

CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

REAL GNP INCREASED by less than 1 percent in 1966, while per capita the figure declined somewhat. The adverse balance in the country's goods and services account was substantially lower than in the previous year, continuing the improvement which began in 1965. The labor force continued to expand, but the arrested growth of the national product did not permit an increase in average gainful employment during the year. This caused unemployment to mount sharply, after many years of steady decline and a state of full and even overemployment. The deceleration of economic activity and the more sluggish growth of the money supply did not prevent wages and prices from rising at the beginning of the year reviewed, but in the final months they showed signs of stabilizing.

After several years of vigorous economic activity, the upward trend in the national product slowed down in 1965, the increase amounting to 8 percent. In 1966 the deceleration was more pronounced, real GNP advancing by less than 1 percent as a result of factors moderating the growth of aggregate domestic demand. The weakening of demand pressure was connected partly with external factors and partly with developments within the economy, including deliberate Government policy. The levelling-off of economic activity must be viewed against the background of the boom that had lasted for several years and the conspicuous expansion of domestic investment, which reached a peak in 1964 when the figure went up by 21 percent at constant prices. This increase in capital formation led to a marked growth in Israel's productive capacity in 1965, and in some sectors—notably construction—it created surplus capacity at a time when demand was beginning to sag.

The slower expansion of demand can be attributed in part to the slower growth of the population in the last two years, and particularly the decline in immigration. Immigration affects the demand for three types of investment: immigrant housing, public institutions and services, and other investments designed to supply the additional demand generated by the newcomers. After rising by a net average of some 50,000 per annum during the years 1961-64, the volume of immigration dropped to only some 20,000 in 1965 and to about 5,000 in 1966.

Other factors moderating the growth of demand in 1965 were the decline in private restitution payments from West Germany, the sharp fall in capital transfers for investment purposes, and the slower expansion of the money

supply. As a result of these and other factors, the rising profitability trend in the economy was arrested, and in some sectors it even turned downward, while builders were left with a stock of vacant dwellings on their hands.

In the early stage the slower growth of aggregate domestic demand was reflected by a decline in capital formation—by some 2 percent in 1965. This, however, was largely offset by a big increase in public consumption and in the demand surplus of the public sector, which averted a sharp recession until 1966.

In the latter part of 1965 and the beginning of 1966, the Government's policy of economic restraint began to make itself felt. This policy was reflected by the contraction of publicly financed investments, especially in construction following the completion of several big projects, by the raising of taxes, and by the stability in long-term investment financing.

At the same time, the downtrend in private investment, particularly in the construction sector, picked up momentum in 1966, being reinforced by investors' expectations. The forces checking demand, both in the construction sector and elsewhere, had a cumulative effect, growing stronger and spreading throughout the economy. These developments were reflected by a decrease of over IL 500 million in capital formation, which in itself partially explains the sagging GNP growth rate. The growth and spread of unemployment and the slower expansion of incomes and consumption caused a further deceleration of economic activity and contributed to the reduction of GNP. In view of the rising unemployment and slackening of economic activity, the Government and the Bank of Israel adopted an expansionary policy in order to check these trends. The steps taken, however, were insufficient to turn the tide in 1966, both because of the time required for their effects to manifest themselves and because of the strength of the recessionary forces.

The economic slowdown, as already mentioned, was accompanied by a sharp fall in the import surplus. After a decrease of \$ 34 million in 1965, the balance of payments deficit on current account declined by \$ 83 million in 1966—from \$ 535 million to \$ 452 million.

The impact of the economic slowdown on the balance of payments was felt most in commodity imports. These did not increase at all in 1966, and in fact have remained virtually unchanged for the past three years. Imports of investment goods were smaller than in 1965, and imported raw materials destined for domestic consumption were also down slightly. On the other hand, raw material imports for export industries expanded. Imports of finished consumer goods, especially durables, also fell off, except for foodstuffs which showed a higher figure in 1966. Service imports expanded by approximately 6 percent during the year. The total increase in commodity and service imports came to only 2 percent.

