Articles

ISRAEL: MIDDLE EAST TENSIONS CLOUD ECONOMIC OUTLOOK

This article assesses some of the economic trade-offs and potentialities of an open-border peace settlement and, alternatively, of an escalation in Middle East tensions. The scenarios are indicative and ***in no way intended to be forecasts*** *of actual political and economic developments. We hope the report, which has been previously distributed in a somewhat longer version, stirs additional thought on the economic implications of peace/war in the area, and we welcome suggestions for alternative types of scenarios.*

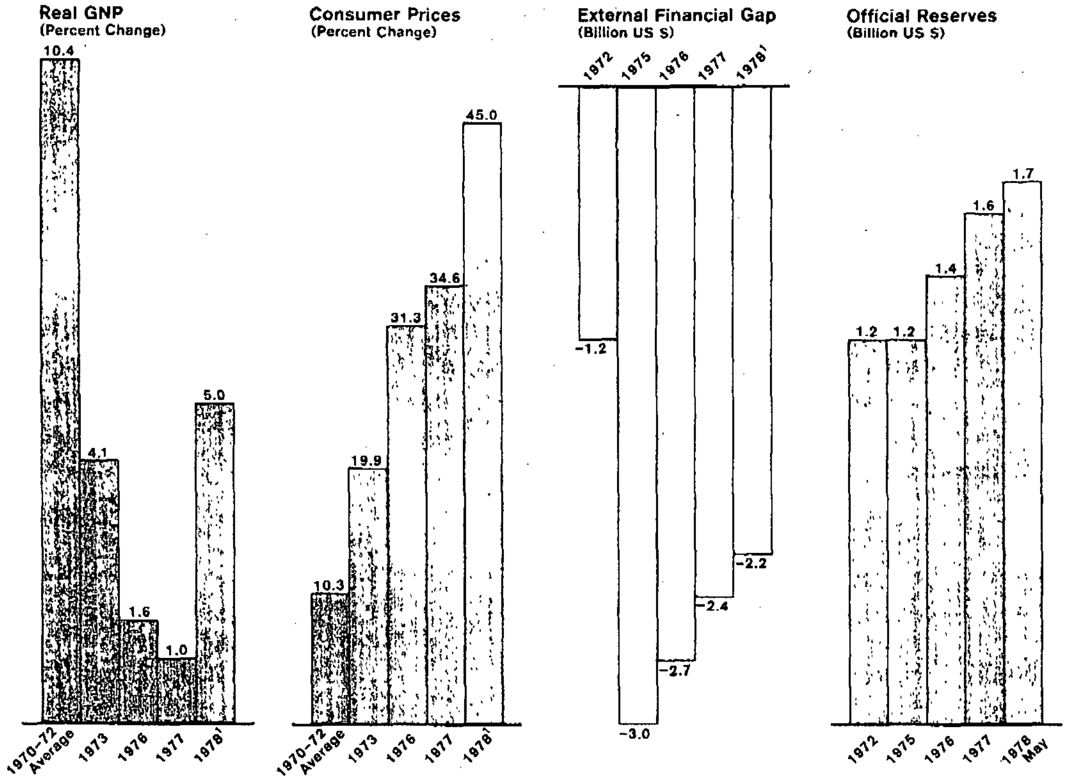
Helped by the New Economic Policy (NEP) introduced by the Begin government last fall, the Israeli economy is slowly climbing out of a three-year-old recession, with some headway being made in reducing the country's external financial gap.* If current economic policies persist and political tensions in the area get no worse, Israel should achieve 4-percent to 5-percent GNP growth this year while trimming the financial gap from $2.4 billion to $2.2 billion. Largely because of the constraints imposed by the massive defense effort, inflation would worsen under these circumstances, rising perhaps to 45 percent compared with 35 percent in 1977.

Over the longer haul, economic performance will be heavily influenced by political developments in the Middle East. We believe that an open-border peace settlement would improve the economic outlook, adding as much as 1.6 percentage points to the 6.8-percent GNP growth expected in 1979 (under the assumptions of the previous paragraph) and further shaving the payments gap, without adding much to inflation. On the other hand, even a typically short Middle Eastern war entailing minimal physical damage to Israel could, by increasing the defense burden, chop as much as 4.2 percentage points off GNP growth next year. An outbreak of hostilities also would substantially boost the external financial gap and speed up price increases.

