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KEY ECONOMIC INDICATORS
In million of U.S. dollars unless noted

	1984	1985	1986 (est.)
Domestic Economy			
Population (millions)	4.16	4.24	4.31
Population growth (%)	2.0	1.8	1.7
GDP in current dollars (billion)	22.0	24.1	n/a
Per capita GDP, current dollars	5,288	5,684	n/a
GNP in current dollars (billion)	20.9	22.8	n/a
Per capita GNP, current dollars	5,024	5,377	n/a
GDP (millions NIS) (1980 prices)	116.0	120.0	122.0
GDP % change	1.7	2.8	1.6
GNP (millions NIS) (1980 prices)	109.0	113.0	115.0
GNP % change	0.3	3.6	1.6
Consumer Price Index % change	444.9	185.2	25.0
Interest rates (% monthly)	19.0	5.8	4.5 (a)
Wholesale price index (1977=100)	393.5	1,440.3	n/a
Production and Employment			
Labor Force (1,000s)	1.44	1.47	1.49
Unemployment (%)	5.9	6.7	7.4
Industrial production, % change, local currency 1983=100	4.9	2.7	n/a
Govt. oper. deficit, as % GDP	38.9	22.2	n/a
Industrial production index (1983 = 100)	104.9	107.7	n/a
Productivity growth/worker %	-1.8	1.4	1.6
Balance of Payments			
Merchandise exports (F.O.B.)	5,807.3	6,256.4	6,757.0
Merchandise imports (C.I.F.)	8,344.0	8,319.6	8,910.3
Trade balance	-2,536.7	2,063.2	2,153.3
Current account balance	-4,767	-3,972	3,500
Foreign direct investment (new gross)	184	217	n/a
Foreign Debt (year end)	2,367	2,385	n/a
Debt service paid (net)	2,837	3,049	n/a
Debt-service ratio as % of merchandise exports	49	49	n/a
Foreign exchange reserves (year end)	3,098.5	3,718.6	n/a
Average exchange rate for year (NIS=U.S.$1.00)	0.2935	1.1813	1.485 (a)
Foreign Investment	not available		
Total (cumulative)			
U.S. (cumulative or %)			
U.S.-Israel Trade			
U.S. exports to Israel (C.I.F.)	1,771.6	1,705.6	n/a
U.S. imports from Israel (F.O.B.)	1,644.6	2,134.1	n/a
U.S. trade balance with Israel	127.0	-428.5	n/a
U.S. share of Israeli exports	24.3	34.1	32.9 (a)
U.S. share of Israeli imports	21.2	20.5	22.0 (a)
U.S. Economic aid	1,200	1,950 (b)	1,950.0 (b/c)
U.S. Military aid	1,124	1,927	1,790.0

Principal U.S. exports (1985): machinery and mechanical equipment; agricultural products; optical and measuring instruments; metal and metal products.

Principal U.S. imports (1985): polished diamonds; mechanical instruments; chemicals; optical and medical instruments.

Sources: Central Bureau of Statistics, Bank of Israel, and Finance Ministry

Note: Using an average annual rate of exchange may produce misleading dollar accounting because the rate was changing so rapidly.
(a) Jan-June
(b) includes one-time grant of $750 million in Special Assistance
(c) does not include return of 4.3 % due to Gramm-Rudman-Hollings

CURRENT ECONOMIC SITUATION AND TRENDS

The New Economic Stabilization Program: Between November 1984 and June 1985 three package deals were concluded with the aim of reducing the rate of hyperinflation. Partners to these deals were private employers, the Histadrut Labor Federation, and the Government. They agreed to implement a general price freeze with periodic adjustments according to increases in input costs; salaried employees received only partial compensation for price rises.

These agreements provided a cooling-off period but failed to establish longer-term stability. In the second quarter of 1985, the rate of inflation accelerated again and almost returned to the average monthly rate for 1984. The improvement in the balance of payments in 1984 stopped in the first half of 1985, causing foreign currency reserves to fall. The inability of the package deals by themselves to reduce domestic demand, restore stability and arrest inflation showed that administrative measures without coordination with monetary and fiscal policy changes were inadequate. By mid-1985, the Government felt that a coordinated policy push was imperative to prevent economic collapse.

