unrelated fields which are primarily exporters. Such combinations can often offer a stronger diversified base from which to develop new export businesses.

Breaking the Marketing Roadblock

We have indicated that Israeli companies have had particular problems with overseas marketing. Small funds exist today to assist companies to explore new markets but these are insufficient and focus mainly on trade shows and initial introductions rather than on building successful marketing organizations. We recommend that:

9. The government should redirect industry supports now given for capital investment in regions B and C to encourage marketing investments abroad. On a matching basis this might include assistance with investments in sales offices, advertising, promotion, market research, standards compliance, and product tailoring for a particular market. Regional development policies work best when they are narrowly focussed. Israel's regional incentives cover too much of the country and put too much focus on capital investment. A single development region should be targeted -- made up of region A and perhaps parts of region B. The funds currently allocated to this new region will then be more successful in encouraging development.
 10. The government should establish the Prime Minister's marketing fellowships to be awarded to a significant number of young Israeli managers each year to spend a few years working for companies in foreign countries. These companies can be related industries or preferably in customer or distribution organizations. The Operation Independence Task Force should assist with placements and also with sponsoring activities for the "fellows" to increase their familiarity with the marketplace.
 11. The Operation Independence Task Force should help establish marketing companies in focussed areas like food, clothing, agricultural technology, or personal care products to assist groups of Israeli companies to build distribution and/or brand image in selected markets. The companies should receive initial encouragement from the Israeli government and Manufacturers' Association, though the goal should be a purely commercial relationship. These marketing companies should help Israeli manufacturers choose products for export and develop the quality and logistics structures necessary to serve the markets.
-

-
12. The Israeli government should assist in the formation of two types of customer financing mechanisms for capital goods exports: the provision of an "Israel risk" insurance scheme including credit guarantees, and the provision of attractive financing for prototype buyers to purchase and participate in the final development stages of prototype Israeli products.

Modernizing the Business Government Relationship

The uneasy relationship which exists between the Israeli government and Israeli businesses must change. The businesses must be allowed to function more independently.

The government had to be a very powerful guide for the nation in its infancy. The creation of national projects to build the Israeli agriculture and chemical industries had to be led by government. Imposing import barriers and fostering the development of import substituting companies to make Israel self sufficient had to be led by government. Building a strong defense industry had to be led by government. Developing the country's educational and research resources had to be led by government.

Now, however, the country is maturing. The government business relationship must mature as well. The government must continue to oversee Israel's economic development but the development will be led by hundreds of companies in thousands of businesses. The government role will be one of setting the national goals and then motivating, supporting, and creating incentives for the companies to succeed.

The new relationship must be one of partnership rather than one of control combined with largesse. In this regard, we recommend that:

13. The government should undertake a review of its industry regulations and taxing procedures with an eye toward making necessary approvals processes more efficient. In principle, prior advisory rulings on tax questions and time limits on approvals processes should be instituted and an attempt should be made to simplify forms and reduce paperwork.
14. The government should loosen exchange controls for Israeli managers traveling on business abroad and grant export companies automatic approvals on applications for marketing and other strategic investments if no action is taken within two weeks to stop the transactions. This would make it easier to conduct export business and will foster the needed development of Israeli multinationals.
15. The government should attempt to ensure greater predictability and continuity in industrial policies. Businesses will postpone long-range and risky investments in an atmosphere where major policy changes occur frequently.

In designing these recommendations we have been mindful of the government's current imperative to control its budget. Thus, we have proposed no major new expenditures. In some cases the proposals are revenue neutral and in others they can be financed by reducing funds

spent on business activity elsewhere. The guiding principle of Israel's industrial policy expenditures should be to assist long-term export development. The overall pattern of business incentives needs to be adjusted accordingly.

The Israeli government has always been successful in the past in assuming the necessary role to address the needs of the country. We are confident it can adjust again.

FULFILLMENT OF THE GOAL

Resuming growth in Israel's living standards will not be easy. Major changes in the behavior of Israel's companies and its government will be required.

We believe that the export led growth goals set in this report can be achieved. To do so, however, will require a strong national will, a commitment to focus on the problem, and a willingness to direct significant efforts towards its solution.

If Israel's government and companies dedicate themselves to the goal and work together toward its achievement, they can be successful.

EXHIBIT 1: GDP PER CAPITA, 1986

	<u>1986 U.S.\$</u>	<u>% OF U.S.</u>
U.S.	\$17,302	100
JAPAN	16,218	94
DENMARK	15,885	92
SWEDEN	15,665	91
GERMANY	14,774	85
FRANCE	12,841	74
BELGIUM	11,464	66
SINGAPORE	7,205	42
IRELAND	6,351	37
ISRAEL	6,245	36
KOREA	3,116	18

SOURCE: IMF. (1986 Yearbook, February 1987)

EXHIBIT 2:

GDP PER CAPITA RELATIVE TO UNITED STATES,
1960-1980

	<u>1960</u>	<u>1970</u>	<u>1986</u>
U.S.	100	100	100
JAPAN	16	40	94
DENMARK	46	65	92
SWEDEN	66	84	91
GERMANY	46	62	85
FRANCE	47	56	74
BELGIUM	43	54	66
SINGAPORE	15	18	42
IRELAND	22	27	37
ISRAEL	33	39	36
KOREA	6	6	18

SOURCE: IMF, OECD, World Bank, and U. S. Dept. of Commerce.

EXHIBIT 3:

PROPORTION OF GOODS AND SERVICES EXPORTS
REQUIRED TO PAY THE INTEREST ON ISRAEL'S
FOREIGN DEBT

	<u>%</u>
1979	20
1980	21
1981	23
1982	26
1983	26
1984	30
1985	32

SOURCE: Bank of Israel Annual Reports, 1982 and 1985

EXHIBIT 4: THE SLOWDOWN IN ISRAEL'S PRODUCTIVITY GROWTH
(% PER YEAR)

	<u>1961-72</u>	<u>1975-81</u>	<u>1982-85</u>
LABOR PRODUCTIVITY GROWTH	5.4	1.6	0.9
TOTAL FACTOR PRODUCTIVITY GROWTH	3.7	0.4	0.2

SOURCE: Bank of Israel Annual Reports, Various Editions

EXHIBIT 5: EXPORTS PER PERSON

	<u>MERCHANDISE EXPORTS</u> (MILLION 1985 \$)	<u>POPULATION</u> (MILLION)	<u>EXPORTS/PERSON</u> (\$)
SINGAPORE	\$21,500	2.56	\$8,398
SWITZERLAND	37,057	6.44	5,754
BELGIUM	47,150	9.85	4,787
HOLLAND	62,402	14.48	4,310
SWEDEN	30,174	8.35	3,614
DENMARK	17,116	5.11	3,350
IRELAND	10,305	3.55	2,903
AUSTRIA	16,955	7.56	2,243
ISRAEL	6,601 ¹	4.24	1,557

¹Includes exports to Judea, Samaria and Gaza.

SOURCE: IMF (1986 Yearbook, February 1987)

EXHIBIT 6:PROSPECTS FOR EXPORT SECTORS AT HISTORICAL
AND EXPECTED GROWTH RATES

	1985 EXPORT 1985 \$MM	REAL GROWTH RATE 1980-1985 (\$)	1995 EXPORTS IF GROWTH CONTINUES AT HISTORICAL RATES 1985 \$MM	EXPECTED GROWTH RATES	1995 EXPORTS AT EXPECTED GROWTH RATES 1985 \$MM
AGRICULTURE & RAW MATERIALS BASED FUND	771	-5.7%	429	1%	852
RAW MATERIALS BASED CHEMICALS	487	+4.4%	749	+4.0%	721
DIAMONDS	1,263	-7.2%	598	+7.0%	2,485
MARKS & SPENSER	102	+6.6%	194	+6.6%	194
DEFENSE	<u>1,160</u>	<u>N.A.</u>	<u>N.A.</u>	<u>+3.7%-8.9%</u>	<u>1,668-2,721</u>
TOTAL OF THESE GROUPS	3,783	N.A.	N.A.	+4.8%-6.5%	5,920-6,971

SOURCE: Telesis

EXHIBIT 7: REQUIRED ANNUAL GROWTH RATE OF AGRICULTURAL
TECHNOLOGY, IMPORT SUBSTITUTER, AND EXPORT
COMPANIES TO ACHIEVE ASSUMED GROWTH-ORIENTED
TARGETS

	1985 EXPORT 1985 \$MM	REAL GROWTH RATE 1980-1985 (%)	1995 EXPORTS IF GROWTH CONTINUES AT HISTORICAL RATES 1985 \$MM	REQUIRED GROWTH IF OTHER SECTORS BEHAVE AS EXPECTED	
				<u>GROWTH</u>	<u>EXPORTS</u> \$MM
AGRICULTURAL- BASED TECHNOLOGY	376	12.4%	1,205	} 12.2% - 13.8%	7,291 - 8,344
IMPORT SUBSTITUTERS	1,051	-11.6%	307		
EXPORT- ORIENTED	870	20.5%	5,630		
TOTAL OF THESE GROUPS	2,297	-1.6%	7,143		

SOURCE: Telesis

EXHIBIT 8:

EXPORT-ORIENTED COMPANIES

	<u>MM\$ EXPORTS</u> (1985 \$)
SCITEX	109
ELSCINT	93
LUZ	38
NILIT	34
DELTA	31
ADIPAZ	27
ORMAT	25
LASER IND.	24
OPTROTECH	20
OTHERS	469
TOTAL:	870

SOURCE: Dun's Guide and company interviews

EXHIBIT 9:

COMMENTS FROM EUROPEAN AND NORTH AMERICAN
CUSTOMERS OF ISRAELI COMPANIES

"I'VE HAD TWO PROBLEMS WITH (NAME WITHHELD) THE ISRAELI COMPANY I WORK WITH: THEY DON'T UNDERSTAND HOW TO SERVICE A PRODUCT ONCE THEY SELL IT AND YOU NEVER CAN TRUST A DEAL WITH THEM. THEY ALWAYS WANT TO COME BACK AND REOPEN POINTS FOR NEGOTIATION."

