CHAPTER II

RESOURCES, USES, AND INCOMES

1. Main Developments

The expansion of economic activity, which had prevailed for many years, came to a halt in 1966. Real gross national product remained on much the same level as in 1965, while aggregate domestic demand at constant prices edged down by 1 to 2 percent. As a result of these two developments, imports held steady. Since exports continued upward, even at a somewhat faster rate than in 1965, the import surplus shrank by 16 to 17 percent and amounted to 9.5 percent of the resources available to the economy for domestic use, as compared with 12 percent in 1965.

This turning-point in Israel's economic development can be ascribed to the slower growth of aggregate domestic demand, which began to manifest itself in 1965 and turned into an actual decline in the second half of 1966. The weakening of demand was due partly to developments in previous years, such as the high level of investment (especially in housing) during the 1960–65 period, which reached a peak in 1964, and the rapid rise in wages during the past two years which resulted in higher taxation, increased production costs, and lower profitability. Demand was also affected by external factors, such as the contraction of immigration and of transfers from abroad. Added to these were the influence of Government policy on capital formation, the smaller expansionary effect of public sector activities on the level of demand, and the decelerated rate of monetary expansion.

Government operations, the level of capital formation, and exports, which largely depend upon developments in foreign markets, exert a very considerable influence on economic activity. They are directly responsible for about half of aggregate domestic demand, while indirectly they determine the size of incomes and thus the volume of private consumption. Since the demand for imports is closely connected with the growth of the national product, the above-mentioned factors can, in the final analysis, determine both the size of the national product and the scale of imports. These components of demand, which increased at rates ranging from 9 to 13 percent per annum during the 1961–64 period, went up by only 5 percent in 1965 and declined by 4.4 percent in 1966.

The rapid increase in capital formation and public consumption in 1961 and 1962 and the exceptionally marked rise in capital formation in 1964

resulted in a vigorous rate of economic activity during that period. It was also fed by the sharp rise in restitution payments from West Germany and in transfers and investments from abroad. These sources accentuated demand, both for current consumption and for investment, particularly in housing. Expectations that the boom would continue apparently led to overinvestment during that period, resulting in a heavy concentration of productive factors, capital, and labor in the building and allied industries. With the sharp drop in immigration in 1965, and particularly in 1966, and the cessation of the rapid growth (and even decline) of private transfers from abroad since 1964, which slowed down the expansion of demand, a number of industries—above all residential construction—were left with surplus production capacity and an accumulated stock of finished products on their hands.

This situation, which was accompanied by a rise in production costs, dampened profitability and deterred investors. This in turn generated expectations of a recession and accentuated the downtrend in investment demand.

To these factors should be added the influence of monetary expansion, which was particularly rapid in 1961–63 and contributed to the growth of demand; since 1964, however, the growth rate has declined steadily.

In view of the conspicuous rise in the balance of payments deficit on current account, the envisaged reduction of capital imports and immigration, the surplus of housing, and the pressure in the labor market which drove up wages to a marked extent, the Government decided at the end of 1964 to moderate the rate of economic activity. However, in 1965 it caused a further substantial increase in consumption and investment demand, and only toward 1966, after a new Government had been formed, were plans drawn up to curb such demand. But the lag in tax collections due to the deceleration of economic activity prompted the Government to nevertheless expand aggregate demand, although to a much smaller extent than in 1965. On the other hand, the public sector's investment in fixed assets did not increase at all, while its extensive measures to raise loans from the public undoubtedly had a contractionary effect on investments. The rapid advance of prices by 8 percent in each of the last two years also helped to reduce liquidity and demand. At the beginning of 1965 some of the price increases probably still reflected the existence of excess demand; however, in the second half of that year and in early 1966 prices went up as a result of mounting costs, and even these rises might not have occurred had producers foreseen the actual extent to which demand would decline.

The rise in costs was mainly due to higher wage rates. In 1965 and 1966 wages went up very steeply, and since the growth of demand slowed down, profitability fell off, reinforcing the declining trend in investment demand. Thus the year 1966 saw a radical change in the distribution of national income

—a substantial increase in the share of wage earnings and a decrease in that of other incomes, which declined even in absolute terms.