Effective July 1, 1985, the Government announced a comprehensive program for economic stabilization. This program was designed to attack simultaneously the two major problems afflicting the economy: balance of payments and inflation. The basic facets of the program included: (1) reducing the budget deficit (to the FY 84/85 budget limit); (2) cutting export and consumer subsidies; (3) devaluing the currency by 18.8 percent; (4) imposing price controls (initially for three months); (5) reducing civil service employment by three percent; (6) freeing the capital market and reducing the linkages which automatically pass through inflation; (7) imposing one-time increases in taxes; and (8) sustaining a stable exchange rate against the U.S. dollar. The government received additional authorizations to extend the price controls until December, 1986, but as signs of stability have become apparent, the price freeze is being gradually lifted. Wages were not officially frozen, but there was a policy against pay increases. It was also agreed that cost of living adjustments would be less than the rate of inflation.

Most observers regard the initial implementation of the program to have been successful in achieving its goals. The measures jolted the July 1985 CPI by 27.5 percent, but contributed to the relative stability of the second half of 1985. During the first ten months of the program (July 1985-April 1986) the CPI index rose only 52.9 percent. The foreign payments position improved so that Israel had a current account surplus of $1.098 million for 1985.

In addition to the success of the program, the Israeli economy has benefited from several fortunate events: the decline in the value of the dollar against the European currencies; the decline in the price of oil; the decline in foreign interest rates and the granting of an additional $1.5

billion in U.S. assistance (half for 1985 and half for 1986). These, however, are occurrences which will most likely not be available to sustain the Israeli economy in the future.

Other developments during the first seven months of 1986 point, moreover, to a potential erosion of the recovery process. They include: relief from immediate economic pressures; some pay increases for last year's erosion accorded both in the private and public sectors; Government failure to reduce the public sector as much as projected; renewed demand for consumer durables; non-implementation of new tax revenue measures and spending cuts; growth of exports below, and of imports above, estimates; and growing pressure on the Government to provide Government support to concerns, particularly major construction, shipping and health concerns, facing financial difficulties. These trends increase pressures for devaluations and price hikes, as well as widening the trade gap. Various economic commentators have warned that while the Government has reduced the budget deficit, it has not set in progress a process of renewed economic growth or structural change with which to sustain the progress already achieved.

In addition, October 1986 will bring the "rotation" in the leadership of the National Unity Government from the Labor Party to the Likud Party. While there is no change anticipated in the direction of or dedication to the Economic Stabilization Program, longer term forecasting is difficult.

National Accounts: Israel's economy grew moderately in 1985 after a slow growth in 1984. The Gross National Product (GNP) increased by 3.6 percent to $22.8 billion versus 0.3 percent growth the year before. Real private consumption remained stable at $14.3 billion, but per capita private consumption declined two percent. This decline was influenced by a decrease in foreign travel and in purchases of new automobiles. Total real public consumption increased 3.8 percent in 1985 (following seven percent growth in 1984) mainly due to a 25 percent rise in direct defense imports. On the other hand, domestic defense consumption decreased by seven percent in real terms largely as a result of a curtailment in domestic military purchases and the withdrawal from Lebanon. A drop of 14 percent in transfer payments, and of 34 percent in subsidies, contributed to the continued stability in civilian public consumption. Gross domestic investment (construction, machinery, equipment and transport) fell in real terms for the second consecutive year, i.e. by 10 percent. In residential construction alone, investment shrank by 14 percent.

The Government, however, anticipates renewed economic activity in the last half of 1986, so that growth overall for 1986 could be 2-3 percent.