MEDICAL ELECTRONICS CUSTOMER

"ISRAELI COMPANIES ALWAYS COMPLAIN ABOUT THEIR PROBLEMS AND EXPECT YOU TO BEAR THE EFFECTS. THEY ARE NEVER AT FAULT AND THEY NEVER ADMIT THAT THINGS CAN BE DONE BETTER THAN THEY DO THEM."

CLOTHING DISTRIBUTOR

"ISRAELIS ARE VERY NICE BUT IT IS DIFFICULT TO DO BUSINESS WITH THEM. THEY ARE VERY STUBBORN AND HAVE TO DO THINGS THEIR OWN WAY, DESPITE WHAT THE MARKET MAY WANT."

V.P. MARKETING, LARGE CONSUMER
ELECTRONICS CHAIN

"ISRAELIS DO NOT KNOW HOW TO ADVERTISE THEMSELVES WELL. THEY KNOW HOW TO MAKE WAR BUT NOT HOW TO TELL PEOPLE WHAT ELSE THEY DO."

FOOD BROKER

"ONE OF ISRAEL'S PROBLEMS IN MARKETING IS THAT THEY CAN'T LET GO. AND THEY CAN'T KNOW THE LOCAL MARKET BECAUSE THEY'RE NOT THERE."

FOOD COMPANY MARKETING MANAGER

"ISRAELIS CAN'T UNDERSTAND CREATIVITY IN ADVERTISING. THEY CAN'T DEAL WITH ANYTHING INTANGIBLE AND IT'S IN THEIR CULTURE NOT TO ADVERTISE."

V.P. SALES, ELECTRONICS FIRM

"IF YOU'VE DEALT WITH ISRAELIS YOU KNOW THERE'S AN ARROGANCE OF VIEW - THEY NEVER GIVE AN INCH TO THEIR PARTNERS OR THEIR CUSTOMERS."

V.P. MANUFACTURING COMPANY

"IT IS HARD FOR AN ISRAELI MANAGER TO BE PLUGGED INTO THE (CLOTHING) MARKET. BY THE TIME HE IS PRODUCING THE MARKET IS DIFFERENT."

PRESIDENT, CLOTHING MFG. CO.

"I HAVE TRIED TO HELP ISRAEL BY DOING BUSINESS THERE. BUT THE QUALITY WAS POOR AND SHIPMENTS WERE NOT UP TO PAR. I'LL SEND MONEY INSTEAD."

PRESIDENT, CLOTHING MFG. CO.

EXHIBIT 9 (CONTINUED):

"WHAT ISRAEL HAS THE CAPACITY TO DO IS BASIC RESEARCH, INEXPENSIVELY. THEY ARE LESS SUCCESSFUL IN PRODUCING A FINAL PRODUCT IN A PROFESSIONAL WAY WITH QUALITY CONTROL AND ALL THE TRIMMINGS. FRANKLY, OUR PROJECTS WITH THEM HAVE FLOUNDERED. WE SHOULD HAVE PURCHASED THEIR TECHNOLOGY AND DONE THE PRODUCTION HERE... THEIR TECHNOLOGY WAS EXCELLENT. THE QUALITY CONTROL WAS TERRIBLE. SO BAD IT LED TO THE ABANDONMENT OF THE PROJECT... AT THIS POINT ISRAEL HAS TWO PROBLEMS: ONE - THEY HAVE A BAD IMAGE, TWO - THE IMAGE IS JUSTIFIED. MANAGEMENT DOESN'T HAVE THE TYPE OF DISPOSITION THAT CAN INTERACT WITH CUSTOMERS SUCCESSFULLY. THEY ARE NOT PROMPT AND NOT CONCERNED."

R&D MANAGER OF A CANADIAN COMPANY
WHICH HAD A MARKETING AGREEMENT
WITH AN ISRAELI FIRM

"I AM EXTREMELY DISAPPOINTED AT HOW (THE KNOW-HOW/MARKETING) AGREEMENT, TURNED OUT. IT HAS NOT HAD ANY REAL SUCCESS. THEIR (THE ISRAELI FIRMS) PROCRASTINATION HAS BEEN VERY COSTLY TO THEM AND TO US. THEY ALWAYS HAD EXCUSES BUT IT TOOK THEM TWO YEARS LONGER THAN IT SHOULD HAVE JUST TO GET THE EQUIPMENT INSTALLED. SINCE THEN, THEIR PRODUCTION HAS NEVER SHOWN ME ANYTHING GOOD ENOUGH TO SELL IN THIS MARKET. POOR QUALITY. THEY DO NOT HAVE ENOUGH EXPERIENCE WITH MEETING CUSTOMERS' DEMANDS. WE SOLD THEM A PATENT FOR (A CERTAIN PRODUCT) IN 1982. NOT ONE INCH HAS BEEN PRODUCED YET. AND WE COULD SELL ALL THEY COULD MAKE. AND NOW THE OPPORTUNITY IS SLIPPING AWAY. WHILE THEY'VE BEEN PUTZING, THE REST OF THE WORLD HAS BEEN ADVANCING... THEY WOULD HAVE BEEN OUT OF BUSINESS BY NOW IF THE (ISRAELI) GOVERNMENT HADN'T BEEN SUPPORTING THEM VIGOROUSLY.

TOP MANAGER OF AN AMERICAN COMPANY
WHICH HAD A KNOW-HOW/MARKETING
AGREEMENT WITH AN ISRAELI FIRM

"NO FOREIGN COMPANY HAS EVER SUCCEEDED IN A BUSINESS VENTURE OF THIS SORT (BIOTECHNOLOGY/PHARMACEUTICALS) WITH AN ISRAELI COMPANY. ISREALIS ARE STUBBORN, NARROW-MINDED AND LESS SOPHISTICATED THAN THEY THINK THEY ARE. IT JUST PLAIN TAKES TOO MUCH EFFORT TO DO BUSINESS WITH THEM. THE REWARD IS NOT COMMENSURATE WITH THE DIFFICULTIES INVOLVED. BROAD-BASED BUSINESS VENTURES WITH ISRAELIS ARE NOT LIKELY TO SUCCEED."

TOP MANAGER OF A EUROPEAN
CORPORATION WHICH HAS A JOINT
VENTURE WITH AN ISRAELI COMPANY

EXHIBIT 10: SUBSIDIES TO BUSINESS SECTOR UNDER LAW FOR
ENCOURAGEMENT OF INVESTMENT, 1984-1986
(MILLIONS \$)

	<u>1984</u>	<u>1985</u>	<u>1986 REVISED</u>
INVESTMENT GRANTS	112 ¹	149 ²	133 ¹
SUBSIDIES ON DEVELOPMENT LOANS (BEING PHASED OUT)	55	11	3 (ESTIM.
TAX CONCESSIONS	73	83	73 (ESTIM.
TOTAL SUBSIDIES TO CAPITAL INVESTMENT	\$240	\$243	\$209

SOURCE: Budget Documents and Interviews with Ministry of Finance
and Ministry of Industry
1986 Exchange Rate 1.58 NIS = \$1 U.S.

¹Applies only to manufacturing

²Revised downward from original budget estimate of \$152 Million

EXHIBIT 11:

DIRECT ASSISTANCE TO EXPORTERS

	TOTAL VALUE OF INCENTIVE (\$)	ESTIMATED % OF INCENTIVE TO MANUFACTURING
<u>MEASURES TO COMPENSATE FOR SELF-IMPOSED DISINCENTIVES TO EXPORT</u>		
EXCHANGE RATE INSURANCE	359	80%
PEACE IN GALILEE IMPORT TAX REBATE	N/A	N/A
REBATE OF IMPORTED SERVICE LEVY	40	80%
REBATE OF CUSTOMS AND PURCHASE TAX	N/A	N/A
TOTAL:	\$399+	
<u>EXPORT INCENTIVES</u>		
FOREIGN TRADE RISK INSURANCE	39	80%
MARKETING ASSISTANCE GRANTS	5	80%
TOTAL:	\$44	80%

NOTES: All numbers are from 1986 Budget and apply only to exporters in manufacturing, agriculture, and tourism.
Exchange Rate Used: 1.58 NIS = \$1 U.S.

SOURCE: 1986 Budget, State Revenue Administration Report, Fogel Commission Report, and interviews at Ministry of Finance.

EXHIBIT 12: GENERAL TAX BENEFITS GIVEN TO MANUFACTURING,
 AGRICULTURE AND TOURISM, - 1986
 (MILLION \$)

<u>TAX ADVANTAGE</u>	<u>VALUE</u>
EMPLOYER'S TAX EXEMPTION ¹ (COMPLETE EXEMPTION)	285
LOWER CORPORATE AND INCOME TAX RATE ² (45% AS OF JULY, 1986)	37
IMPORTED SERVICES LEVY EXEMPTION ³	25
PEACE IN GALILEE IMPORT TAX EXEMPTION	23
REDUCED EMPLOYEE TAXES ON 2ND AND ⁴ 3RD SHIFTS	17
SALES TAX EXEMPTION ON FACTORY SALES ² TO EMPLOYEES	11
WAGE SUBSIDIES FOR EX-SOLDIERS IN FIRST JOBS	8
CUSTOMS AND PURCHASE TAX EXEMPTIONS ⁵	7
TOTAL TAX BENEFITS	\$413

NOTE: EXCHANGE RATE: 1.58 NIS = \$1 U.S.

¹Higher than original estimate.

²Applies to manufacturing and tourism.

³Figure includes only manufacturing. Exemption also applies to shipping, airlines, etc.

⁴Applies only to manufacturing and electricity branch.

⁵Full exemption is \$66 Million but goes mainly to government agencies. Manufacturing received only \$7 Million.