As the propensity to consume is greater among employees than among self-employed or employers, the above change increased the average propensity to consume, and correspondingly depressed the rate of private saving. The greater propensity to consume can also be ascribed to the rigidity marking the consumption of self-employed and unemployed relative to their current income.

The improvement in the balance of payments in 1966 as a result of the contraction of demand was achieved at the cost of a possible increase of nearly 8 percent in GNP due to the existence of idle productive factors.

2. The National Product

The national product failed to advance in 1966, after a prolonged steady growth. During the years 1955 to 1962 real GNP went up by an average of 9 percent per annum, and in 1961–64 the rate even reached approximately 11 percent. The rise slowed down in 1965, but still came to about 8 percent. In 1966, however, it amounted to less than 1 percent. This growth pattern was influenced to some extent by the disparate rates of population growth during various periods, and especially by the size of immigration. But the arresting of the upward trend in economic activity was also reflected in the national product per capita. During the years 1955–62 real GNP per capita moved up by an average of 4.9 percent per annum, and between 1961 and 1964 by even 6.7 percent per annum. In 1965 the rate slowed down to 4.6 percent, while in 1966 real GNP per capita decreased by 2.0 percent, to stand at IL 4,512 at current prices.

From the statistical data one cannot determine when exactly the growth trend turned downward. It is possible that in the middle of 1965 it declined or levelled off for a short period, and that in the second half of that year economic activity began to pick up again (see Diagram II–1).

In the early months of 1966 the product apparently continued to edge up slowly, but in the second half of the year it began to lose ground, the decline sharpening in the third quarter.

This GNP trend reflects a steady drop in investment, which apparently was particularly steep during the second quarter of 1966, as well as a decline in private consumption, which was most rapid during the last quarter of the year. On the other hand, the level of public consumption remained stable during the first half of the year reviewed, declined in the third quarter, and rose again toward the end of the year.

A contraction, or much slower expansion, of output characterized all the major economic sectors. Industrial output reached a peak in February 1966, but between that month and the end of December the level fell off by 11 percent. Construction activity was about 23 percent smaller at the end of 1966

Table II-1

RESOURCES AND USES, 1965–66

	IL million at current prices		Percent increase or decrease (–)		
	1965	1966	Quantity[a]	Price	Value
Private consumption					
Households	6,514	7,216	3.7	6.8	10.8
Nonprofit institutions	671	784	–1.8	18.9	16.8
Total	7,185	8,000	3.2	7.8	11.3
Public consumption					
Government	1,716	2,058	7.2	11.8	19.9
Local authorities	358	429	5.8	13.1	19.6
National Institutions	111	98	–22.8	14.8	–11.4
Total	2,185	2,585	5.5	12.1	18.3
Gross investment					
Housing	974	776	–20.3	0.0	–20.3
Other construction	964	789	–19.0	1.0	–18.2
Equipment	1,032	843	–20.3	2.1	–18.3
Inventories	86	110	30.3	–1.8	27.9
Total	3,056	2,518	–18.4	1.0	–17.6
Total domestic demand	12,426	13,103	–1.7	7.2	5.4
Imports	3,674	3,740	–0.9	2.7	1.8
Exports	2,181	2,500	9.5	4.7	14.6
Import surplus	1,495	1,240	–16.2	–1.1	–17.1
Gross national product at market prices	10,831	11,863	0.3	8.2	8.5

NOTE: This table is based on data of the Central Bureau of Statistics, with the following differences:

