

MAIN DEVELOPMENTS IN THE ISRAEL ECONOMY

The level of economic activity in Israel rose considerably during 1955, and the year was characterised by increased production and employment. Industrial production rose by 12 per cent and the volume of building expanded by 16 per cent. Agricultural output increased by only 3.5 per cent but the limited extent of this expansion was due to the drought. Increases in output were supplemented by a growing volume of imports, which expanded by 11 per cent. The number of earners in the economy increased by 30,000, thus bringing about a certain reduction in the number of unemployed despite the considerable increase in the potential labour force during the year caused by changes in the age structure of the population and by immigration. Net immigration rose to 31,200 in 1955. Real output increased by 10 per cent, while the number of earners rose by only 5.5 per cent, indicating a rise of more than 4 per cent in the average output per earner.

The greater resources available to the economy, both from its own output and from imports, naturally caused incomes to rise. Gross national income increased by 14 per cent. The net national income, representing the residue remaining in the hands of the public after deduction of direct taxes, rose by 12 per cent. Incomes were further expanded by private capital transfers from abroad. Demand increased together with incomes, raising the levels of consumption and investment. Both private and public consumption grew at a more rapid rate than the increase in population causing a rise in the level of average *per capita* consumption. Private consumption increased, mainly owing to larger purchases of food and durable consumption goods. The real level of investment rose considerably, to the extent of 22.5 per cent, but this was particularly due to the expansion of residential building and to large-scale investments in shipping, other transport branches and electricity. Investment in mining and in stocks also increased, though at a slower rate. Investment in building was particularly heavy, its volume approaching that of 1952 when building activities were at their peak. On the other hand, there was little or no change in the real volume of investment in industry or agriculture.

One of the important economic events of 1955 was the striking of oil at Heletz. Though the estimated output of the well, and of the additional wells subsequently discovered, is small when compared with Israel's fuel consumption, the discovery of oil may yet make a considerable contribution to the improvement of the country's trade balance.

The expansion of economic activity during 1955 was partly caused, as in previous years, by factors unrelated to Israel's internal development. The most important of these was the great stream of capital imports, which stimulated economic activity,

both by increasing the budgets of the Government and other public bodies and by expanding the money supply through the conversion of foreign currency balances into Israel pounds.

Apart from capital imports, there were several internal factors stimulating economic activity. The inflation which, but for a few short intervals, has been prevalent in the economy of the country ever since 1939, gave rise to the widespread belief that the exchange of money for consumer or capital goods is a paying proposition. Such action was further encouraged by the possibilities of obtaining loans repayable in depreciated currency.

There exists a natural tendency in Israel towards expansion, characteristic of an economy built up over a relatively short period of time which has had to absorb a very large immigration in proportion to the size of the settled population. The creation of a relatively well-protected market encouraged investments, even when these had to be financed by loans at high interest rates. This tendency is not based on sufficient internal savings. Net investment in agriculture and industry has been mainly financed by public capital imported from abroad, and only to a lesser extent by imports of private capital.

These trends, acting together, encouraged the expansion of credit, and brought about an excess of budgetary expenditure over budgetary revenue as well as a marked increase in the money supply, especially during the first half of 1955. During this period, the money supply expanded at the very rapid rate of 2.5 per cent per month. This was caused, not only by the conversion of foreign currency balances into Israel pounds, but also by increased Government spending on residential housing, public works, subsidies and defence (although revenues did not increase sufficiently to prevent deficit financing) and by the expansion of credit to the non-governmental sectors of the economy. The rise in personal incomes was reflected by the marked rise in the level of private consumption. All these factors created inflationary pressures on demand, in addition to the cost inflation encouraged by the steady rise in production costs, whether these were wages, indirect taxes or the price of imported commodities.

Despite these developments, prices rose in 1955 at a slower rate than during any of the four preceding years. The consumer price index rose by 4.8 per cent, the prices of capital goods and consumer goods not reflected in this index probably rising to a slightly larger extent. Even though these limited price increases must be considered undesirable, the relative stability represents something of an achievement under the conditions prevailing in the Israel economy.