Balance of Payments: The deficit in the balance of payments on goods and services declined to $3.972 billion in 1985, i.e. a drop of $795 million, or 17 percent less than in 1984. Exports of goods and services grew two percent to $10.688 billion, while imports declined four percent to $14.688 billion. Commodity exports increased 7.7 percent in dollar value (by over $500 million) to $6.256 billion, while non-military imports remained stable at about $8.32 billion. The deficit in the services account also narrowed by some $600 million due to a 12.6 percent drop in services (foreign travel, interest payments and transport services). Unilateral transfers, which amounted to $5.07 billion, more than covered the entire goods and services deficit in the current account. In 1985 the bulk of these transfers came from the U.S. Government; the balance constituted remittances from institutions (i.e., the United Jewish Appeal), personal restitutions from Germany, and transfers by individuals. The sizable surplus of unilateral transfers in the current account enabled the Israeli Government to keep its debt balance stable, to repay obligations, and to increase its foreign currency reserves by $620 million. Total external debt at the end of 1985 stood at $23.7 billion, of which 70 percent was long-term, 15 percent medium-term, and 15 percent short-term. Israel's foreign exchange reserves totalled $3.72 billion at year end (IMF definition).

All of the regular U.S. assistance in U.S. FY 85, $2.6 billion, was interest free for the first time. For FY 86 total regular assistance amounted to $2.871 billion. In addition the U.S. provided special assistance of $750 million each for FY 85 and FY 86, a one-time provision to assist Israel in implementing its economic program.

The official outlook for 1986 is for a continued improvement in the balance of payments. The government is forecasting a decline of $500 million in the current account, a rise of seven percent in exports, and an increase of seven percent in imports. The predicted improvement in the balance of payments is based on a strict adherence to the economic plan's guidelines, continued low petroleum prices, and further recovery in the economies of the United States and other western developed countries. To finance the 1986 shortfall, which will be about $3.5 billion, Israel will still have to rely on U.S. assistance, lending from the Bank of Israel, private and institutional remittances, and on commercial borrowing.

<u>Trade</u>: The United States remains Israel's largest single trading partner, although trade with the European Community is larger overall. Non-military Israeli imports from the United States decreased slightly from $1.77 billion in 1984 to $1.71 billion in 1985, or to 20.5 percent of Israel's merchandise imports. Israel's sales to the United States increased by nearly 30 percent to $2.13 billion and constituted 34 percent of total exports. For the first time, Israel had a surplus in its civilian trade with the United States in 1985 of $448 million.

Three trading arrangements help Israel: (1) the European Economic Community (EEC) agreement systematically lowers the duties between the EEC and Israel for non-agricultural products; (2) the U.S. Generalized Schedule of Preferences (GSP) allows 2,700 manufactures to enter the United States without duties; (3) the Free Trade Agreement (FTA) with the United States, which came into effect September 1, 1985, is similar to the EEC pact, and should increase trade between the two countries. The Agreement calls for mutual immediate duty free status for many products, progressive reductions on others, with further reductions on a third category still to be negotiated. The United States and Israel, under FTA, have also agreed to establish a committee to meet for discussions on "trade in services" with the goal of removing existing trade barriers. They are negotiating agreements on various services, including thus far tourism, telecommunications, and insurance.

Israel established the Red Sea port of Eilat as a Free Trade Area with significant benefits to local residents and entrepreneurs. The impact of this change has not yet been felt either in the region or on the economy.

Inflation: In nominal terms, the Israeli shekel depreciated vis-a-vis the dollar in 1985 by 134.8 percent, which means in real terms (after adjustments for domestic inflation) it appreciated against the U.S. dollar by some 18 percent. By contrast, in 1984 and in 1983, the shekel was devalued by 493 and 220 percent respectively. Since July 1, 1985 (when the shekel was devalued by 18.8 percent), the exchange rate of the dollar remained stable at around NIS 1.5 to one U.S. dollar. During the same period, the shekel was devalued by some 22 percent against European and Japanese currencies.