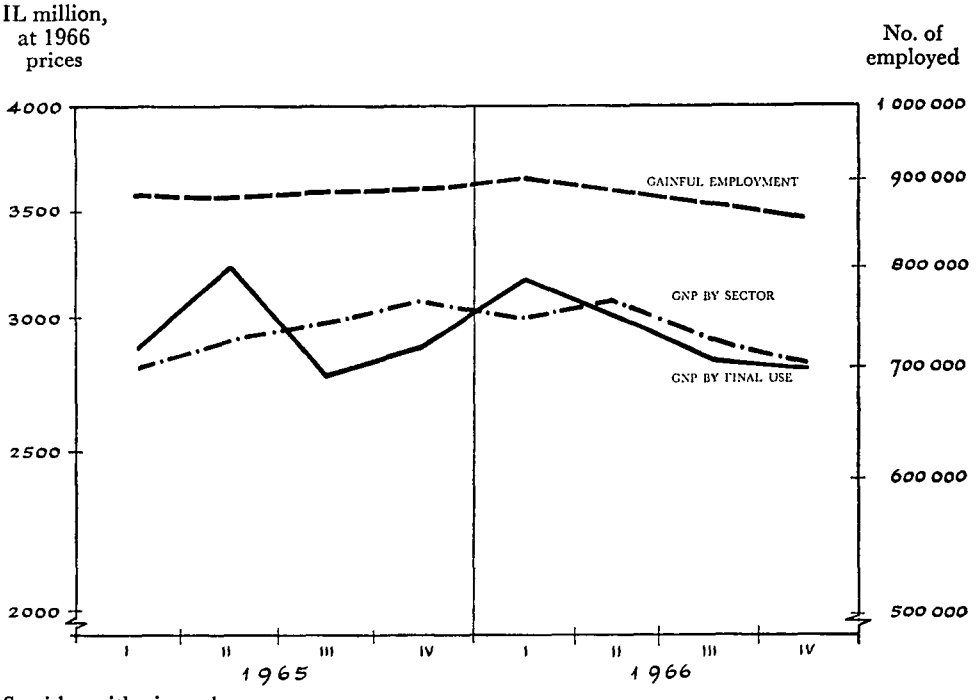
Imports are cited exclusive of import taxes, but inclusive of factor payments to the rest of the world. Exports include factor payments to the rest of the world but exclude export subsidies. Import taxes totalled IL 489 million in 1965 and IL 484 million in 1966, export subsidies IL 43 million and IL 90 million, and factor payments IL 109 million and IL 119 million.

The Central Bureau of Statistics cites net factor payments to the rest of the world separately, deducting them from GNP. If import taxes net of export subsidies are deducted from the value of the product as shown in this table, we obtain the value of the product as defined by the CBS. A detailed explanation of the conceptual differences and the adjustment of the data is found in the appendix to the 1965 and 1966 Annual Reports (in Hebrew only).

[a] Calculated at 1965 prices.

Diagram II-1

THE NATIONAL PRODUCT, QUARTERLY, ACCORDING TO VARIOUS INDICATORS, 1965–66



Semi-logarithmic scale.

than at the beginning of the year, continuing the downtrend that began in 1965.

In transportation and communications output apparently moved upward throughout most of the year, a decline setting in only toward the end. Agricultural output increased during the first half of the year, fell off in the third quarter, and rose again in the last quarter.

Fluctuations in the national product in the course of the year were undoubtedly influenced by seasonal factors, particularly in the case of agriculture and transportation and communications. Nevertheless, the product declined by an average of 18 percent in the construction sector[1] and by about 2 percent in agriculture, while remaining at approximately the 1965 level in industry and in transportation and communications. Only in the services—especially the public sector, where the scope of operations does not depend on business considerations, as is the case with most other sectors—was there further growth during the year reviewed.

[1] Investment in construction declined by 20 percent, but outlays not regarded as investment (defense construction and maintenance and repair work) apparently remained unchanged; hence the decrease in the sector's product came to an estimated 18 percent.

The first branch to show a decline was residential construction. Signs of a slump, reflected in the area of buildings started, were initially felt at the end of 1964. But because of the large number of dwellings under construction, the level of activity held steady throughout most of 1965, declining steeply only toward the end of the year. As the import component of residential construction is very low (10 to 20 percent), the slackening of activity had a relatively sharp impact on GNP, whereas its influence on imports was comparatively limited. Since the construction sector accounted for 7.2 percent of the national product in 1965, the decline of some 18 percent in its activities in 1966 was tantamount to a direct decrease of 1.2 percent in the national product. Moreover, it resulted in smaller purchases of building materials, transportation services, etc. from the rest of the economy. There are many branches supplying the construction sector, and for some of them it is a major customer. As may be seen from Table II–2, developments in the construction sector probably explain the entire decline in the output of glass, ceramics, cement and cement products, basic metals, machinery, and electrical equipment.[1] The figures are of course very rough and primarily indicate the ramified repercussions which fluctuations in construction activity are likely to have on aggregate production, and especially on the output of those branches working largely for the construction industry. If both the subsidiary and direct effects are taken into account, we find that a decline in construction activity may cause a substantial reduction in GNP.