The rise in the price level during 1955 was limited by the satiation of the market, resulting from increased local output and a greater surplus of imports over exports. The value of imported goods and services increased by \$68.6 millions during the year, owing to high prices in the world market, the expansion of stocks and greater consumption and investment. Meanwhile, exports did not expand during the year and, indeed, their volume at fixed prices slightly contracted. These developments

were caused largely by climatic conditions. Moreover, the constant rise in production costs weakened the ability of Israel products to compete in foreign markets. Changing conditions in the Turkish and Finnish markets, both of which are of importance to Israel's industrial exports, reduced exports to these countries, while no other markets were found to take their place. Further, the growing internal demand during the first half of the year absorbed locally some potential export products.

As the gap in the trade balance grew, the net foreign currency liabilities of the Israel economy grew with it, increasing, after deduction of the rise in foreign currency reserves, by \$ 34 millions.

The tendency for economic activity to expand side by side with the monetary expansion which took place in 1954 and 1955, is exemplified by various indicators shown in Table 1.

TABLE 1
INDICATORS OF ECONOMIC ACTIVITY
(changes in per cent)

	1954 <i>in comparison with 1953</i>	1955 <i>in comparison with 1954</i>
Real Gross National Product	+12.5	+10.0
Real Agricultural Output *	+20.0	+ 3.5
Real Industrial Output *	+20.0	+12.0
Volume of Building	+25.0	+16.0
Number of Earners	—	+ 5.5
Average Number of Persons Seeking Work through Labour Exchanges	—24.0	—20.0
Nominal National Income	+25.0	+14.0
Real National Income <i>per capita</i>	+ 9.0	+ 3.5
Real Private Consumption, <i>per capita</i>	+ 6.0	+ 2.5
Real Public Consumption, <i>per capita</i>	—	+13.5
Real Gross Investment	+ 5.0	+22.5
Money Supply **	+20.0	+20.0
Bank Credit to the Public **	+16.0	+10.0
Current Expenditure of the Government and Local Authorities	+55.0	+26.0
Consumer Price Index	+12.0	+ 6.0
Deficit in the Balance of Goods and Services	— 9.0	+26.5

* *Value of products, including intermediate products.*

** *At the end of the year.*

SOURCE: *Calculations of the Bank of Israel.*

The monetary policy of the Bank of Israel was designed to provide high levels of production, employment, national income and capital investment on the basis of a stable currency. Whenever the money supply increased to an extent which might have endangered the stability of the currency and upset the equilibrium of the economy, the Governor of the Bank submitted a report to the Government and

to the *Knesset* Finance Committee in accordance with Paragraph 35 of the Bank of Israel Law. Such reports were submitted on 30 March 1955 and 15 November 1955. The Bank of Israel pointed out the dangers inherent in the developments described above and advised the following steps:

1. Balancing the cash income and expenditure in the budgets of the Government and of other public authorities.
2. Restricting the rate of credit expansion to the rate of increase in real output and directing the limited volume of credit with the object of increasing the share of credits which were financing industrial and agricultural production, increasing exports or acting as substitutes for essential imports.
3. Preventing the rise in personal incomes, insofar as such a rise is not linked to a parallel rise in productivity; and encouraging personal savings.

During the last months of the year, the Government took various steps to implement the most important of these recommendations, and ceased to finance its expenditure from credits. Credit in Israel currency granted to the Government by the banking system, including the Bank of Israel, contracted from IL. 80 millions at the end of June to IL. 77 millions at the end of December 1955. At the same time, the Government and other public authorities reduced their expenditure on housing and public works. A general improvement in tax collection, as well as increases in certain tax rates, raised public revenues. Income from counterpart funds and other collections also increased.

The volume of credit granted to the public by the banking system expanded during this period to only a limited extent. This credit, including re-discounts in Israel currency, totalled IL. 237 millions at the end of December as against IL. 232 millions at the end of June 1955. Apart from quantitative limitation, there was a qualitative direction of credit which increased the share of agriculture, from 23 per cent of all credits granted from the banks' own resources at the end of 1954 to 26 per cent at the end of 1955. The share of industry rose from 29 to 30 per cent.