* The **external financial gap** consists of the civilian goods and services deficit, debt repayment, and non-US-financed direct military imports.

Note: Comments and queries regarding the ***Economic Intelligence Weekly Review*** are welcome. For the text, they may be directed to [redacted] Office of Economic Research, [redacted] for the Economic Indicators, to [redacted] OER, [redacted]

Israel: Selected Economic Indicators



1. CIA Estimate.

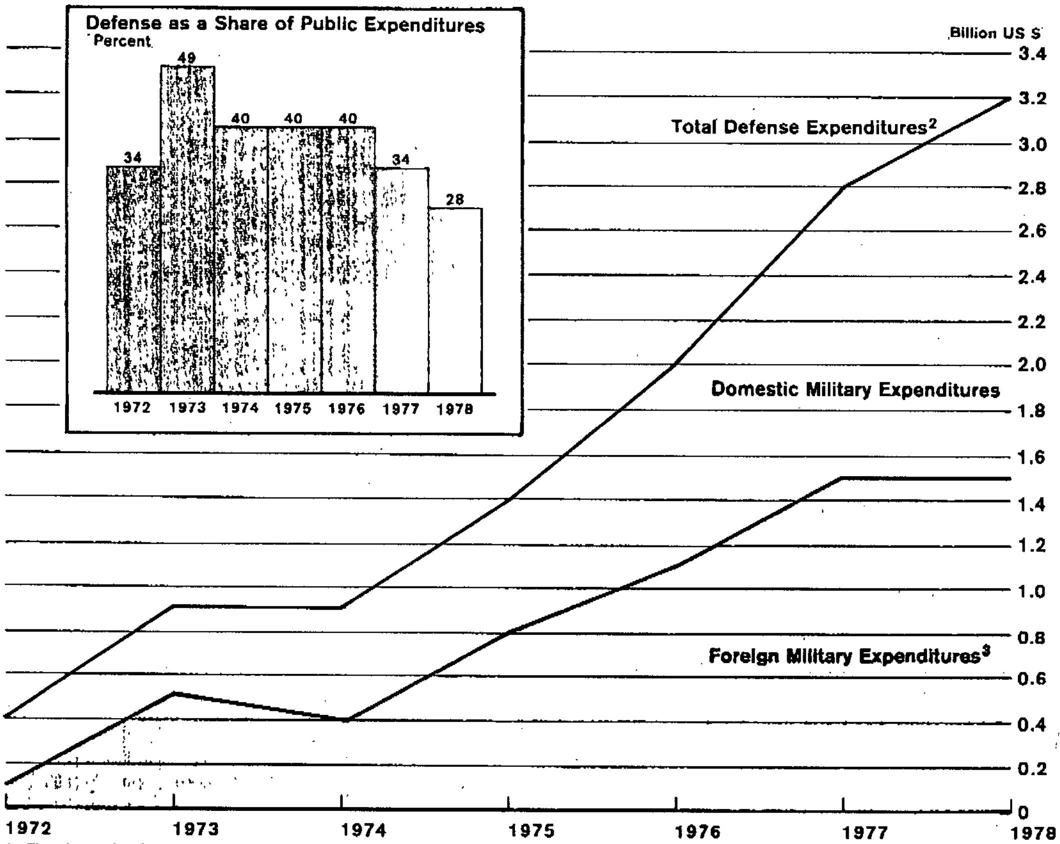
Confidential

The Defense Burden

Since the 1973 war with Egypt and Syria, the Israeli defense effort has put a major crimp on the economy. An additional 50,000 troops have been inducted into the standing army since 1972, reserve duties have increased, and defense spending on salaries and equipment has risen 41 percent in real terms. Tel Aviv plans to spend $3.2 billion on defense this year, about 28 percent of public expenditures. US grants and concessionary loans for major weapons purchases will cover more than $1 billion of this. Approximately one-half of these defense expenditures will go into imported equipment and services, thereby providing little stimulus to domestic economic activity, which until very recently has stagnated.

The stepped-up defense effort also has resulted in a major preemption of manpower. The increases in the standing army and reserves have heightened pressures

Israel: Defense Expenditures[1]



1. Fiscal year begins 1 April.
2. Data converted at 17.5 Israeli pounds=US $1.00.
3. Imports of military goods and services.