SOURCE: 1986 Budget, State Revenue Administration Report, and
Interviews at Ministry of Finance, Taxation Division

EXHIBIT 13: ROLE OF FOREIGN-OWNED COMPANIES IN SELECTED COUNTRIES

	EMPLOYMENT IN FOREIGN- OWNED COMPANIES AS A % <u>OF TOTAL EMPLOYMENT</u>		FOREIGN-OWNED COMPANIES' EXPORTS AS A % <u>OF THEIR PRODUCTION</u>
<u>SMALL COUNTRIES</u>			
SINGAPORE	51	(1980)	90-95
PUERTO RICO	73	(1980)	90-95
IRELAND	34	(1980)	90-95
BELGIUM	33	(1978)	68
SCOTLAND	19	(1975)	80-85 ¹
ISRAEL	1	(1985)	50-60

LARGE COUNTRIES

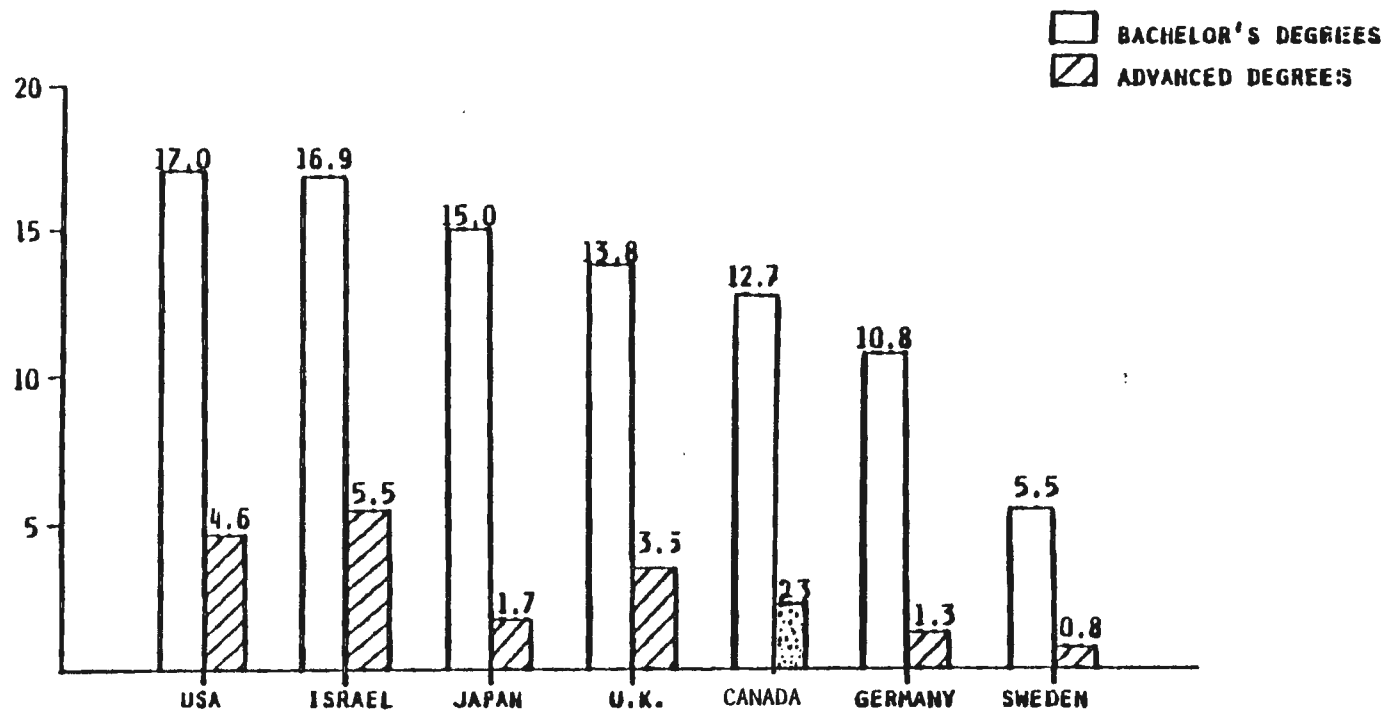
GERMANY	15	(1974)	17
UNITED STATES	3	(1977)	7

¹Exports include shipments to England.

SOURCE: Singapore Economic Development Board; Scottish Development Agency; Fomento; ILO Reports on effects of multi-national enterprises in U.K., Germany, Belgium; and Telesis Analysis.

EXHIBIT 14:

ADVANCED DEGREES AWARDED, NATURAL SCIENCE AND ENGINEERING
BACHELOR'S IN ISRAEL VS. OTHER COUNTRIES
(DEGREES PER 10,000 PARTICIPANTS IN LABOR FORCE - 1982)



SOURCE: UNESCO and Israel National Council for Research and Development.

EXHIBIT 15:

COMPARATIVE RANK OF ISRAELI SCIENTISTS IN
TERMS OF SCIENTIFIC PUBLICATIONS AND CITATIONS

	<u>RATIO OF¹ ISRAEL'S SHARE OF WORLD PUBLICATIONS RELATIVE TO ISRAEL'S SHARE OF DEVELOPED COUNTRY POPULATION</u>	<u>ISRAEL'S RANK² AMONG 15 COUNTRIES IN CITATIONS PER ARTICLE</u>
BIOMEDICAL RESEARCH	3.1	3
PHYSICS	3.2	3
ENGINEERING & TECHNOLOGY	2.5	3
CHEMISTRY	1.7	4
MATHEMATICS	4.4	4
BIOLOGY	3.2	5
CLINICAL MEDICINE	3.2	6
EARTH & SPACE SCIENCES	<u>2.3</u>	<u>9</u>
TOTAL	2.8	N/A

¹Includes Israel, U.S., Canada, Western Europe, East Germany, U.S.S.R., Japan, Australia, and New Zealand.

²Citations in the years 1973-1980 to papers published in the years 1973-1975. The fifteen countries in comparison were Israel, United States, United Kingdom, Federal Republic of Germany, France, U.S.S.R., Japan, German Democratic Republic, Canada, India, New Zealand, Italy, Australia, Sweden, and South Africa.

SOURCE: U.S. National Science Foundation, Computer Horizons Inc. and Telesis Analysis.

A NOTE ABOUT HOW WE DID THE STUDY

This project was commissioned and funded by the Manufacturers' Association of Israel, Hevrat Ovdim, the Operation Independence Task Force, and the Jerusalem Institute of Management Board of Directors. It was also encouraged and supported by the Government of Israel.

We interviewed over 150 managers, mainly in the manufacturing sector, including most of the country's major exporters. The interviews focused on gaining knowledge about such issues as: their main sources of competitive advantage, current and potential competitive positions, value added per employee, and employment and output growth potential. To understand the place of these firms in international markets, we also interviewed over 125 customers, competitors or partners of Israeli companies in North America and Europe.

Because we believe Israel must increase the number of its exporters, we devoted special attention to the study of a large number of start-up firms, both through interviews and in a statistical analysis of 900 firms that applied for grants from the Chief Scientist of the Ministry of Industry and Trade in the period from 1968 to 1985.

To achieve higher exports, Israeli firms must collaborate with universities and research institutions as well as with governments. To understand this perspective on exports, we spoke with the university professors and officials responsible for R&D, with heads of applied R&D institutions and with top civil servants (about 80 individuals). We also analyzed macro-economic data and rules and regulations pertaining to the business climate in Israel.

We wanted to place our analysis of Israel in an international context. We therefore analyzed relevant industrial policies abroad -- especially in Sweden, France, Germany, U.K., EEC, Canada, U.S., Japan, Singapore and elsewhere. Although no experience is directly transferrable from one country to another, other countries have faced problems similar to Israel's, and lessons can be learned from them. In this spirit, we reviewed government policies in Israel including various types of assistance and compared them to those of other countries.

In analyzing these issues it has not been the intention to suggest normative conclusions on relative expenditure devoted to exports versus other government purposes, or on methods of reducing all the constraints identified. We also do not wish to suggest that the government can (or should) choose winners. Exports are made by business firms, and they hold the major responsibility for the design and implementation of a strategy to achieve sustainable competitive advantages. The role of the government is to create a supportive climate for the right strategic investments that will give companies better chances of success.

It is our conclusion that export growth should be recognized as a major national priority in Israel, and an effort should be made to move more rapidly in the direction of national economic independence.

*Israel's
Economy*

EXPORT-LED GROWTH STRATEGY FOR ISRAEL

EXECUTIVE SUMMARY & SLIDE PRESENTATION

GIVEN BY:

J I M - JERUSALEM INSTITUTE
OF MANAGEMENT

TELESIS - CONSULTANT

DR. S. TILLES - CONSULTANT

FEBRUARY 1987

THE MESSAGE OF THIS REPORT

Over the past 40 years, the public leadership of Israel has led the people of Israel on a series of successful quests which have required vision, determination, energy and intelligence to accomplish.

- * The establishment in a hostile environment of the state of Israel from the ashes of the Holocaust;
- * The creation of an impressive defense establishment to protect the state;
- * The transformation of seemingly useless land into a garden of bountiful food and a source of useful minerals;
- * The development of industry to bring self sufficiency in food, clothing, and shelter and the conveniences of modern day life to the people of Israel;
- * The forging of an educational and research establishment unparalleled for a small nation.

All of these missions were accomplished by people who felt that they must be independent and self sufficient, for the non-Jewish world had often not been hospitable to the Jewish people.

After three decades of startling accomplishment, Israel's economy stagnated in the late 1970s and 1980s. The leaders of Israel had to borrow from abroad increasingly to maintain the living standards of the Israeli people, creating an uncomfortable dependence.

This report discusses a new quest which must be undertaken to assure Israel's economic prosperity. Israel has one of two choices for its economic future: dependence on or interdependence with the rest of the world. Israel is too small a country to be an independent economic island and still be prosperous. The scale required to develop, manufacture and market goods in today's world is too large. Israel must trade extensively and successfully.

