

## CHAPTER I

### MAIN ECONOMIC DEVELOPMENTS IN 1962

THE YEAR 1962 opened with the devaluation of the Israel pound and a new policy for stabilizing the economy. On February 9, the official rate of exchange was raised from IL 1.80 per dollar to IL 3.00, and simultaneously the majority of import levies and export subsidies, which in recent years could be regarded as a substitute for a higher rate of exchange, were abolished. The alteration of the exchange rate was aimed both at eliminating the multiple rate system and at improving the balance of payments by rendering import more expensive and increasing export returns.

The return per dollar of export rose by 20 per cent, from an average effective rate of IL 2.50 to the dollar to IL 3.00. The increases were not uniform: the largest took place in exports of services, citrus, and diamonds; in industrial exports, apart from diamonds, the increase was smaller. The average price of imports rose by 44 per cent—from an effective rate of IL 2.31 per dollar to IL 3.00 plus customs duties at an average rate of 10 per cent. In imports for the local market, apart from those intended for export, the average rise came to 42 per cent. The alteration of the exchange rate was accompanied by a large reduction of the differentials between the effective rates for imports, the increase in the effective rate being greater the lower it had been before devaluation. The greatest increase occurred in the import of equipment, while with regard to imports of consumption goods, which had previously been subject to the highest duties, the incremental cost was less than with other import commodities.

The effect of the new rate of exchange on the balance of payments did not fully express itself in 1962, since a considerable part of the import and export in the first few months after devaluation was still the result of orders placed in the period preceding devaluation. The increase in the foreign currency value of exports of goods and services came to 18 per cent, which was similar to that of 1961; the value of imported goods and services went up by 11 per cent, compared with a rise of 20 per cent in 1961. If the import of ships and aircraft—the timing of which is largely influenced by random factors—is subtracted, the rise in imports reached 17 per cent—the same rate as in 1961.

The large growth in import despite its higher cost reflects not only the volume of orders placed before devaluation, but also the greater demand and activity in the economy, and is in part the result of imports of goods for defense purposes at a higher rate than in 1961. A comparison of the expansion of imports

with the incremental real product shows that—apart from annual fluctuations apparently caused by changes in inventory—the growth in imports destined for the various sectors of the economy paralleled the growth in their output; however, because of the more rapid development of sectors with a relatively high import component, the volume of imports increased faster in previous years than the national product. At the same time, the rate of import increase was not uniform throughout 1962: after an appreciable rise in the early part of the year, there was a marked deceleration in the final months, which continued into the first months of 1963.

**Table I-1**  
**INDICATORS OF ECONOMIC DEVELOPMENT, 1958-62**

	Per cent increase or decrease (-)			
	From 1958 to 1959	From 1959 to 1960	From 1960 to 1961	From 1961 1962
<b>Resources and their uses</b>				
(at constant prices)				
Total resources	11	10	12	12
Gross national product	11	8	10	12
Private consumption	10	9	10	11
Private consumption per capita	6.3	5.6	6.8	6.3
Public consumption	4	10	10	11
Gross investment	9	3	17	11
<b>Foreign trade—goods and services</b>				
(in dollars)				
Imports	6	14	20	11
Exports	22	24	18	18
Import surplus	-5	6	20	4
<b>Population and employment</b>				
Average population	3.1	2.7	3.3	4.5
Number of employed	3.8	3.2	4.7	5.7
<b>Prices and national income</b>				
(nominal)				
Wages per normal hour of work	5	5	10	12
National product	3	3	8	7
Consumer price index	2	2	7	10
National income	13	11	18	18
National income per capita	10	8	15	13
<b>Finance</b>				
Money supply (annual average)	13	14	18	17
Bank credit to the public (annual average)	23	26	31	15

The surplus of imports over exports grew by \$ 14 million, to \$ 416 million. This increase was smaller than in the two preceding years.