Confidential

on the country's skilled labor pool, the more so since the prolonged tensions with Egypt and other Arab states have discouraged immigration and have encouraged many Israelis to seek employment overseas. The shortage of skilled labor in industry is particularly acute; more than two-thirds of 1977 requests for new workers went unfilled. Because of the tight manpower situation, mnay plants are able to operate only single shifts, and attempts to spur GNP carry high inflationary risks.

The defense buildup since the war has badly strained Israel's balance-of-payments accounts. Direct Israeli-paid-for military imports averaged $220 million a year in 1974-77, the equivalent of 8.5 percent of civilian export earnings in the period. Indirect Israeli military purchases (for instance, intermediate goods such as airframes) and Israeli payments for military-related services add another few hundred million

Israel: Migration

Persons

	Immigrants	Emigrants	Net Immigration
1970	31,043	12,759	18,284
1971	37,078	16,756	20,322
1972	52,353	16,996	35,357
1973	52,238	15,326	36,912
1974	29,722	30,528	−806
1975	18,104	19,979	−1,875
1976	17,772	22,492	−4,720
1977 [1]	17,690	18,430	−740
Jan-May 1978 [1]	8,670	12,980	−4,310

[1] Estimate.

dollars a year to the import bill. With exports suffering from sluggish demand in developed countries and from Israel's high inflation rate in 1974-77 relative to its competitors, these purchases have greatly boosted external financing requirements and have necessitated domestic austerity policies to hold down consumer goods imports. Without the contributions of world Jewry, which has responded to the threat to Israel's security with large purchases of Israeli bonds and remittances to friends and relatives, and US economic assistance, Tel Aviv would have had to (a) go deeper into foreign debt or (b) tighten the consumer's belt more relentlessly.

Impact of the NEP

In October 1977 the Begin government acted to get the civilian economy on the move by spurring exports. At the same time it aspired to shave the external financial gap by limiting the growth of nonessential civilian imports tbrough fiscal restraints on disposable income. A secondary goal was to improve the domestic business climate by increasing the role of market forces in the economy. Although attempting to minimize price increases, the government apparently has been willing to tolerate an acceleration in inflation to achieve its other goals. The NEP has involved:

- A float of the Israeli pound, which from October 1977 to June 1978 led to an 81-percent trade-weighted devaluation.
- Elimination of most foreign exchange restrictions.
- A 50-percent hike in the value-added tax.
- Cuts in the subsidies on basic commodities and hikes in charges for public services.

The government moderated its stance vis-a-vis disposable income in April 1978 under pressure from the Histadrut—the large labor organization closely allied to the opposition Labor Party. To forestall labor unrest, the government (a) froze public service fees and prices of some subsidized commodities, (b) reduced income tax rates, and (c) allowed wage increases of between 10 and 13 percent on top of cost-of-living adjustments. In part to accommodate these measures, the government had to issue a supplementary budget, which boosts 1978 public expenditures to $11.6 billion, or 44 percent above the 1977 level. These large increases in civilian expenditures have reduced defense's share of total public spending from 49 percent a few years ago to the current 28 percent.

The government's policies have been moderately successful. The devaluation has souped up export growth to a 25-percent annual rate, and GNP is expected to rise 4 to 5 percent for the year. With the supplementary budget, government consumption will be up 7 to 8 percent in real terms after declining 10 percent last year. Public nonmilitary consumption should rise a little faster than last year, although these gains will be far outpaced by an 11.5-percent hike in real foreign military expenditures. Investment also is rebounding after two years of absolute decline. Local businessmen are reacting favorably to the government's measures, and private capital inflows are on the rise, fostering a rise in spending on machinery and equipment, especially in mining and in the chemical and other intermediate goods sectors.

Israel's external financing deficit should drop off by $200 million this year, to about $2.2 billion. The civilian goods and services deficit is expected to decline by $300 million to $1.1 billion as the rise in exports will probably far exceed the increase in imports sparked by rising economic activity. The capital account, including bond purchases by world Jewry, showed a $252 million surplus in the first quarter of the year, up somewhat from fourth quarter 1977. These inflows, remittances from world Jewry (which are likely to remain strong after reaching $740 million last year), US economic aid flows, and West German restitution payments should more than cover Israel's external financial gap, enabling Tel Aviv to add to its official reserves.