Israel exports now, but unlike many small countries in Europe, its exports are not large and do not command a high value in the international economy. Achieving prosperity through increased high value exports is the quest addressed in this report.

This report is long and technical but it really has only four simple but powerful messages:

- * The goal of increased exports must become a national priority;

- * The strategy and culture of most Israeli firms needs to change from import substituter, defense supplier or raw material developer to focussed builder of international competitive advantage;
- * Israelis must learn to market their products better;
- * The uneasy relationship which exists between the Israeli government and Israeli businesses must be modernized: the businesses must be allowed to function more independently.

This report is offered as a call to action. Its specific recommendations are presented with our firm belief that they can be of help to Israel in its quest. However, more important than adopting any one of the recommendations is the understanding by all concerned that Israel's future depends on achieving economic prosperity through increased high value added exports.

Israel's choice is between economic dependence and stagnation or economic interdependence and prosperity. The choice will be made soon.

EXECUTIVE SUMMARY

EXPORT LED GROWTH: AN ISRAELI IMPERATIVE

THE PROBLEM

Israel's economy has lost its capacity to grow and to increase the living standards of its people. Between 1960 and 1973, the gross domestic product per person in Israel grew by over 100%. Between 1973 and 1986 it grew by only 9%. Since 1980, it has increased by only 0.3% per year.

In 1986 Israel's GDP per person was only 37% that of the United States down from 39% in 1970. Israel now has a lower GDP per person than Ireland and Singapore and is one of the only developed countries in the world to decline relative to the U.S. since 1970 (Exhibit 1).

The increase in living standards experienced by Israelis during the 1980s has been made possible by a massive increase in foreign borrowing. Foreign debt now is almost \$20 billion and 32% of Israel's exports go to pay the net debt servicing, up from 20% in 1979 (Exhibit 2).

THE NEED FOR EXPORT LED GROWTH

To increase its peoples' living standards and reduce its foreign dependence, Israel must seek export-led growth. Without exports the country cannot import the raw materials and industrial components needed for production. Moreover, the country is too small to achieve efficient production scale in a wide variety of industries by serving its home market alone. Attempts to make these items for the local market alone would inevitably be inefficient. Israel's people would pay high prices. The economy would be unproductive and would continue to stagnate.

Attempts to bring about growth through stimulation of demand would result in greater inflation and a worse balance of international payments. Imports would increase, Israeli firms would divert product from export to the local market, and prices would rise in Israel.

The only solution to Israel's stagnation is increased exports.

THE EXPORT GOAL

The Jerusalem Institute of Management, using the economic model of the Israeli Finance Ministry, has projected the level of export growth which would be required to achieve a balance in Israel's external accounts (assuming a continuation of U.S. military assistance and private transfers from abroad) by 1995. Based on certain assumptions about the growth of domestic consumption, the service

sector, and exports to territories, the model indicates that goods exports abroad must increase at a rate of 8.9% per year in constant 1985 dollars.

If this growth rate can be achieved, the model projects that GDP will grow an average of 5.0% per year and GDP per capita an average of 3.1% per year. Assumptions and model relationships can be changed to produce many different results, but it is clear that living standard improvement and an end to international dependence will require significant export growth.

Substantial productivity improvements will have to be made to achieve this goal. This will not be easy since Israel's productivity growth has stagnated during the 1980s (Exhibit 3).

While this goal may sound ambitious, it can be achieved if appropriate actions are taken by business and government. Israel currently exports a much lower amount per person than other small countries (Exhibit 4). The growth we have set as a goal would take Israel only to Ireland's current level of exports per person by 1995.

WHERE WILL THE GROWTH COME FROM

In real 1985 dollars (U.S. GNP deflated), Israel's export of goods grew by 9.6% per year from 1960 to 1970 and by 13.5% per year from 1970 to 1980. However, between 1980 and 1985, it declined by 2.5% per year.*

Israel's exports are made up 21% of products based on natural endowments in agriculture (citrus products, cotton and vegetables mainly) and in minerals (bromine, potash, phosphates and periclase).

Another 48% of its exports come in areas where Israel has some special advantage: 19% in defense products where Israel's government is a relatively large and sophisticated purchaser; 21% in diamonds where the emigration of Jews active in the diamond industry from Belgium in the 1940s transferred an established export industry to Israel; 2% in products sold to Marks & Spencer where a Zionist sympathy provided the initial impetus; and 6% in products used in agriculture (for example for arid conditions) where Israel again has sophisticated purchasers.

Only 32% of Israel's exports originate in products where Israeli companies entered world markets based on advantages not due to local conditions.

* There are a number of ways to measure real export growth; no one is perfect. We have used dollars at average yearly exchange rates inflated with a U.S. GNP deflator to 1985 dollars. This has the advantage of making international comparisons possible, but the disadvantage of being affected by differences in the U.S. dollar exchange rate with other currencies. No matter which measure is used, the reality of export growth decline in the 1980s is clear.

During the 1970s all of these areas showed considerable export growth. During the 1980s exports of agricultural products and diamonds and most of the areas not grounded in a special Israeli advantage actually declined in real dollars and the growth in other areas slowed considerably.

The study team analyzed the future prospects of each of these export groups in depth. This was possible because Israel's exports are quite centralized with over 75% of exports coming from only 55 companies. By interviewing 150 companies in Israel and over 125 customers, partners, and competitors in the U.S. and Europe, it was possible to develop a view of growth prospects and impediments to growth.

The findings show that much of Israel's exports have reached a plateau. With the exception of agricultural technology markets, all other areas where Israel has some obvious advantage are unlikely to grow sufficiently to meet our growth targets.

Raw Materials Based Exports

Israel's agriculture is facing two constraints: increased competition from Brazil in citrus concentrate and from Spain, Portugal and Greece in various products as they enter the EEC; and a water constraint which limits the production potential of water intensive crops. Israel's farmers have been resourceful and have drawn international admiration for their success in developing Israel's arid land. Nevertheless, Israel's agricultural exports declined by 5.7% per year from 1980 to 1985. All of the ingenuity of Israel's farmers will be required to produce even a slight real growth during the next decade.

Israel has also shown great resourcefulness in developing its raw material based chemical industry. Extraction techniques are first rate, new technology has driven the development of downstream compounds to add value to the minerals, and bold marketing steps have been taken to secure distribution channels and customers in Europe and the U.S.

However, a changing competitive environment and evolving demand patterns threaten future prospects for growth. In potash the supply-demand balance is expected to be unfavorable for producers until the mid-1990s. Potash demand will grow only 1.3% per year in the U.S. and 1.0% in Europe. Meanwhile, new capacity is being planned or built in Africa, the Far East, South and North America, and Saudi Arabia. Growth of potassium nitrate, a major downstream product from potash, is also expected to be slow.

In phosphates Israel has maintained market share in Europe only by meeting prices which have declined by over 40% in the past five years. Substantial new capacity additions in Jordan and Tunisia will hinder a price recovery. Israel's production costs are not fully competitive in phosphates, and its deposits are of relatively low

purity limiting downstream product opportunities.

Israel's bromine exports are also threatened by decreasing demand in ethylene dibromide and other end uses, although bromine exports overall should continue to increase. Periclane, which has grown rapidly in the past five years, will face significant increased competition from Mexico and Japan.

Israel's raw materials based chemicals have grown at 4.4% during the 1980s. It will be difficult to maintain that growth rate in these products over the next decade.

Special Market Exports

Diamonds experienced a price explosion in international markets in the 1970s. Prices collapsed in the early 1980s and total exports have still not recovered to 1980 levels. Over the last 40 years diamond trade in dollars has grown at a rate of 7% per year. Since the value added in Israel is only about 20% of total diamond exports, slight variations from this rate will not affect Israel's overall balance of payments.

Israel's exports to Marks & Spencer have grown by 6.6% during the past five years. Marks & Spencer only imports about 10% of its requirements preferring to maintain as many British made goods in its stores as possible. Israeli goods now represent about 40% of its imports. Growth is likely to continue but will be constrained by overall store policies.

Israel's defense sector has grown in real terms between 1980 and 1985. Since our ability to study this sector was limited for national security reasons, it is hard for us to project potential future growth. We have projected two scenarios, one assuming a 3.7% growth rate into the future, and the other assuming an 8.9% growth (our target for all exports) as an optimistic assumption. Defense exports are subject to geopolitical factors and can often be volatile. Increasing the share of Israel's total exports accounted for by defense might entail considerable risk.

Of the special market based exports, only the agricultural technology based sector has no natural or externally imposed constraints. Nevertheless, exporters in this area face a number of challenges. Pesticides which make up 33% of the sector's total exports are facing severe price competition from Far East competitors, particularly Korea. Many of the other exports of this sector are plastic products which have low barriers to entry. It is common for purchasers of Israeli products from abroad to set up local sources of supply in their own countries to replace Israeli exports. Finally, kibbutzim are major exporters in this area. Ideological concerns about hiring outside labor sometimes restrict their growth.

Exhibit 5 shows the growth which can come from these constrained and special market export sectors (not including agricultural technology). It ranges from 4.7% to 6.2% per year, considerably lower

than our goals. If the goals are to be achieved, other exporters including the agricultural technology sector must grow at 12.9% to 14.4% per year (Exhibit 6). How to accomplish this goal is the major focus of our study.

THE CHALLENGE OF GROWTH FOR OTHER EXPORTERS

Exports not based on the Israeli advantages described above accounted for about \$1.9 billion in 1985. These exports originated in two very different types of firms: those set up primarily as import substituters to serve the Israeli market and those set up primarily for export. Since it is in these businesses where Israel's future growth will be won or lost, the problems confronting these exporters deserve careful attention.