Inflation decelerated in 1985 after three years of consecutive steep increases. Prices rose 185.2 percent in 1985 compared with a rise of 444.5 percent in 1984 and of 190.7 percent in 1983. During the second half of 1985, the CPI went up by 45.4 percent, i.e. by the lowest six month rate since 1981. During the first third of 1986, inflation totaled only 5.2 percent, a rate prevailing in the early 70s. The relatively low inflation rate is expected to continue through 1986, reaching 18-25 percent for the year, assuming that the world oil prices stay at the current low level and that the economic plan's measures are fully implemented.

Prices and Wages: To simplify monetary calculations, effective January 1, 1986, all financial transactions were denominated in "new shekel" terms (NIS). One new shekel equals one thousand old shekels. Both currencies were intended to be in circulation during 1986, but beginning in September, 1986 old shekels must be redeemed at a bank. The change has no economic significance but may have contributed to the public's feeling that prices are becoming more stable.

Beginning August 1, 1986 the Government linked the shekel to a trade weighted basket of currencies of Israel's major trading partners. The unit composition of the basket is roughly: U.S. dollar 60 percent; the West German mark 20 percent; the pound sterling 10 percent; the French franc and the Japanese yen five percent each. The move is intended to reestablish some linkage with currencies other than the dollar and to minimize the degree of fluctuation against these currencies. The Government envisions that the rate of the basket would be 1.5 NIS to the basket.

Wage control during most of 1985 resulted, as planned, in a decline in real wages of 9.1 percent by year end. As part of the agreed economic plan, the first months of 1986 show an increase in labor costs and real wages in the private sector which as of June 1 were about four percent below the average 1984 level. For the public sector the decline remains somewhat larger.

The two-year public and private sector blanket wage agreements with the Histadrut Labor Federation expired March 31, 1986. Negotiations, underway since April, appeared to be under little pressure to reach a conclusion until recently. The Histadrut is seeking a real wage increase, but the Government has stated frequently that it will devalue the shekel, if necessary, to offset any major gains. Already negotiated is a cost of living agreement (COLA) which stipulates a 70 percent adjustment whenever the CPI increase exceeds a seven percent cumulative increase within a given time period. This weakens the linkage between wages and inflation somewhat. In addition, the Histadrut unilaterally announced that it will increase the minimum wage for its employees to 450 NIS/month beginning August 1. This is approximately 40 percent of the average wage and affects 20-25 percent of the work force. Many feel that wages remain too high, relative to productivity, to achieve greater employment without inflation or other disequilibria. Although workers now experience no significant wage erosion of their salaries during the month, and have benefitted from adjustments in the tax brackets to increase their take home pay, they still must bear the impact of increased expenses as subsidies and benefits are reduced.

Price controls have maintained price stability, and, with contracting demand, have produced no major shortages or black market suppliers. By the beginning of June 1986, more than half of the items in the CPI were no longer controlled. The Government is continuing to decontrol items throughout the summer. Eventually only a quarter of the items in the CPI, i.e. those provided by monopolies and cartels, or certain health and education services, will be controlled.

Employment and Productivity: The unemployment rate rose to 6.7 percent of the civilian labor force in 1985 from 5.9 percent in 1984. The largest increase came in the third quarter of 1985 when the unemployment rate reached 7.8 percent. There was some fear that the implementation of the economic plan, combined with slackening demand, would raise joblessness over 10 percent. The rate, however, declined to 7.1 percent in the last quarter, and has remained relatively stable at 7.2 percent during the first half of 1986. Productivity per worker, low by European and U.S. standards, increased 1.6 percent.

Monetary Policy: The Central Bank pursued a tight monetary policy which coincided with the objectives of the economic stabilization plan. Its aim was to prevent expansion of credit to the public at a time of price and wage control, and to attract more savings by keeping the real rate of interest high. This caused financial hardship to numerous enterprises during the slowdown of the second half of 1985. On the other hand, the policy contributed to the gradual transition from foreign-currency-linked liquid assets to longer-term, shekel denominated savings schemes. Towards the end of 1985, when inflation stabilized at a lower level, the central bank allowed interest rates to drop, albeit not as fast as inflation. The ordinary business borrowing rate declined from 19.0 percent per month in December 1984 to 5.8 percent per month in December 1985, and to 4.5 percent per month in March 1986. As of April 1986, commercial banks are making interest computations on a quarterly basis, in lieu of a monthly basis and credit card companies are billing monthly rather than biweekly.