Commodity exports advanced 17 percent—i.e. a little more rapidly than

Table I-1
INDICATORS OF ECONOMIC ACTIVITY, 1963-66
 (percentages)

	Increase or decrease (-) as against previous year			
	1963	1964	1965	1966
Resources and uses				
(at constant prices)				
Aggregate domestic demand	8.4	12.5	6.1	-1.4
Gross national product	11.5	10.3	8.2	0.6
Gross national product per capita	7.2	6.0	4.6	-1.9
Private consumption	10.4	11.5	8.2	3.2
Private consumption per capita	6.2	7.1	4.6	0.6
Public consumption	6.6	4.8	10.6	5.5
Gross investment	5.3	21.3	-1.7	-18.4
Foreign trade—goods and services				
(in dollars)				
Imports	6	18	5	2
Exports	21	8	14	15
Import surplus	-9	31	-6	-16
Population and employment				
Average population	4.0	4.1	3.4	2.6
Number of employed	3.2	5.6	3.0	-0.1
Prices and national income				
(nominal)				
Wages per normal hour of work	10	13	19	19
GNP prices	8	5	9	8
Consumer price index (annual average)	7	5	8	8
National income	22	16	20	8
National income per capita	17	11	16	5
Finance				
Money supply (annual average)	31	13	9	7
Bank credit to the public (annual average)	20	20	10	19

in 1965 and much faster than in 1964. Of the export increment of approximately \$ 70 million, nearly half was accounted for by diamonds. The acceleration of the export growth rate as compared with 1965 or 1964 must be viewed in conjunction with the rise of production costs in recent years, which began

at a point where the profitability of export was already low. Factors influencing the expansion of overseas sales were the growing demand for various Israeli goods abroad and the higher prices fetched, the shrinking of the domestic market, which had previously absorbed much of the output, and the enlarging of export subsidies. Exports of services were up 12 percent in 1966. This is a slightly lower rate than in previous years, a development attributable to the transportation item. The total increase in visible and invisible exports in 1966 reached 15 percent.

Despite the improvement in the current balance, there was some depletion of foreign exchange reserves, since capital imports declined to a greater extent than the import surplus. Unilateral transfers and investments from abroad were down \$ 50 million, while net long- and medium-term loans were nearly \$ 47 million below the 1965 figure.

Net foreign currency assets of the Israeli banking system contracted by \$ 23 million, after having expanded by some \$ 73 million in 1965—a development that had a contractionary monetary effect. The main cause of monetary expansion in 1966 was the larger volume of bank credit to the public and to the Government. In view of the tight money situation at the end of 1965 and early 1966, the standstill in GNP, and growing unemployment, the Bank of Israel introduced an expansionary monetary policy in the second half of 1966, after a long period of monetary restraint. Under the new policy the liquidity ratio was pared and rediscounts by the Bank of Israel stepped up; this resulted in a growth of some IL 290 million, or about 24 percent, in the amount of bank credit extended to the public, as compared with some 13 percent in 1965. In addition, the Government's net debt to the banking system grew by about IL 200 million, as against IL 55 million in 1965.

The big expansion of bank credit was only partly reflected by a rise in the money supply—which went up by no more than IL 110 million, or 5.7 percent, during the year—as there was a substantial increase in less liquid deposits of the public with banking institutions. This development was in line with the general tendency to prefer liquid financial assets with a high nominal yield, a tendency also reflected by the declining demand for real assets.

Despite the much more sluggish growth of demand and mounting unemployment, prices resumed their upward climb at the beginning of 1966. The consumer price index moved up approximately 8 percent during the year, most of the rise occurring in the early months. In the second half of 1966 the price advance slowed down considerably because of the recession, and the index went up by about 1.5 percent only. The price increases at the beginning of 1966 under conditions of sagging economic activity and growing unemployment were due to several factors: the time-lag in the adjustment of prices to forces operating in earlier periods, the big wage increases at the beginning of 1966 in most sectors as a result of the payment of a cost-of-living allowance

increment and new collective agreements which revised basic pay rates, and the raising of taxes, tariffs, and prices subject to a considerable degree of direct Government influence. Prices actually went up less than what the rise in costs would have warranted, a fact reflecting the subsiding of demand pressure in 1966.