Import Substituters

The vast majority of Israel's exporters in this category exist to serve the domestic market. They are provincial rather than international in outlook. They export less than 30% of their production, regarding exports as a way either to sell surplus production (a surplus mentality) or to make some money when good deals can be found (an opportunistic mentality). In aggregate, these import substituters exported \$1.1 billion in 1985 down from \$1.9 billion in 1980.

Most of these companies have always operated behind import barriers without having to worry about international competitiveness. Because they are import substituters, these firms often have very broad product lines produced in small quantities.

The transition from import substituter to sustained exporter is a difficult one. Areas of specialization must be built, foreign commercial relationships must be established, and significant investments made in product development, production capacity, and distribution.

A company set up for export lives or dies in its international business. One that has a profitable home market may choose to export (especially if there are general government subsidies to do so), but will withdraw without too much hesitation if the markets become more competitive.

This happened extensively in the 1980s as companies that had developed export markets to sell surplus production in the 1970s, withdrew in the face of increased international competition and more attractive conditions at home. Israel has a large base of import substitution companies. For Israel to achieve the necessary real growth rates in exports, many of these will have to become more successful exporters.

Export Oriented Companies

Beginning in the late 1960s, a new breed of Israeli companies formed, many with a technology base, to serve international markets. Exports made up well over 70% of their production from the beginning and their success totally depended on international markets. This group accounted for only \$20 million in exports in 1970, grew to \$342 million by 1980 and to \$870 million by 1985. Exhibit 7 lists some members of this group, a few of which are Israeli business legends.

Beginning in the mid-1980s, several of the best known of these companies began to experience difficulty maintaining growth and profitability. The near bankruptcy of Elscint and two years of losses for Scitex, the biggest exporters of this group, have raised questions about the ability of young Israeli firms to reach significant size.

Companies trying to grow to a large size from a small home base face a number of problems:

- * These companies usually focus in a particular market niche. If the niche remains small, the company does too. If it grows big, it attracts large competitors who can make life difficult for the small competitors.
- * Markets for products now develop almost simultaneously around the world. A growth oriented company must develop an international network in the business rapidly. Being small and remote from major markets makes it difficult to have the type of intensive customer interaction necessary for good product development and market adaptation.
- * Product life cycles are growing shorter while new product generations are becoming increasingly expensive to develop. Risks have increased greatly.
- * All companies make mistakes in growing businesses. Large companies take write-offs and keep going, small companies often stall or go bankrupt.

Almost all of Israel's exporting companies are small in international terms with sales no higher than \$200 million. Their typical pattern has been one of brilliant product development, good financial backing, rapid growth once a start-up phase has been passed, and then a flattening of growth due to some of the problems listed above.

Israel's export companies are aggressive and savvy. They must overcome these inherent problems of small home market base and small relative size, however, if they are to experience significant export growth.

The Marketing Problem

There is another problem which seems to plague many Israeli exporters, particularly the import substituters. It involves insufficient attention to and ability in international marketing.

There are many examples of Israeli firms who develop a leading product but lose its full commercial potential to competitors because they do not have the marketing, sales, or service network to support the product adequately.

Our interviews often turned up extensive praise for Israeli products from fashion clothing to electronic instruments but strong disillusionment with an Israeli company's ability to promote and support the product.

Exhibit 8 lists quotes representative of many we heard from the roughly 125 market interviews conducted by Telesis. They graphically point at a serious problem of many Israeli companies - lack of marketing skill - which must be overcome if growth is to be achieved.

Other Constraints

Our interviews with Israeli companies and their customers also turned up some other constraints hindering their ability to grow.

One problem was best expressed by the outside board director of one of Israel's major companies when he said

"A major share of the time, energy, and attention of the chief executive and other top managers has had to be devoted to relationships with government ministries, the Bank of Israel, and large commercial banks because of the critical importance of government approvals (foreign currency, etc.) and government aid... combined with the complexity of procedures associated with these programs.

All this inevitably reduces the time and energy available for attention to competitive issues in the company's product markets..."

Problems with foreign exchange controls came up frequently in this regard.

Another problem often raised was securing customer finance for capital goods exports. Israel is sometimes not as generous as other countries in its provision of guarantees and thus competitive financing cannot be achieved.

New Firms

We have examined the role of new companies in Israel's export growth. Start-up companies take a long time to become significant exporters. Only nine companies formed since 1970 are in Israel's top fifty exporters making up about 9% of total industrial exports.

Start-up companies are unlikely to provide the major share of export growth in the next ten years, but they are crucial to Israel's long term economic development.

Israel has a healthy rate of start-ups. Moving from initial start-up to full commercialization is sometimes a problem, however. In a number of cases Israeli start-ups develop an innovation only to be beaten by a technological follower who is quicker to develop manufacturing and marketing capabilities and more professional management.

THE EXPORT TASK - SUMMARY

Israel must grow its goods exports at 8.9% per year. Traditional sources of export growth in raw materials based industries, diamonds, defense, and Marks & Spencer will not be able to provide the growth that is needed.

Most Israeli companies were formed behind import barriers to produce a small volume of a large number of goods to make Israel self sufficient. Others were formed to serve Israel's defense needs or to exploit raw materials. Very few were formed with international markets in mind and most of those which were are less than fifteen years old.

The transformation from import substituter, defense supplier and raw material developer to international exporter is very complex and difficult. The new breed of Israeli companies focussed on export also faces serious constraints on growth due to the firms' small size, the small size of their home market and their remoteness from major customers. Most Israeli companies of all types lack marketing skills and must confront the difficulties of Israel as a business environment.

Building strong international companies that can export large quantities of high value products successfully is difficult from a small country base. It requires product focus and the building of long-term international price or cost advantage. Israel's firms will need to direct their efforts to this goal and change their corporate organizations and cultures to accomplish it.

RECOMMENDATIONS TO ISRAELI COMPANIES

Companies build exports, not countries. If Israel is to achieve the economic goals we have set for it, a large group of Israeli firms will have to change the way they do business and new export oriented firms will have to be established. Firms must think more strategically and define their international opportunities precisely.

Many will need to take risks far greater than they do now. Most will need to improve their marketing. Some must seek out partners abroad or look for ways to cooperate at home. All will need to know what makes for competitive advantage in their businesses.

The following recommendations, based on perceptions of the strengths and weaknesses of Israel's companies, provide directions for Israeli firms to follow:

Seeking Competitive Advantage

1. Israeli companies should build exports based on long-term competitive advantage, not surplus capacity. It is necessary to identify clearly and pursue the basis for competitive advantage and adapt if it changes.
2. Israeli companies should seek to increase value added per employee by developing competitive advantages based on factors other than low wage labor costs.
3. Israeli companies should focus on specific market niches which are appropriate to their capabilities. These companies are small in world terms and even if they are technologically capable of entering large markets, they cannot survive there over the long-term.

Marketing

4. In businesses where marketing scale is important, Israeli companies should aim to build foreign marketing systems they can control. Joint marketing agreements or OEM supply can be interim steps to that goal but should not be end-points in themselves.
5. Israeli companies with brand opportunities should look for ways to cooperate and secure scale to reduce the high costs of establishing branded products.
6. Service investment is critical to sales success. The sale is the start of a long-term relationship which the customer must find satisfying. Entry to a new market must be accompanied by investment in service capability.
7. Israeli companies should invest much more heavily in developing marketing skills in their people. In some companies this should be a crash program.

Product Development

8. Product development should start with the market not with the product.
9. Israeli firms competing in applications engineering intensive businesses must invest to standardize application engineering rather than customizing each new order.
10. Israeli companies must recognize that product innovation, by itself, rarely secures competitive advantage. Attention must also be paid to investing in other sources of potential advantage in the early stages of business development.
11. In areas requiring large scale R&D and where Israel has some inherent world class capabilities, companies should actively cooperate in joint development.

Manufacturing

12. Israeli companies should place more emphasis on manufacturing basics like cost control, quality control, machine maintenance, higher machine utilization, efficient production scheduling and meeting delivery timetables, rather than focussing mainly on automation.

Management Capability

13. Israeli firms must accelerate their investments in managerial skill development.

THE GOVERNMENT ROLE

The Israeli government has always been deeply involved with the economic development of the country. The nature of that involvement has changed substantially over the years, as new economic challenges or opportunities arose.

For example, direct government investment to develop the mineral resources of the Negev and agriculture in the early years of the state was followed by a policy of industrialization through import substitution in the late 1950s. This was followed by government efforts to broaden and enhance Israel's military industries in the 1960s.

Over the last three decades, the government has played a major role in directing the flow of funds in the economy. In recent years the government role has included increased encouragement to business related research and development and greater aid to exporters.

The pattern of these diverse government activities adds up to an industrial policy, although not necessarily a clearly defined one. Indeed, many of Israel's industrial policies have been developed with other priorities in mind - two of the most significant being frontier settlement and military self sufficiency.

Exhibit 9 summarizes funds allocated in the current budget to Israel's industries. Some of the allocations such as the exchange rate insurance are designed to compensate Israel's exporters for the fact that currency devaluations have not kept pace with Israel's inflation which is higher than that in major competing countries. The regional development program provides capital grants to exporters who invest in certain parts of the country. Other policies subsidize manufacturing, agriculture, and tourism with income and employers tax exemptions. Another set of programs provides funds for research and development. Two important areas of government assistance, that provided to military companies and to firms which are in difficulty, are not accurately reflected in the chart since their amounts are not public information.

One of the most important aspects of Israel's industrial policy has been the achievement of free trade treaties both with the EEC and the United States. Israel's industrial policies also include elaborate exchange controls, capital controls and merger laws.

ISRAELI INDUSTRIAL POLICIES IN PERSPECTIVE

A number of small countries have tried to accelerate their economic development since World War II with active government involvement. Ireland, Portugal, Greece, Singapore and Taiwan have all followed the path of aggressive government incentives to attract foreign investment to their countries. More recently Ireland and Singapore have also established programs to encourage research and development, skills development, new company start-ups, technology transfer, and the general development of indigenous companies. Israel stands alone in basing its development on indigenous industry. Countries which have based their export growth on foreign firms have found it hard to increase their value added beyond a certain point since higher value activities like R&D, automated production, marketing and such are rarely located locally.