Public Finance: For the Israeli fiscal year ending March 31, 1986, the government budget deficit was NIS 4.8 billion (about $3.5 billion) on total outlays of NIS 20.2 billion (some $14.8 billion). The budget deficit is defined as the portion of budget revenues which the Central Bank lends to the government. Such direct borrowing from the Central Bank adds to the inflationary pressures. By contrast, the budget deficit for the current fiscal year (1986/87) is forecast at NIS 1.3 billion ($0.82 billion), out of total expenditures of NIS 30.2 billion ($ 19.1 billion). The new budget is said to represent a 5.3 percent real cut in expenditures from that of the preceding fiscal year. The proposed budget, as of August 1, still depends on Knesset approval, with the imposition of additional taxes and levies yet to be decided.

In fiscal 1986/87, about 65 percent of the expenditures is devoted to defense and debt servicing; 16.5 percent for transfer payments; nine percent for civilian consumption; and 6.6 percent for investments. Of total anticipated revenues, 52 percent are expected from taxes and levies, 22.2 percent from foreign grants and loans (20 percent from the U.S. Government), and 16.5 percent from domestic loans and emissions.

During fiscal year 1984/85, the Government recycled 98 percent of its redeemed domestic loans and savings schemes. The government's capital raising reached $2.81 billion as against total budgetary redemptions of $2.93 billion. In October 1985 the Government was required to redeem $700 million worth of bank shares held by pensioners which it had guaranteed when the value of those shares collapsed in 1983.

Implications for the United States

Although the Israeli Government's austerity program has slowed market expansion and left a good number of Israeli companies, both large and small, in financial difficulties, several factors combine now to make Israel an especially attractive market for U.S. products. First, the FTA is reducing customs duties to zero for both countries; most items will reach that level by 1989, and the remainder by 1995. The immediate benefit of the FTA for the United States has been to place U.S. exporters on a par in most product areas with their European competitors who, through Israel's earlier Associate Agreement with the European Economic Community, have been enjoying a small but growing advantage in tariff rates. The FTA has also reduced the number of U.S. products requiring import licenses, and provides a more systematic procedure for both sides to work out any disagreements that develop over trade barriers. Second, the more competitive dollar has sparked a growing interest in a broad range of U.S. products. U.S. high-tech equipment, which has been the backbone of U.S. exports to Israel, has become even more attractive while, at the same time, new markets are opening up for all kinds of U.S. industrial and consumer goods and services. Israeli businessmen are making inquiries at the Embassy's commercial section regarding U.S. representations and sources. Renewed interest has been seen in such diverse items as in pumps, graphic arts materials and accessories and clothing and cookware. While the interest and curiosity are there, however, in many areas U.S. exporters will have to be aggressive if they are to dislodge existing commercial ties with European and Japanese competitors. A third factor, Israel's generally favorable orientation toward United States, complements the other factors and should support the penetration of U.S. goods into the market. Israelis generally appreciate U.S. culture, speak English and enjoy traveling to the United States. Given the other factors, this general interest in the United States facilitates market penetration, assuming there is a reciprocal commercial interest by the U.S. exporter.

Finally, the Israeli austerity program, for all its problems, provides the U.S. exporter a sounder, more confident market place than has been the case in recent years. Although it is too early to lose caution, the Government has been able to subdue inflation, decrease subsidies, improve foreign reserves and keep wages and prices in check.

Although, as mentioned above, the interest in U.S. products is broadening to the less sophisticated industrial as well as the consumer areas, the best prospects in the market continue to be in the high tech areas.