The increase in personal incomes did not significantly exceed the rise in output. Though salary increases for academic and administrative staff came under extensive discussion, and these groups actually received advances on account of such increases during the last months of 1955, the sum total of these advances was relatively small. The Government, moreover, organised or encouraged a number of savings projects implemented during this period, and these somewhat reduced the liquidity of financial institutions and of certain sections of the public.

Indeed, subsequent development proved the efficacy of these monetary and fiscal policies in what might almost be termed a classic manner. The money supply did not expand at all between August and November 1955, while in December it increased by only 1.2 per cent. The last months of 1955 also witnessed a certain recession in the private demand for consumer goods. This phenomenon was due, in part, to consumers exhibiting restraint in their purchases as a result of the deterioration

in the defence situation. Some expectations concerning the volume of sales were not realised, and this served to slow down the rate of expansion in certain industrial branches, especially clothing and footwear. However, the total volume of industrial production continued to expand, as did production in agriculture and building. Though unemployment increased in the last months of the year, it did not exceed the bounds set by the seasonal fluctuations in 1954, despite the additional labour force available. However, these developments left practically no mark on the balance of trade in the last months of 1955, as imports for stock and public investment were increased.

The fact that the balance of trade was not improved indicates serious dangers to the future of the economy, since some of the main sources of capital imports (Reparations, the United States Grant-in-Aid and other unrequited payments) may in time become exhausted or limited, while the increase in Israel's foreign indebtedness will necessitate larger interest and principal repayments at a time when the volume of capital imports at the disposal of the State will be much smaller than at present.

Experience in the Israel economy has proved the theory that demand increases and prices rise whenever the money supply expands at a rate faster than real output, while the liquidity preference of the public remains unchanged. It is possible to slow down this process by increasing imports, but such a policy requires additional financing through loans or a reduction in Israel's foreign currency balances.

Excessive monetary expansion thus has a damaging effect on the trade balance and the balance of payments, both directly, by increasing the State's foreign indebtedness and preventing the reduction of the trade deficit and, indirectly, by upsetting the general stability of the economy.

A healthy and stable economy is one of the essential pre-conditions for improving the security situation of a state. A firm trade balance and large foreign currency balances represent important factors in the strengthening of the national economy and, viewed from this angle, careless monetary expansion may be said to weaken the state.

There is an alternative to satiating the local market by increasing imports: a policy with marked negative effects on the trade balance, when accompanied by excessive monetary expansion. This alternative lies in the re-introduction of rationing for essential commodities. But experience in Israel, as in some other countries, has demonstrated that rationing money is preferable to rationing goods; for the rationing of goods and the introduction of price controls lead to a serious distortion of production processes and the economic structure, which is avoided when the directed channelling of money determines the general framework of economic activity, without interference with the individual actions of consumers or producers. Hence, the public itself generally prefers monetary direction to rationing and price controls.

Yet, for all its achievements, the disinflationary policy could not alone repair the flaws in the structure of the economy. As long as inflation continues to distort

the production system and to cause a deterioration in the balance of payments, this policy cannot do more than create the background necessary for eliminating the flaws.

Indeed, the year 1955 witnessed only a very slow advance towards the solution of the basic problems facing the Israel economy. The proportion of earners in the commodity producing branches, and especially in the branches producing exports and import substitutes, increased slightly but remained low. Local production continued to be largely dependent on imports, despite the fact that real progress was made in some directions, notably in industrial crops, towards substituting local raw materials for imports. The heavy burden of public expenditure continued to absorb a large share of the labour force and of available materials. The tendency for production costs to rise may become still more pronounced, as wages paid to the majority of earners, as well as other production costs, increase; and this may, in turn, adversely affect the volume of employment.

The following have been, and continue to be, the primary conditions of economic progress in Israel:

1. a policy restricting the expansion of the money supply and the direction of credit into channels where it can encourage essential production;
2. the balancing of the Government's cash revenue and expenditure;
3. the prevention of rises in production costs;
4. the use of additional resources accruing from increased output and from capital imports for purposes that will improve the trade balance, i.e. for productive investments contributing to the expansion of exports and the production of import substitutes, or to the increasing of the country's foreign currency balances;
5. active encouragement of saving, which serves to limit current consumption; and, lastly,
6. more productive and efficient employment of manpower and other factors of production.