Capital import expanded considerably in 1962. Besides the increased receipts from foreign currency transfers, this was due to the transfer of sums from abroad which had previously been deferred in expectation of devaluation. The inflow of capital amounted to \$ 556 million, and this made it possible to cover the import surplus while increasing the foreign currency reserves at the disposal of the economy by about \$ 110 million.<sup>1</sup> This accumulation of foreign currency, most of which was converted into local currency at the higher exchange rate, was the main source of the expanded money supply in 1962.

The economic reform did not create any special difficulties as regards the expansion of output and productive capacity. In 1962 the national product advanced, at fixed prices, by 11–12 per cent, a higher rate than in 1961 and even somewhat higher than the average for the last few years. The acceleration was due to a considerable increase in the activity of the transport and construction sectors.

Construction expanded at the rate of 15 per cent, owing both to an increase in public housing for newcomers following the larger immigration of the last two years, and to the growth in private construction and that connected with development projects. The output of the transport sector rose by 17 per cent, mostly in shipping and aviation; this was due to the extensive investments in the development of the merchant fleet in 1961 and the transition to jet aviation in the last two years.

In agriculture and industry, on the other hand, development took place at a somewhat slower pace than in 1961. Agricultural output expanded by 7 per cent as against 9 per cent the previous year. The deceleration was caused by the drought, which affected field crops, and by the more limited marketing possibilities, mainly in the poultry and vegetable branches.

In industry output rose by 14 per cent as against 16 per cent in 1961. In the trade and service branches the rate of increase continued at 12 per cent, which was similar to the average rate in the economy as a whole.

The large growth in product was partly due to the unusually high increase of 5.7 per cent in the number of employed. Product per employed person grew by about 6 per cent. The growth in employment was due to bigger immigration and natural increase on the one hand, and to the continued decrease in unemployment, on the other.

The population grew by an average of 4.5 per cent in 1962, compared with 3.3 per cent the year before. This was the highest rate of expansion since 1957; on the one hand, the downward trend in the birth rate which had marked recent years was halted, and on the other, there was a further rise in the size

<sup>1</sup> Capital import exceeded the import surplus plus the increase in foreign currency balances by \$ 40 million; this difference is attributable to "errors and omissions".

of immigration, which in the previous year as well had been at an accelerated pace. Despite this increase in population and the growth of the civilian labor force by 5.3 per cent, employment rose even a little more rapidly—by 5.7 per cent. The drop in unemployment continued, from 4.7 per cent of the total labor force in 1961 to 3.8 per cent in 1962. This decrease occurred primarily in the urban areas, where job vacancies outnumbered job applicants. On the other hand, the direction of half the immigrants to development areas, especially in the North, led to a worsening of the employment situation in such places.

The increase in the number of employed persons was expressed mainly in an addition of wage-earners, whereas the number of self-employed rose only slightly. The increase in wages was a little higher than in 1961, mainly because of the larger cost-of-living allowance increment and the excess demand for workers in most branches of the economy. Especially high increases were reported in construction and public services.

In addition to the larger number of gainfully employed, the rise in product was connected with the appreciable growth of the economy's capital stock. Nevertheless, there was some slowing down in the expansion of gross investment, which was at the rate of 10 per cent as compared with 17 per cent in 1961. There was a considerable advance in housing investment (20 per cent), while investments in quarries, electricity, waterworks, ports, land transportation, and services also increased. On the other hand, investments in agricultural farms continued to decrease, while a temporary drop took place in shipping investments. The volume of industrial investments declined by 3 per cent. Active capital in the productive sectors increased by 12 per cent, and capital per employed person by 6 per cent. The rising trend in productivity at the rate of 3–4 per cent continued in 1962.

The rapid growth in private consumption continued, amounting to 6 per cent per capita, in real terms—the same as in previous years. Total private consumption went up by 11 per cent. A marked increase of 18 per cent took place in respect of durable goods, particularly those indicative of a high standard of living, such as refrigerators, washing machines, phonographs, mixers, and vacuum cleaners. Travel abroad was up 16 per cent. An above-average increase also took place in many commodities where the rise in price was relatively small, such as clothing and fresh fruit.

Public consumption was 11 per cent higher, in real terms, compared with a growth of 10 per cent in 1961. The more rapid increase reflects the higher security expenditure.