The cost of these improvements has been a marked acceleration in inflation, to a 45-percent annual rate—about 15 percentage points higher than anticipated when the NEP was introduced. Although Begin campaigned on a platform that included reducing inflation, he apparently is willing to accept this rate to maintain growth and keep labor peace. Breaking the inflation spiral will be difficult given the political/economic strength of labor and the cost-push factors already working through the economy. The next round of wage negotiations in October are likely to center once again on cost-of-living adjustments, commodity subsidies, and public service fees. In an attempt to maintain a united domestic front, the Begin government probably will

Israel: External Financial Gap

Million US $

	1972	1975	1976	1977	1978[1]
Civilian goods and services balance	−624	−2,215	−1,820	−1,415	−1,100
Non-US-financed military imports	158	235	198	250	270
Foreign debt amortization	−440	−528	−655	−750	−850
External financial gap[2]	**−1,222**	**−2,978**	**−2,673**	**−2,415**	**−2,220**
US economic assistance	110	467	651	811	885
Remittances from world Jewry	715	769	788	739	750
Israel Bond purchases	300	310	347	355	370
West German restitutions	292	359	314	345	350
Other capital flows	290	1,055	764	363	165
Change in official reserves	485	−18	191	198	300

[1] Estimate.
[2] Excludes US-financed military imports.

meet most labor demands rather than risk crippling strikes. For 1978 as a whole, real wage earnings are likely to be slightly higher than in 1977.

Looking Ahead

Assuming the continuation of the present uneasy balance in Israeli-Egyptian relations, the Israeli economy should do well in the next two years, compared with most of its post-1972 experience. A continuation of present government policies—which seems likely—would probably boost GNP on the order of 6.8 percent next year and another 5.5 percent the following one. Public nonmilitary expenditures should accelerate again in the wake of increasing public sector employment and escalating wages. Because of an Israeli-projected lull in real foreign defense purchases in 1979, the increase in nonmilitary purchases should raise the share of the civilian sector in the budget considerably. Private consumption also is apt to do well because of 1978 wage gains, while the export boom, by all indications, will continue to foster an investment recovery.

In these bullish circumstances, inflation is unlikely to abate any time soon, and the payments situation could worsen. The projected GNP rates would push up civilian imports of goods and services faster than exports, leading to an increase in the civilian deficit, possibly on the order of $300 million a year in 1979-80. Adding in Israeli estimates of non-US-financed direct military imports ($300 million a year) and debt repayments ($900 million a year), the external financial gap should hover a little above the $2.4 billion 1977 level. Nevertheless, even if contributions from world Jewry wane a little—a possibility given some disenchantment with Begin's policies—and Israeli estimates of capital inflows prove optimistic, Tel Aviv's strong international credit rating should enable Israel to cover the gap with little impact on official reserves.

Some Alternative Futures

Because the economic outlook is so sensitive to Israel's relations with its Arab neighbors, we have developed several alternative scenarios to illustrate potential economic gains or losses associated with varying levels of political tensions. On the peace side, we have examined the economic potentialities of (a) a situation of partial demobilization and (b) a reduced defense buildup program coupled with demobilization; on the opposite side, we have set up (c) a partial mobilization scenario linked to heightened political tensions and (d) a short-term war scenario.