Israel has the problem of being a small country trying to industrialize but has developed a much stronger base of local companies and a stronger technical base than other small newly industrializing countries. For this reason, problems like the ones Israeli firms are facing have more often been addressed by developed countries. Programs which are relevant to Israel include:

- * Programs in Sweden, France, and Japan for risk sharing in new products and markets
- * Programs in Denmark and Germany to sponsor collaboration in marketing

- * Programs in Canada, France, and Japan to restructure import substituters for export
- * Programs in Germany, the U.S., and the U.K. to assist start-up firms
- * Programs in Japan, France, Germany, and Europe to encourage R&D collaboration
- * Programs in Sweden and Japan to minimize the bureaucracy associated with controls

We have chosen a number of successful examples from these programs which we discuss in detail in the full report.

Most developed countries have a wide variety of industrial incentive programs. Some speak a rhetoric of opposition to government industrial policies, but all use these policies extensively. On paper most countries appear to address a similar list of competitive and structural problems. In practice, many programs are wasteful or mere public relations while others are successful. Most successful programs share common ingredients including:

- * Continuity of programs despite changes in political leadership
- * A pragmatic rather than ideological debate about policies
- * Incentives toward industries involved in foreign trade, not sheltered ones
- * Decentralized identification of market opportunities (companies rather than bureaucracy) except where government is the key purchaser
- * A focus on international competitiveness as the driving discipline for actions
- * A focus on incentives to invest on a matching basis rather than a pure subsidy to sales
- * A structuring of incentives to focus on specific competitive leverage points

Israel's industrial policies, with the exception of its R&D and BIRD programs lack many of these characteristics. They change frequently, they tend toward subsidy rather than incentive, and they are not focussed on competitiveness.

RECOMMENDATIONS FOR GOVERNMENT, HISTADRUT, AND THE INDEPENDENCE TASK FORCE

Perhaps the two most important supports that any government can provide for industry are to secure a stable macroeconomic environment from which to operate and to provide good knowledge (educated people and a research base) and physical (transportation and communication) infrastructures.

Israel's government has recently had a poor record on the macroeconomic environment and a mixed record on infrastructure. Many have studied the policies of Israel with regard to macroeconomics and infrastructure. We do not have much to add on these issues other than to indicate that a rekindling of the hyperinflation of recent years or an inability to improve the communications infrastructure will certainly jeopardize any growth program.

While these government roles are paramount, the government also has an important role to play in fostering industrial development in ways which specifically address the impediments to growth mentioned above. The Histadrut also has a crucial role to play in garnering public support for the importance of the export program and in helping implement it through its companies and its role in negotiating pay rises. The Operation Independence Task Force can play a catalyzing role as it is uniquely suited to mobilize commercial assistance for Israeli companies in export markets.

The roles of the government, the Histadrut, and the Task Force in achieving the goals set forth in this report have four parts: to create an export imperative in Israel; to assist in company restructuring by helping spread the risk of necessary investments; to assist in the effort to make Israel's firms better marketers; and to modernize the government/business relationship in Israel.

Creating an Export Imperative

Israel's economic prosperity depends upon dramatic growth in its exports. The government must take a leadership role in creating an export culture in Israel. Concretely, this means motivating companies to export and enhancing their capabilities to do so.

The motivation must come in order to stimulate companies with comfortable positions in the home market or in defense or raw materials businesses to turn to the difficult task of developing exports in products where there is no obvious or special home advantage. The motivation will also come from creating a national acceptance of the special importance of exports to the country. Nations with high living standards based on exports recognize exports as a national mission and subordinate other priorities to export success. This must happen in Israel.

Enhancing capabilities means assisting Israeli firms to overcome impediments to success which are rooted mainly in the small size of their home market, their relative infancy as international businesses, and the particular economic problems faced by Israel because of its geopolitical position.

Neither Adam Smith nor Karl Marx have much to say about this effort. Even in a purely free market world or a purely socialist world, Israeli firms would trade and would be at a competitive disadvantage because of the small home market. In the real world, not only is this true, but all nations try to assist their companies to enhance their capabilities to compete successfully. Israel must do this also.

To carry out these goals, we recommend that:

1. The government should ensure that adequate funds are available for export industry. Sufficient access to capital markets must be allowed to finance the needed growth. Export companies should not be penalized by having to pay higher rates for financing export activities than their international competitors.
2. The government and the Histadrut should promote a program to tie wage increases across the economy to productivity improvements in the export sector.
3. In keeping with the higher risks and cost of exporting, investments to create sustained competitive advantages in export markets should be assured a higher rate of profitability, if successful, than activities serving the local market. As a possible example, export firms could receive preferential depreciation schedules for capital investments for export and a sliding scale of tax credits for R&D and market related investments based on the proportion of sales they have in exports and their overseas export growth. This would penalize non-exporters and reward exporters, helping to motivate a sustained building of export positions. Any such set of incentives can be designed to be neutral in its revenue implications for the government.

The Restructuring of Industry - Spreading the Risk

We have said that a major restructuring must take place in Israel's industry. We have indicated that one of the biggest impediments to this process is the high risk for Israeli firms, which are small in international terms, to develop new products and markets. To encourage these investments by spreading the risks associated with them we recommend the following:

4. The government should establish a conditionally reimbursable loan fund which provides matching loans to companies for investment (capital, engineering, and marketing) in projects which involve entry into risky new products or markets for

export. The loans would be repayable on a sliding scale depending on the success of the project - no payback if the project fails and an above market payback if it succeeds. The fund should be administered in an independent agency (like the BIRD Foundation) outside of the government. Based on the experience of other countries, such a fund could be self-sustaining after its initial capitalization.

5. The government should continue the Chief Scientist and BIRD programs, increasing funding in relation to the expansion of the export economy. These programs have played a positive role in Israel's export development to date.
6. The government should license venture capital funds whose investors can receive tax incentives against personal income tax. Each fund would be required to invest at least 20% of its total capital as seed capital and would have to provide management assistance to companies it funds.
7. Many of Israel's larger companies are government owned. They should be free to and even encouraged to seek export opportunities outside of their base businesses. While diversification has sometimes not been a successful path for companies abroad, in Israel's case it is a necessity. Some large companies in military and chemical industries have limited growth prospects and yet have the managerial capability and business base to enter new businesses and increase exports.
8. The mergers law should be loosened to remove the tax penalty for mergers of companies in unrelated fields which are primarily exporters. Such combinations can often offer a stronger diversified base from which to develop new export businesses.

Breaking the Marketing Roadblock

We have indicated that Israeli companies have had particular problems with overseas marketing. Small funds exist today to assist companies to explore new markets but these are insufficient and focus mainly on trade shows and initial introductions rather than on building successful marketing organizations. We recommend that:

9. The government should redirect industry supports now given for capital investment in regions B and C to encourage marketing investments abroad. On a matching basis this might include assistance with investments in sales offices, advertising, promotion, market research, standards compliance, and product tailoring for a particular market. Regional development policies work best when they are narrowly focussed. Israel's regional incentives cover too much of the country and put too much focus on capital investment. A single development region should be targeted -

made up of region A and perhaps parts of region B. The funds currently allocated to this new region will then be more successful in encouraging development.

10. The government should establish the Prime Minister's marketing fellowships to be awarded to a significant number of young Israeli managers each year to spend a few years working for companies in foreign countries. These companies can be in related industries or preferably in customer or distribution organizations. The Operation Independence Task Force should assist with placements and also with sponsoring activities for the "fellows" to increase their familiarity with the marketplace.
11. The Operation Independence Task Force should help establish marketing companies in focussed areas like food, clothing, agricultural technology, or personal care products to assist groups of Israeli companies to build distribution and/or brand image in selected markets. The companies should receive initial encouragement from the Israeli government and Manufacturers' Association, though the goal should be a purely commercial relationship. These marketing companies should help Israeli manufacturers choose products for export and develop the quality and logistics structures necessary to serve the markets.
12. The Israeli government should assist in the formation of two types of customer financing mechanisms for capital goods exports: the provision of an "Israel risk" insurance scheme including credit guarantees, and the provision of attractive financing for prototype buyers to purchase and participate in the final development stages of prototype Israeli products.

Modernizing the Business Government Relationship

The uneasy relationship which exists between the Israeli government and Israeli businesses must change. The businesses must be allowed to function more independently.

The government had to be a very powerful guide for the nation in its infancy. The creation of national projects to build the Israeli agriculture and chemical industries had to be led by government. Imposing import barriers and fostering the development of import substituting companies to make Israel self sufficient had to be led by government. Building a strong defense industry had to be led by government. Developing the country's educational and research resources had to be led by government.

Now, however, the country is maturing. The government business relationship must mature as well. The government must continue to oversee Israel's economic development but the development will be led by hundreds of companies in thousands of businesses. The government role will be one of setting the national goals and then motivating, supporting, and creating incentives for the companies to succeed.

The new relationship must be one of partnership rather than one of control combined with largesse. In this regard, we recommend that:

13. The government should undertake a review of its industry regulations and taxing procedures with an eye toward making necessary approvals processes more efficient. In principle, prior advisory rulings on tax questions and time limits on approvals processes should be instituted and an attempt should be made to simplify forms and reduce paperwork.
14. The government should loosen exchange controls for Israeli managers traveling on business abroad and grant export companies automatic approvals on applications for marketing and other strategic investments if no action is taken within two weeks to stop the transactions. This would make it easier to conduct export business and will foster the needed development of Israeli multinationals.
15. The government should attempt to ensure greater predictability and continuity in industrial policies. Businesses will postpone long-range and risky investments in an atmosphere where major policy changes occur frequently.