Devaluation, by its very nature, involves a general rise in the price level of the economy—in the first stage, by rendering the import component in production and in final uses more expensive, and afterward because of the cost-of-living allowance increment stemming from the higher price of the import component. The rise in costs resulting from devaluation should have expressed itself in a

price increase of 11 per cent, but in actual fact it reached 14 per cent. This difference is some indication that demand pressure was the factor in the price increase. Moreover, the highest rate of increase did not necessarily occur in those commodities most strongly influenced by devaluation.

The greatest rise, at a rate of 20 per cent, took place in investment prices, where the import component is high and the increase in the cost of imports following devaluation was particularly large. On the other hand, private consumption prices rose by 9–10 per cent. The biggest variance between the rise in prices expected as a result of devaluation and that which occurred in fact was to be found in the prices of consumption and of dwellings.

The rise in prices over and above that attributable to the increase in import prices and the cost-of-living allowance should be considered against the background of the accelerated monetary expansion that took place in 1962. In 1961, when there was also considerable monetary growth, the price level climbed by 7 per cent. At the same time, it should be pointed out that at the end of 1962 and the beginning of 1963 a stabilizing of prices occurred.

The rapid monetary expansion, which was the source of the upward pressure on prices, was mainly due to the conversion of foreign currency. The money supply rose by 30 per cent during the year, while the annual average increase reached 17 per cent. The effect of conversion as a source of monetary expansion was accentuated after devaluation in three ways: through a rise in the volume of foreign currency reserves accumulated, through a rise in the value of foreign currency in terms of Israel pounds, and through the higher rate of conversion of current transfers and existing foreign currency deposits.

The increment to foreign currency assets in the banking system, which amounted to \$ 128 million in 1962, and the high rate of foreign currency conversion would have brought about a much greater expansion of the money supply than actually occurred were it not for counter-measures taken by the Bank of Israel and the Government. Despite the large increase of IL 120 million—or more than 50 per cent—in the amount of liquid assets at the disposal of the banking institutions, bank credit to the public rose by only 15 per cent—a considerably lower rate than in former years; this was due to the change in the liquidity regulations, which obligated the banking institutions to freeze most of the additional liquid assets. The “recognized” deficiency produced by the change in the liquidity regulations introduced in 1961 claimed its share of the incremental liquid assets. In addition, the Bank of Israel refrained from approving the full amount within the framework of the 22 per cent of directed credit exempt from liquidity—an action having the same force as raising the liquidity ratios further. This instrument, intended mainly for the qualitative direction of credit, also served the objective of quantitative limitation in 1962. Rediscounting of bills by the Bank of Israel decreased slightly, despite its larger participation in the financing of export through a new industrial export financing fund.

In order to encourage the non-conversion of foreign currency by recipients

of personal restitution, the rate of interest on Pazak and Tamam deposits held for 12 months or more was raised from 6 to 7 per cent. Arrangements were also made with the banking institutions for the introduction of linked saving schemes and non-linked schemes bearing a higher rate of interest than those formerly in existence. To those saving under the old, unlinked schemes a one-time grant was offered on the condition that they maintain their deposits for a further year after devaluation. The influence of these steps was apparent in the slowing down of the growth of the money supply.

The Government's transactions with the banking system in 1962 had a contracting monetary effect. The Government froze its revaluation differentials and also those which the Bank of Israel transferred to it, and did not use them to increase expenditure. These sums amounted to IL 227 million.<sup>1</sup> Moreover, as part of its effort to absorb and sterilize monies both within and outside the budget, such as revenue from the advance redemption of mortgages, compulsory saving, and so forth, the Government created a cash surplus which enabled it to reduce its net debt to the banking system by another IL 68 million.

However, the steps taken by the Government and the Bank of Israel to restrain monetary expansion were not on the requisite scale, being incapable of preventing the large increase in the money supply. The injection of additional purchasing power in such large proportions as in 1962 demanded more stringent measures than those actually adopted, in the field of both fiscal and monetary policy. Nevertheless, it should be remembered that the devaluation was carried out in a period of rapid accumulation of foreign currency and at a time when the public had at its disposal a large balance of foreign currency deposits—circumstances which tended to make the curbing of monetary expansion more difficult.