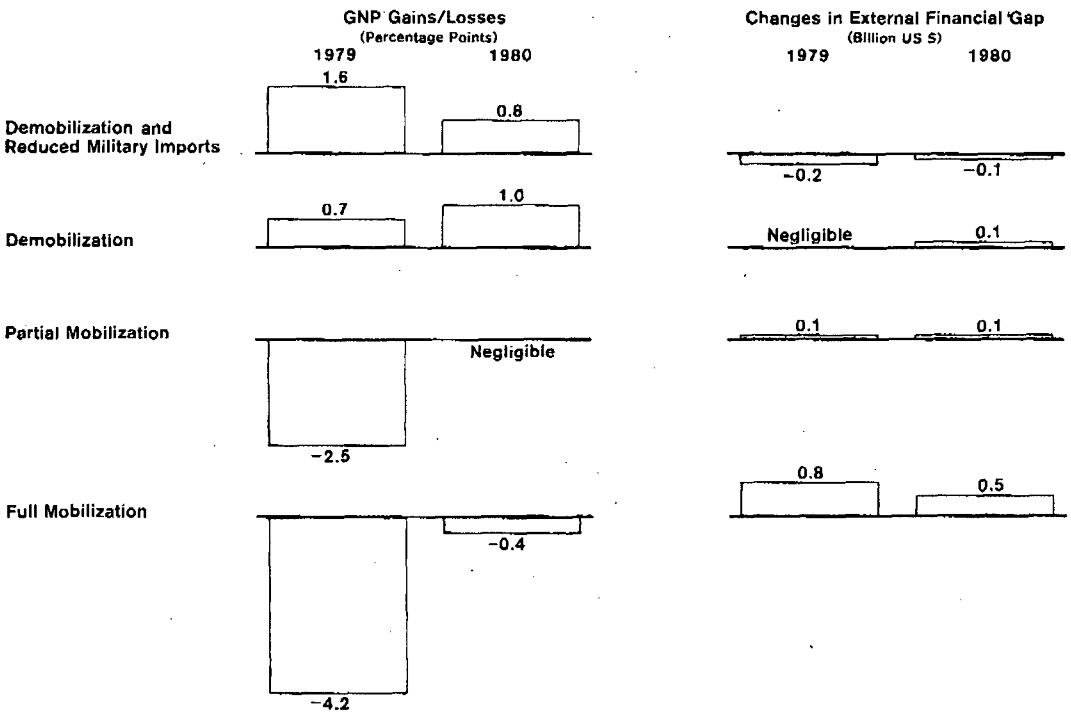
Economic Potential of Peace

A peace settlement involving relatively open borders could ease the manpower constraint on Israeli growth, facilitating increased industrial output and exports. Partial demobilization of troops, an influx of new immigrants, and a reduction of emigrants would add to the labor force, accommodating more rapid growth without much risk to inflation. At the same time, the alleviation of political tension presumably would spur GNP through increased tourism and foreign investment in reexport industries such as electronics. Additional gains from national and regional economic development could be anticipated over the longer run, their size depending on Tel Aviv's ability to get financing.

The extent of GNP gains under a peace settlement would of course depend on how far Tel Aviv was willing to go to demobilize its forces, moderate its defense buildup, and transfer these resources to civilian growth. If, for instance, Israel decided to demobilize the 50,000 additional troops put in place since 1972 (say 20,000 next year and 30,000 in 1980) and to divert the cost of maintaining these troops into civilian investment and income tax breaks, we estimate that, along with the benefits of improved tourism and foreign investment, the easing of this constraint would add almost an additional percentage point to 1979 and 1980 GNP growth. Although civilian imports would pick up, exports would also grow faster, and the external financial gap would be close to our baseline projections.

If on top of demobilization, Tel Aviv felt able to reduce its own foreign military imports, (assuming US military aid continues as now scheduled) and to spend this money on civilian investment and consumption, GNP could grow even faster than in our first scenario. Given the optimistic baseline outlook, this policy change could yield an 8.4-percent GNP growth rate next year, the highest annual rate since 1972. With

Israel: Impact of Changed Political Tensions on GNP and External Financial Gap[1]



1. Deviations from baseline projections of 6.8-percent and 5.5-percent GNP growth in 1979 and 1980 and external financial gaps of $2.6 billion and $2.5 billion in 1979 and in 1980, respectively.

foreign military purchases down, the external financial gap would be about $2.4 billion.

Some Economic Implications of Escalated Tensions

Any rise in Middle East tensions involving temporary partial mobilizations would cut back industrial output and tourist services, trim private consumption and investment growth from our baseline projections, and disrupt transportation and distribution as schedules were adjusted to meet the priority of putting reserves in place. Israeli-paid-for purchases of foreign military goods would undoubtedly increase. We estimate that intermittently calling up 100,000 men would cut 2.5 percentage points off next year's GNP growth and a little off growth in 1980. Although civilian imports would be less dynamic as economic activity slacked off, greater foreign military purchases and some reduction in export growth would add about $100 million to the external financial gap, assuming that US military aid stayed at currently projected levels. At the same time, the civilian labor pinch would probably boost domestic inflation to the 50-percent rate and beyond.

An outbreak of hostilities in early 1979—leading to, say, a typical Middle East conflict lasting less than a month—would put a severe damper on economic growth even if Israel escaped serious damage from shelling and bombing. The changed psychological atmosphere and full mobilization of reserves (300,000 troops) would probably lead to actual drops in private consumption and investment in 1979. The diversion of government expenditures from civilian to military use with its high import content would further contract the economic growth rate. Overall, GNP growth could fall more than 4 percentage points in 1979, although the impact in 1980 would be small since the economy would be returning to more normal production patterns. If 1973 patterns held, this war scenario would substantially add to the external financial gap.