The demand for high performance metal working machinery and equipment (N/C, robotic, cutting and finishing machines) is based on a continuing demand from Israel's electronic, aircraft and defense industries. Total demand is around $200 million a year of which 75-80 percent is provided by imports. The demand is growing at above 15 percent a year. The U.S. share, about 20 percent, has been hurt in the past by the over-valued dollar and strong Japanese competition. U.S. exporters must seize the opportunity of the more reasonable dollar to win back some of the lost ground. The U.S. Pavilion in Technology 87, to be held in Tel Aviv in May 1987, provides an excellent vehicle to do this.

U.S. computers and their peripheral equipment also have a good market in Israel. In an import market of about $350 million, the United States holds 54 percent. Growth in the next three years is estimated at just under 20 percent. The Israeli defense establishment generates about 60-70 percent of the demand. The mini-computer market should expand significantly, especially in the services sector, in order to save on labor costs. An excellent opportunity to explore the Israeli market is the Computer Trade Mission being organized by the U.S. Department of Commerce for December 1986. The mission will also visit Greece and Turkey.

Software, which will also be featured in the December Trade Mission, has a $50 million import market in Israel and it is expected to grow at an annual rate of about 80 percent. Currently the U.S. has about a 35 percent share of this market. Israel has a healthy, growing software industry of its own, producing about $150 million annually; it is made up of over 120 software houses.

Electronic components are another good prospect for U.S. exporters. Out of a $200 million import market, the United States has about 60 percent. The continued growth of the Israeli electronics industry and the vital role played by American electronics firms as investors, licensors and technological advisors in this market, assures a strong favorable interest by Israeli firms in U.S. components.

The $100 million import market for telecommunications equipment is also dominated by the United States which holds a 50 percent share. The import market is expected to expand by just under 10 percent a year. Upcoming projects include a proposed Israeli satellite system, a second TV channel, and a possible cable TV network. Further, Bezek (the Israeli telecommunciations company) plans to upgrade its international and domestic communication facilities, including the development of a cellular telephone system. A Voice of America transmitter station in Israel is also being planned and will be an opportunity for U.S. exporters.

Other areas of interest include avionic equipment, which is dominated by U.S. companies, and medical equipment which, although a contracting market because of reductions in the government budget, still represents a sizeable amount of imports, $80 million. In this area, major pieces of equipment would be difficult to place but disposible materials and money saving devices would have attractive prospects.

With the more competitive dollar, consumer items come to the fore. The two major department stores have held or are planning promotions for U.S. textiles. Lingerie, children's clothing and flatware seem the most attractive in that area. Graphic arts materials, now in the hands of European suppliers, is another area that appears to be opening up to a more aggressive approach by U.S. exporters.

Summary

The Government of Israel instituted on July 1, 1985 an economic stabilization program, designed to tackle the two major problems facing the economy: a balance of payments (BOP) deficit and hyperinflation. To date they have been relatively successful in improving the BOP situation and very successful in containing inflation, in part due to the program and in part due to felicitious international circumstances. The current account of the balance of payments shows a surplus of $1.098 billion; the level of inflation is only one to two percent a month and foreign exchange reserves have increased while foreign debt has decreased.

Maintaining the progress achieved and making further progress are now the goals, and the Government recognizes that it faces several difficulties: restraining of excessive increases during the nationwide wage negotiations; controlling public and private pressure for assistance, particularly for businesses in distress; limiting rising consumer demand; directing a growth scenario for the economy and opening the capital market. In addition, the position of Prime Minister shifts from the Labor Party to the Likud Party in October.

Although the economic program has slowed market expansion, several factors combine to make Israel an attractive market for U.S. products: the Free Trade Agreement is reducing customs duties to zero for both countries; it is also reducing the number of items requiring import licences; the more competitive dollar has ignited interest in a broader range of U.S. products; Israelis have a favorable orientation towards the U.S. and U.S. products; and, most importantly, the economic program provides the U.S. exporter a sounder, more confident marketplace than has been the situation in recent years. In this environment both the standard high-tech exports, as well as the less sophisticated industrial and consumer items, should do well in the foreseeable future.