In addition to the restrictive steps taken in the fiscal and monetary spheres, an effort was made to restrain producers from raising their prices—by bringing pressure to bear on them to absorb the cost-of-living allowance and to increase efficiency, and by opening the door somewhat to unrestricted import. These measures delayed the rise of various prices, but in view of the prevailing excess demand they were not adequate to prevent the general price level from rising *pari passu* with the monetary expansion.

An examination of the sectorial composition of the demand surplus in 1962 points up the increased surplus of the public sector, including the Government, National Institutions, and local authorities. This growth is mainly a reflection of the altered exchange rate in the recording of foreign currency income and expenditure in the public sector accounts. In fact, devaluation revealed the demand surplus which had existed even in previous years but which had been concealed by the unrealistic rate of exchange. Nevertheless, the rise in the

<sup>1</sup> Against these differentials the Treasury paid IL 35 million on account of exchange rate guarantees given to importers before devaluation.

demand surplus should be regarded in the light of the real increase in the expenditure of the public sector in general, and that of the Government in particular—mainly in the sphere of defense and in development investments—and in the light of the considerable wage increases in the public sector. These increases in expenditure were not accompanied by a parallel growth in income from internal sources. Moreover, owing to the growing demand pressure following devaluation, it was incumbent upon the public sector to bring about a contraction in their demand surplus, which reached 19 per cent of total purchases.

In contrast to the direct growth of the demand surplus, a drop took place in the net credit given by the public sector to other sectors of the economy. This was connected with the early redemption of linked loans on the one hand, and with the contraction of the volume of credit through the development budget—excepting that for housing purposes—on the other.

The contribution of the public sector to the aggregate demand surplus, both through its own direct surplus and by financing that of other sectors, reached IL 520 million compared with IL 370 million in 1961. The means for financing this increment originated in the large growth in long-term credit from abroad.

Consumption of households expanded more rapidly than their local income, but at a rate slightly lower than the 23 per cent increase in disposable income, which includes transfer receipts from abroad. The rise in the rate of saving out of disposable income is attributable to the increased weight of personal restitution payments from abroad, since the percentage of expenditure on consumption from such transfer receipts is lower than that from local income. The investment of households in dwellings, at current prices, also went up at a slightly lower rate than disposable income, and accordingly their investments in financial assets were larger.

Investments of the private business sector expanded by 24 per cent, but in view of the large rise in investment prices, this represents only a small gain in real terms. By contrast, there was a large increase in the investments of public sector companies, mainly in the construction of immigrant homes and in the Dead Sea Works and the Israel Electric Corporation. This increment was financed by credit obtained through the development budget and by foreign loans.

Despite the alteration of the exchange rate, national saving remained positive in 1962. It amounted to one per cent of national income, if unilateral transfers from abroad are not included in the latter. Capital import financed 94 per cent of net investment. The rate of saving out of national income plus current transfers from abroad reached 6–7 per cent in 1962. The higher rate of saving in the years before devaluation was merely the result of recording capital import at the unrealistic exchange rate of IL 1.80 to the dollar. From an estimate of saving in 1961 based on the new exchange rate, it appears that no actual increase took place in the rate of saving in these two years.

By correcting distortions and setting a realistic exchange rate, devaluation

laid the foundations for healthy future development; at the same time, however, it was accompanied by rapid monetary expansion which has led to exaggerated economic activity. The consequences of the monetary growth and excessive liquidity cannot be eliminated by expanding production, since the economy is actually in a state of full employment and does not possess dormant factors of production which can be activated with the help of monetary expansion. The objectives facing the economy today are the curbing of monetary growth by fiscal and monetary measures, increased efficiency and higher productivity, selectivity of investments, the creation of political and economic conditions aimed at integration in the world economy, and the formulation of a revenue policy which will aid the expansion of production without the additional output being entirely swallowed up by increased consumption.