If the Arabs responded to the outbreak of hostilties by placing another oil embargo on the industrial countries, the impact of the war on Israel would be particularly severe. For every 1-percentage-point decline in OECD economic growth due to the embargo, Israel's export receipts would fall by as much as $300 million, whittling away additional points from GNP growth. If Iran, which supplies two-thirds of Israel's oil needs, changed its policy and joined the embargo, Israel, of course, would face the possibility of additional production losses, depending on the length of the embargo.

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ITALY: BLEAK PROSPECTS FOR WAGE RESTRAINT

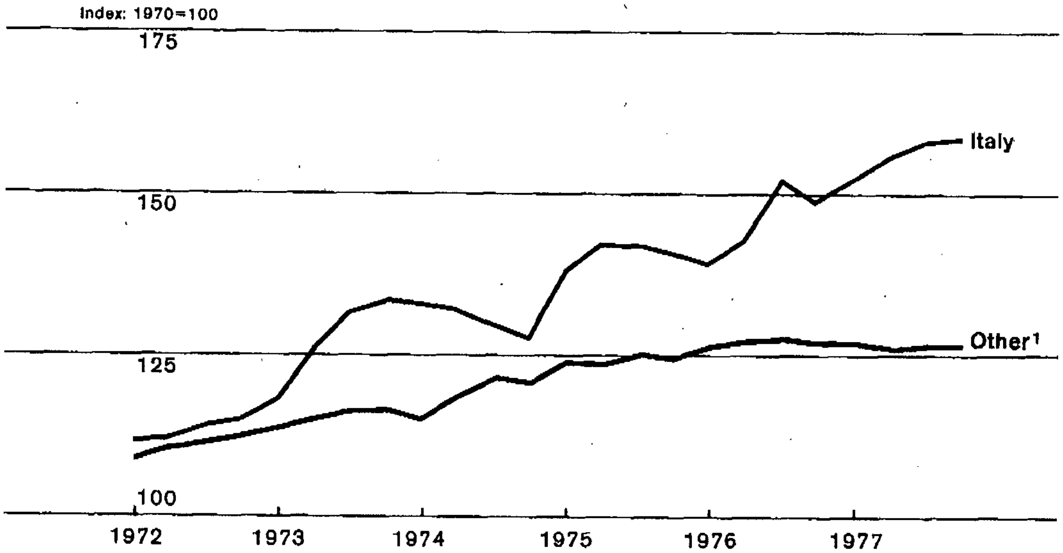
The comparative calm on the Italian labor scene over the past 18 months masks dissension within the labor movement over its goals in upcoming national wage negotiations. Key unions have come out against Communist labor chief Luciano Lama's call to restrain the growth of labor costs. A recent settlement with Fiat on working hours and productivity portends further strong growth in real wage rates and unit labor costs. For its part, the Andreotti government has thus far failed to come up with an effective incomes policy.

A continuation of this trend will weigh heavily on the economy in the form of depressed investment, continued high unemployment, and an acceleration of inflation. Should the Communists fail to deliver on their promise of labor restraint, they will lose vital leverage in their struggle for greater government power.

Background

Reflecting the increased muscle of the union movement and the widespread indexation of wages to the cost of living, real industrial wages in Italy have climbed 60 percent since 1970—the steepest rise among all developed countries. Even in last year's relatively weak labor market, industrial workers secured a 27-percent increase in nominal wages, yielding a remarkable 7-percent rise in real wages. Since cost-of-living adjustments lag prices by three months, real wages also tend to rise when inflation decelerates as it did in 1977 in response to an austerity program which boosted taxes and sharply restricted credit. This year real wages are expected to increase 4 to 5 percent.

Big Seven: Real Industrial Wages



1. Including the United States, Japan, West Germany, France, the United Kingdom, and Canada.

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Productivity growth, on the other hand, has slowed over the years, and unit labor costs have skyrocketed. Last year alone, unit labor costs in manufacturing soared 22.0 percent, bringing the average annual increase since 1969 to 16.9 percent.

The labor scene has been comparatively quiet for the past 18 months; a 62-percent reduction in man-hours lost due to strikes made 1977 the lightest strike year