In designing these recommendations we have been mindful of the government's current imperative to control its budget. Thus, we have proposed no major new expenditures. In some cases the proposals are revenue neutral and in others they can be financed by reducing funds spent on business activity elsewhere. The guiding principle of Israel's industrial policy expenditures should be to assist long-term export development. The overall pattern of business incentives needs to be adjusted accordingly.

The Israeli government has always been successful in the past in assuming the necessary role to address the needs of the country. We are confident it can adjust again.

FULFILLMENT OF THE GOAL

Resuming growth in Israel's living standards will not be easy. Major changes in the behavior of Israel's companies and its government will be required.

We believe that the export led growth goals set in this report can be achieved. To do so, however, will require a strong national will, a commitment to focus on the problem, and a willingness to direct significant efforts towards its solution.

If Israel's government and companies dedicate themselves to the goal and work together toward its achievement, they can be successful.

UNCLASSIFIED Department of State

INCOMING
TELEGRAM

PAGE 01 OF 03 TEL AV 17883 00 OF 05 181702Z
ACTION NEA-07

1486

AS OUTLINED:

INFO LOG-00 COPY-01 ADS-00 AID-00 INR-10 SS-00 CIAE-00
EB-00 DODE-00 H-01 EXIM-06 NSCE-00 NSAE-00 COME-00
SSO-00 LAB-04 TRSE-00 ITC-01 OPIC-07 CEA-01 OMB-01
STR-17 INRE-00 FRD-01 USIE-00 JUSE-00 SP-02 FDIC-01
SNP-01 /069 W

-----000756 181706Z /47 44

O 181606Z DEC 86
FM AMEMBASSY TEL AVIV
TO SECSTATE WASHDC IMMEDIATE 4350
INFO AMCONSUL JERUSALEM

UNCLAS TEL AVIV 17883

E.O. 12356: N/A
TAGS: EFIN, ECON, IS
SUBJECT: DRAFT BUDGET PROPOSAL AND REFORMS

REF: TEL AVIV 17642

1. UNCLASSIFIED ENTIRE TEXT.

2. SUMMARY

FINANCE MINISTER NISSIM PRESENTED HIS MINISTRY'S PROPOSED BUDGET AND REFORMS AT A PRESS CONFERENCE (SEE FBIS REPORTS TA 171539, TA 171752 AND 172152) WEDNESDAY, DECEMBER 17, 1986. WE HAVE SUMMARIZED, WITHOUT COMMENT, THE MAJOR POINTS OF THE REFORMS, AND INCLUDED SEVERAL TABLES ON THE BUDGET FOR ISRAELI FISCAL YEAR (IFY) 1987/88. THE MINISTRY SEEKS TO REDUCE THE BUDGET NIS 490 MILLION FROM THIS YEAR; IT ALSO PROPOSED IMPLEMENTING STEPS TO DECREASE TAXES, OPEN UP THE CAPITAL MARKET, LOOSEN MONETARY POLICY AND LIGHTEN FOREIGN EXCHANGE RESTRICTIONS. END SUMMARY.

3. BACKGROUND

FINANCE MINISTER MOSHE NISSIM PRESENTED THE GOVERNMENT BUDGET AND REFORM PACKAGE AT A PRESS CONFERENCE ON WEDNESDAY, DECEMBER 17 IN JERUSALEM. DRAWING ON HIS COMMENTS, PRESS REPORTS AND THE OFFICIAL MINISTRY DOCUMENTS (AND DISTILLING THE CONSIDERABLE RHETORIC ESTABLISHING THE GOALS OF THE VARIOUS MEASURES), WE HAVE SUMMARIZED THE MAIN POINTS, AS FOLLOWS:

4. BUDGET

LOWER THE BUDGET BASE BY NIS 490 MILLION (SEE TABLES AT END).

THE GOVERNMENT WILL MOVE TO A THREE-YEAR BUDGET, BEGINNING ISRAELI FISCAL YEAR 1988/89 (STARTING APRIL 1, 1988).

ANY LEGISLATION WHICH INCREASES THE BUDGET MUST MAKE A CORRESPONDING CUT SOMEWHERE ELSE IN THE BUDGET OR FIND AN ALTERNATIVE SOURCE OF INCOME.

THE GOVERNMENT WILL CONTINUE WITH A NOMINAL BUDGET.

5. TAXES

THERE WILL BE A CODIFICATION, CLARIFICATION AND SIMPLIFICATION OF THE TAX LAW TO BE ISSUED IN 1987,

6. PERSONAL MARGINAL TAX RATES

THE GOAL IS TO REDUCE THE RATE WHILE BROADENING THE BASE, WITHOUT PENALIZING THE POOR. THE NEW PROGRAM WOULD ELIMINATE CREDIT POINTS (WORTH NIS 38), ALTHOUGH HOW POINTS ARE AWARDED NOW IS NOT STATED.

TABLE 1A: PROPOSED TAX BRACKETS

GROSS WAGE (NIS/MO)	MARGINAL RATE
0-550/800 (A)	ZERO
551/801	15
1001-1500	25
1501	35
2000	45

(A) NIS 800 IS FOR MARRIED MEN WHOSE WIVES DO NOT WORK, OR A MARRIED WOMAN WITH THREE OR MORE CHILDREN.

TABLE 1B: CURRENT TAX BRACKETS

GROSS WAGE	MARGINAL RATE
0-650	20
651-1260	30
1261-1660	35
1761-2320	45
2321-3180	50
3181	60

7. CORPORATE TAX RATES

TABLE 11A: PROPOSED RATES

TYPE	CORP TAX	INCOME TAX	TOTAL TAX UNDIST. PROFITS	TOTAL TAX DISTRIBUTED PROFITS
REGULAR COMPANY	30	20	44	51
INDUSTRIAL COMPANY	30	20	44	41
AUTHORIZED COMPANY	25	--	25	36.25

TABLE 11B: CURRENT RATES

TYPE	CORP TAX	INCOME TAX	TOTAL TAX UNDIST. PROFITS	TOTAL TAX DISTRIBUTED PROFITS
REGULAR COMPANY	40	35	61	61-67
INDUSTRIAL COMPANY	40	8.33	45	61-67
AUTHORIZED COMPANY	10-30	--	10-30	23.5-40.5

THE PERCENTAGE ON "AUTHORIZED COMPANY" DEPENDS ON THE PERCENTAGE OF OUTSIDE INVESTMENT. WHERE THE PERCENTAGE INCREASES IN THE NEW PROPOSAL, THE

UNCLASSIFIED

UNCLASSIFIED
Department of State

INCOMING
TELEGRAM

PAGE 02 OF 03

RATES WOULD BE PHASED IN OVER TWO YEARS.

8. EMPLOYERS' TAX

THE EMPLOYERS' TAX WILL BE REDUCE FROM SEVEN TO FOUR PERCENT, EFFECTIVE APRIL 1, FOR AN EMPLOYER WHICH IS NOT AN INDUSTRIAL PLANT, A HOTEL, OR ENGAGED IN AGRICULTURE OR RESIDENTIAL CONSTRUCTION.

9. INDIRECT TAXES

TARIFFS: THESE WILL BE CUT IN AGREEMENT WITH EEC AND THE U.S.; ON SOME ARTICLES THE REDUCTION WILL BE 60 PERCENT. THE FISCAL LOSS WILL BE ABOUT 200 MILLION NIS/YEAR. THE GOVERNMENT IS WILLING TO DISCUSS THE SAME REDUCTION OF TARIFFS ON THOSE ARTICLES AFFECTED WITH OTHER COUNTRIES.

PURCHASE TAX: THIS WILL BE RECLASSIFIED (AND CONSOLIDATED) INTO FIVE MAIN CATEGORIES: 10, 20, 30, 45, AND 65 PERCENT. THIS SHOULD BRING REVENUE OF 60 MILLION NIS.

IMPORT DEPOSITS: THERE WILL BE A GRADUAL ABOLITION. THERE WILL BE A THREE PERCENT DECLINE BEGINNING JAN 1, 1987 AND THREE PERCENT A MONTH DECLINE THEREAFTER. SINCE DEPOSITS ARE RETURNED THERE IS NO REVENUE IMPACT.

FEES: THERE WILL BE A REFORM IN THE FEE SCHEDULES (FEES FOR WHAT IS NOT STATED).

STAMP TAX: THIS WILL BE ABOLISHED. THE LOSS OF REVENUE IS INSIGNIFICANT.

TRAVEL AND ASSOCIATED TAXES: THE TRAVEL TAX WILL BE INCREASED TO NIS 250, BUT WITHOUT THE AUTOMATIC UPDATING FOR INFLATION. THE TAX ON TICKETS WILL BE ABOLISHED AND THE DOUBLE TAX ON THE PURCHASE OF LAND SERVICES ABROAD WILL BE CONSOLIDATED TO 15 PERCENT, PLUS ONE PERCENT "PEACE FOR GALILEE" LEVY, INSTEAD OF 33.25 PERCENT. THE CHANGES SHOULD BE REVENUE NEUTRAL.

10. VAT REPORTING

VAT REPORTING AND PAYMENT WILL BE REQUIRED ONLY ONCE EVERY TWO MONTHS, INSTEAD OF ONCE A MONTH FOR 80 PERCENT OF DEALERS. REVENUE LOSS WILL BE

INSIGNIFICANT WITH THE DECLINE OF INFLATION.

11. CAPITAL MARKET

THE FINANCE MINISTER WILL SUSPEND HIS AUTHORITY TO APPROVE THE FLOTATION OF BONDS AND PRIVATE SHARES. PRIVATE ISSUANCE WILL REQUIRE ONLY APPROVAL OF THE SECURITY AUTHORITY, WHICH WILL TIGHTEN ITS PROFESSIONAL CONTROL OVER ISSUANCES.

AT THE SAME TIME, THE REQUIREMENT OF INVESTMENT IN GOVERNMENT SECURITIES OF MANY INSTITUTIONS (PROVIDENT FUNDS, STUDY FUNDS, ETC.) WILL BE CURTAILED.