The stability of the national product in 1966 was reflected in all the principal economic sectors. In agriculture, industry, and transportation and communications, output remained at virtually the same level as in 1965. The construction sector experienced a striking decline of some 20 percent, but there was a rise in the service sectors. Though the real national product held steady in the early part of 1966, the trend subsequently began to turn downward and continued in that direction until the end of the year reviewed. The construction sector played an important part in these developments. It was the first where output began to shrink with the weakening of domestic demand. Because of the considerable weight of construction in the national product and the relatively high value added of construction output, the 20 percent decline in the sector's output was one of the direct causes of the smaller GNP in 1966. Moreover, since there are numerous industries supplying construction inputs, this drop in output spread throughout a large part of the economy.

The recession dampened demand in the labor market, with the result that—in contrast to previous years—there was no increase in the average number of gainfully employed in 1966, and toward the end of the year the figure even moved downward. On the other hand, the labor force continued to expand with the growth of the population. The fact that gainful employment did not rise while an average of some 36,000 were added to the labor force during the year suggests the number of additional jobless. Since there was a net separation of gainfully employed—especially from the construction sector, but also from agriculture and industry—the growth of unemployment during the course of the year was even greater.

The much larger volume of unemployment was reflected in the number of unemployed registered at labor exchanges and in the number of jobless shown by manpower surveys,¹ as well as in the big increase in relief projects employment.

The standstill in economic activity found expression not only in the growth of unemployment but also in the product per gainfully employed, which advanced by only 1 percent in 1966 after having risen by about 5 percent in both 1964 and 1965.

The average population expanded by 2.6 percent in 1966, compared with 3.4 percent in 1965 and 4 percent in both 1963 and 1964. This decline in

¹ There is a wide disparity between these two estimates, due to differences in the method of collecting data and in defining persons seeking work. Manpower surveys showed nearly 30,000 unemployed job-seekers in years of full and even overemployment.

the growth rate is attributable to the sharp fall in immigration. Net immigration accounted for only one-eighth of the population increment in 1966, as against one-third in 1965 and roughly one-half in preceding years.

At the beginning of 1966 wages rose sharply in all sectors as a result of three factors: the payment of a cost-of-living allowance increment of nearly 9 percent, new collective wage agreements in most sectors (except the public services) which upped wages by about 8 percent, and the payment of retroactive wage increments in the public services in accordance with previous agreements. These factors, together with the substantial wage hikes of 1965, drove up monthly wages per employee by an average of 19 percent in 1966. The decline in demand and increasing unemployment began to make themselves felt on wages only in the second half of 1966 and the beginning of 1967. In July 1966 no cost-of-living allowance increment was paid, and in several sectors wage increases were actually smaller than what the existing wage agreements called for.

The real decrease of about 20 percent in fixed nondwelling investment in the year reviewed was reflected by a slower expansion of the economy's gross capital stock—7 percent as compared with 10 percent in 1965 and an average of some 11 percent per annum in previous years. The contraction of investment affected all economic sectors. That in residential building declined by some 20 percent. On the other hand, inventories were approximately 30 percent larger, both the Government and private business showing higher figures than in 1965.

The drop in the private consumption growth rate was even steeper than in 1965. Real consumption per capita rose by 0.5 percent only, compared with 4-5 percent in 1965 and over 6 percent in previous years. The slower growth of total consumption affected all major components except food. Purchases of durable consumer goods were down by a substantial 17 percent, following the rapid rise of previous years.

The slow expansion of private consumption nevertheless exceeded the increase in disposable private income. Consequently, the net saving rate of the private sector fell from 11.4 percent in 1965 to 7.6 percent in the year reviewed. Total private saving was likewise smaller than in 1965. This decrease must be attributed to the rigidity of consumption as regards a downward movement, there being a time-lag in the adjustment of the consumption level to a decline in real incomes. Another factor was the reduced income of the self-employed and business enterprises while that of wage earners rose, for the latter are much poorer savers. In a year when total saving decreased, the much larger volume of financial assets held by households was a striking phenomenon. The decrease in saving was chiefly reflected by smaller purchases of real assets. The accumulation of financial assets was particularly marked as regards highly liquid nonlinked assets with a high nominal interest yield, such as promissory notes

traded through banks, the Government Short-Term Loan, and time deposits in Israeli currency.

The economic slowdown affected not only the saving of the private sector but also that of the public sector, which dissaved considerably more in the year reviewed—IL 310 million as against IL 155 million in 1965. This, together with the smaller saving of the private sector, depressed the national saving rate sharply, from 5.5 percent in 1965 to 1.3 percent.

The budgets of the Government and local authorities for fiscal 1966/67, which reflected the policy of economic moderation, provided for higher taxes in order to avert the need for inflationary financing. Indirect levies were revised on a long list of products, income tax was raised, and the freeze on local authority tax rates, in force since 1962, was lifted. However, the recession caused revenue from taxes and other compulsory payments to lag considerably behind the estimates, and it increased more slowly than in previous years. On the other hand, expenditure was almost as budgeted. Total current outlays were up by 20 percent, and those on capital account by 8 percent, the latter rise mainly reflecting the accumulation of stocks in Government warehouses.

These developments caused the demand surplus of the public sector to increase by some IL 210 million—to IL 875 million as compared with approximately IL 670 million in 1965 and IL 460 million in 1964. A contrary trend marked the net credit outflow from the public sector to the rest of the economy: the figure fell by IL 250 million, mainly owing to the stability in long-term lending on the one hand and the much greater sum raised from the public in the form of loans, especially short-term, on the other.

The policy of economic restraint must be viewed against the backdrop of the buoyant activity of previous years, reflected by overemployment and labor shortages in most parts of the country, wage and price increases, as well as the widening of the balance of payments deficit on current account, which topped the \$ 570 million-mark in 1964. The financing of the steadily growing deficit was made possible by a rapid rise in capital imports. However, when the latter levelled off in 1965 and declined in 1966, while the proportion of loans rose and that of unilateral transfers and investments decreased, it became obvious that a change of trend was imperative.

The most favorable results of the economic slowdown have been the sharp decrease in the import surplus and the relative stabilization of prices as from the middle of 1966. Workers have also revealed more restraint in their wage claims. But as the recession wore on it became necessary to mitigate this trend, since the national product and employment ceased to grow and even began to decline. The downturn started in the construction sector, the restriction of whose activity was one of the policy objectives. Thus, in order to prevent the deepening of the recession, the Government and the Bank of Israel took steps in the latter part of 1966 to stimulate investment,

employment, and exports. These measures have still not left their imprint on economic activity, neither in 1966 nor in the early months of 1967, but they have considerably increased the liquidity of the economy and arrested the declining trends. However, there is a danger that the lagged effect of these measures—especially if further extensive steps are taken in this direction within the framework of the planned deficit budgets for 1967/68 or in some other form—will restore the inflationary conditions of former years.

The continued growth of the economy, with full exploitation of the available productive factors, can no longer be based primarily on an increase in capital imports, but hinges on the expansion of exports. The recession has led to a considerable improvement in the balance of payments by accelerating exports while imports have held steady, but it has not produced a satisfactory structural change in employment, production, and investment, nor has it diverted idle productive factors to export branches to a sufficient degree. The central problem of the economy is thus the establishment of new export industries and the expansion of existing ones in order to absorb the unemployed and additional productive factors. Further encouragement was in fact given to exporters in the latter part of 1966 and the beginning of 1967, but the revamping of the economic structure by attracting large-scale investments to the export branches is, in the final analysis, conditional on the existence of an adequate profitability level in these branches.