UNIFIED BORROWING TERMS WILL BE ESTABLISHED FOR GOVERNMENT AND PRIVATE SECTOR ISSUANCES, TO ELIMINATE GOVERNMENT PREFERENCES.

THE PREFERRED TAX RATES FOR GOVERNMENT ISSUANCES WILL BE ABOLISHED.

THE GOVERNMENT WILL RAISE FROM THE PUBLIC ONLY 550 MILLION NIS. TOTAL REDEMPTIONS BY THE PUBLIC WILL BE EIGHT BILLION NIS.

THE GOVERNMENT WILL ALLOW THE BANKING SYSTEM TO RAISE UP TO 250 MILLION NIS IN THE NEXT YEAR, TO BE USED AS THE BANK SEES FIT (I.E., FOR RELENDING).

THE LIQUIDITY REQUIREMENT ON INDEX-LINKED SAVINGS SCHEMES WILL BE DROPPED FROM 75 TO 60 PERCENT, AND, ON FOREIGN CURRENCY LINKED SAVINGS, IT WILL BE REDUCED FROM 100 PERCENT TO 75 PERCENT.

THE REQUIREMENT TO INVEST IN GOVERNMENT BONDS WILL BE DECREASED.

OTHER STEPS WILL BE LISTED LATER.

12. MONETARY POLICY

THE PRICE OF FOREIGN CURRENCY CREDIT WILL BE RAISED THROUGH A LEVY OF THREE PERCENT. THIS WILL APPLY TO BOTH SHORT AND LONG TERM CREDIT; HOWEVER THE LEVY ON LONG-TERM CREDIT COULD BE ADJUSTED DURING THE LIFE OF THE LOAN, IF INTERNATIONAL CONDITIONS CHANGE. ONCE THE GAP BETWEEN THE PRICE OF DOMESTIC AND FOREIGN CREDIT NARROWS THE LEVY WILL BE ADJUSTED.

INTEREST ON LOCAL CURRENCY DEBT WILL BE DECREASED.

CREDIT CEILINGS ON FOREIGN CURRENCY WILL BE ABOLISHED, BUT WITHOUT AFFECTING OVERALL EXPORT PROFITABILITY.

13. FOREIGN CURRENCY

THE GOVERNMENT WILL REPLACE GRADUALLY THE FOREIGN CURRENCY CONTROLS.

THERE WILL BE AN INCREASE IN THE ALLOWANCE TO TRAVELLERS GOING ABROAD, AND THE CEILING OF ASSISTANCE SENT BY ISRAELIS TO FAMILY MEMBERS OR STUDENTS ABROAD WILL BE RAISED.

THERE WILL BE A "GENERAL PERMISSION" FOR COMPANIES TO TRANSFER WAGES TO THEIR EMPLOYEES ABROAD.

CONCESSIONS WILL ALSO BE GIVEN TO INVEST IN ISRAELI COMPANIES ABROAD, WHEN IT BENEFITS THE BALANCE OF PAYMENTS.

14. PUBLIC SECTOR

THE GOVERNMENT WILL CONSIDER SELLING PAZ OIL COMPANY, MAHON STORAGE, AND ZION CABLE, DEAD SEA PERICLASE, DEAD SEA BROMIDE, AND THE JERUSALEM ECONOMIC COMPANY. ALSO IT WILL TRANSFORM SOME GOVERNMENT ENTITIES, LIKE RAFAEL, MILITARY INDUSTRIES, THE GOVERNMENT PRINTERS AND THE VOLCANI INSTITUTE, INTO CORPORATIONS AND THEN, AS

INTEREST WARRANTS, SELL THEM TO THE PUBLIC.

THE GOVERNMENT WILL CONSIDER CONTRACTING OUT

UNCLASSIFIED

UNCLASSIFIED Department of State

INCOMING
TELEGRAM

PAGE 03 OF 03

CERTAIN SERVICES: MEDICAL SERVICES OR THE GOVERNMENT PRINTING SERVICE. IT WILL ALSO CONSIDER ESTABLISHING A GOVERNMENT HOLDING COMPANY WHOSE AIM IS TO RUN THE GOVERNMENT CORPORATIONS. THIS COMPANY WOULD ISSUE SHARES OF GOVERNMENT CORPORATIONS TO THE PUBLIC. THE VALUE OF THE SHARES THE HOLDING COMPANY WOULD CONTROL IS ABOUT NINE BILLION NIS. THE GOVERNMENT WOULD ALSO ISSUE SHARES TO THE PUBLIC OF THE HOLDING COMPANY ITSELF.

THE GOVERNMENT WILL CURTAIL ITS INVOLVEMENT IN IMPORT OF RAW MATERIAL; RATHER IT WILL MONITOR QUALITY AND REGULATE IMPORTERS. FROZEN MEAT WILL BE TRANSFERRED TO PRIVATE IMPORTERS (WITH NO RESTRICTION ON NUMBERS). SOYA (BEAN AND EDIBLE OIL) WILL ALSO BE OPEN TO FREE COMPETITION. FODDER SUBSTITUTES WILL BE FREELY IMPORTED. THE GOVERNMENT HOLDS TO ITSELF THE RIGHT TO PURCHASE CONTROLLING SHARES OF NATURAL ASSETS, I.E., SHOULD OIL BE DISCOVERED. THE GOVERNMENT WILL LIBERALIZE FUEL IMPORT OVER THE NEXT SIX TO NINE MONTHS; THE ALLOTMENTS BETWEEN THE EXISTING COMPANIES WILL BE ABOLISHED. CONTROLS ON DISTRIBUTION CHAIN WILL BE ABOLISHED. THERE WILL BE A PRICE CEILING FOR SIX MONTHS FROM THE TIME THE PRICE FREEZE IS LIFTED. FUEL COMPANIES AND LARGE CONSUMERS WILL BE ALLOWED TO IMPORT OIL PRODUCTS.

15. BUDGET STATISTICS

TABLE III: BUDGET DEFICIT AND ITS FINANCING
-- (MILLIONS OF NEW SHEKELS)

--	--	ORIGINAL		PROPOSE
--	--	1986	BASE	1987
--	--	BUDGET	1987 (A)	BUDGET
1. TOTAL EXPENDITURES AND				
GRANTING OF CREDIT	25,695	26,656	26,200	
-- DOMESTIC	20,112	21,087	20,580	
- A. CONSUMPTION AND				
GOVERNMENT INVESTMENTS	11,318	11,357		
---- DOMESTIC	8,076	8,109		
- B. TRANSFER PAYMENTS				
AND SUBSIDIES	5,270	6,176		
- C. INTEREST PAYMENTS	6,258	6,297		
---- DOMESTIC	3,948	4,007		
- D. GRANTING OF CREDIT	1,040	952		
---- DOMESTIC	1,009	921		
- E. OTHER EXPENDITURES	1,307	1,871		
2. TOTAL REVENUES AND				
GRANTS	25,057	24,946	25,000	
-- DOMESTIC REVENUES	18,630	19,704	19,680	
- A. TAX REVENUES	15,760	16,496		
- B. OTHER REVENUES	3,372	3,710		
- C. GRANTS FROM ABROAD	5,925	4,740		
3. OVERALL SURPLUS/				
OVERALL DEFICIT				
(MINUS) (2-1)	-636	-1,709	-1,200	
-- DOMESTIC	-1,481	-1,382	-900	
- A. DOMESTIC WITHOUT				
GRANTING OF CREDIT	-988	-1,223	-750	
- B. ABROAD	844	-326	-300	
4. FINANCING				
- A. FOREIGN FINANCING	637	1,709	1,200	

(NET)	-595	-844	-850
---- RECEIPT OF LOANS	894	815	
---- REPAYMENT (PRIN.)	1,490	1,660	
- B. DOMESTIC FINANCING			
FROM THE PUBLIC	1,058	557	550
---- RECEIPT OF LOANS	4,433	6,502	
---- REPAYMENT (PRIN.)	3,375	5,945	
---- -- BANK SHARES		1,700	
- C. BANK OF ISRAEL			
FINANCING	174	1,996	1,500
INJECTION	423	825	350

(A) THIS IS A DEMOGRAPHICALLY PROJECTED BUDGET WHICH CONTAINS NO POLICY CHANGES.

(B) THIS CONTAINS THE REQUESTED POLICY CUTS.

TABLE IV: PROPOSED CUTS IN 1987 BUDGET BASE BY MINISTRY
-- (IN MILLIONS OF SHEKELS)

FUNCTION	AMOUNT
DEFENSE	180.0
SUBSIDIES	110.0 (A)
HEALTH	46.0
INDUSTRY	34.0
EDUCATION AND CULTURE	30.0
JEWISH AGENCY (B)	30.0 (B)
CONSTRUCTION	28.0
PUBLIC SECTOR	
EFFICIENCY MEASURES	19.5 (C)
LOCAL AUTHORITIES	16.7
POLICE	6.0
ENERGY	3.3
FINANCE	3.0
RELIGIOUS AFFAIRS	3.0
AGRICULTURE	1.5
ABSORPTION	1.0
FOREIGN AFFAIRS	0.5
INTERIOR	0.5
JUSTICE	0.5
TRANSPORT	0.5
LAND AUTHORITY	0.5
SCIENCE	0.2

(A) LOWERING SUBSIDY FOR PUBLIC TRANSPORT; EQUALIZING SUBSIDIES FOR STANDARD BREAD AND WHITE BREAD.

(B) ABOLITION OF THE DUPLICATION BETWEEN THE ACTIVITIES OF THE JEWISH AGENCY AND GOVERNMENT MINISTRIES

(C) ACCORDING TO MINISTERIAL COMMITTEE'S DECISION TO TRIM PERSONNEL IN THE PUBLIC SECTOR. PICKERING

UNCLASSIFIED