Despite the close connection between the construction and a number of other industries, the contraction of activity in the former did not have an immediate effect on the others, which as already mentioned, began to feel the results mainly in 1966. This was due to the fact that the decline in construction did not affect all stages of work at once, but began in building starts, which mainly affect the mining and quarrying industry and nonmetallic minerals (quarry products and cement). Only later in the year, when the slump spread to the final stages of building, did it begin to leave its impress on other industries, such as metal, wood, and household equipment.

The recessionary forces operating in 1966 largely emanated from the construction sector. But other, largely unrelated, branches, such as agriculture, passenger transport, and industries manufacturing durable consumer goods—also experienced a deceleration or drop in activity. As regards agriculture, this was due to weather conditions and other factors reducing productivity; in transportation and communications the expansion of production capacity slowed down, and in addition, there was a smaller increase in tourism. Purchases of durable goods were apparently affected also by the smaller volume of transfers from abroad in the last two years. Nevertheless,

[1] In these branches the decline was smaller than what the building slump alone would have caused, owing to larger sales to other customers.

Table II–2

INFLUENCE OF CONSTRUCTION ACTIVITY ON THE OUTPUT OF VARIOUS BRANCHES

(percentages)

	Sales to the construction sector in 1965[a]	Effect of the sector's purchases on output of the branch[b]	Change in output of the branch
Glass, ceramics, cement and cement products	83	–14.9	–7.6
Basic metals and pipes	50	–9.0	–7.0
Mining and quarrying	30	–5.4	2.6
Wood and carpentry	33	–6.0	1.8
Metal products	21	–3.8	–4.6
Land transport	17	–3.1	–5.0
Machinery and electrical equipment	16	–2.8	–1.7

[a] Seven branches (of the 30 in the economy), whose sales to the construction sector accounted for more than 15 percent of their output in 1964, have been included in the table. The percentages were obtained from the total input coefficients of the construction sector, inclusive of purchases between the branches concerned.

[b] Based on changes in the output of the construction sector, which declined by 18 percent in 1966. The data here cited are 2 to 3 percent lower than the figures on investment in construction, as construction activities not regarded as investment have been included in the calculation.

it is clear that the forces slowing down the growth of the economy originated in the construction sector, especially if, in addition to the direct and indirect impact of the reduction of building activity on allied industries, account is taken of the "multiplier" effect of such a development. This added effect stemmed from the decline of incomes in the allied industries, especially in respect of workers who lost their jobs. The drop in incomes tended to reduce domestic demand, causing the recession to spread to other branches.

The lagged effect of sagging demand in various spheres of economic activity may explain the continued downtrend in the product even after the Government reverted to a policy of encouraging the growth of production. The policy measures, which included increased Government spending on capital projects, deficit financing of the budget, and the easing of credit restrictions, were implemented mainly toward the end of 1966 and the beginning of 1967, and consequently were incapable of reversing the declining GNP trend during the year reviewed. Under the prevailing conditions, they apparently had only a limited immediate effect, and their main results will probably become apparent later on.

3. Causes of the Turn in Israel's Economy

(a) *Supply and productive factors*

The sharp downturn in the national product growth rate apparently cannot be ascribed to any quantitative constraints in the supply of productive factors. Although the working-age population increased more slowly than in 1965, the labor force participation rate went up more rapidly (3.9 as against 3.2 percent).[1] Since employment remained at the 1965 level, the number of jobless increased to the same extent as the labor force. Thus the availability of labor was not a factor checking the expansion of output.

Nor was the stock of productive capital assets a restrictive factor. While the increment was relatively smaller than in previous years, it still totalled nearly 7 percent. True, not all of the incremental capital stock can be exploited during the same year, but it should be remembered that part of the increment of 1965 could be exploited only in 1966.[2] It should also be borne in mind that it was possible to increase the rate of capital utilization and productivity, whereas in actual fact productivity declined somewhat (see Table II–7).

These developments suggest that from the supply aspect there was no impediment to a greater growth of GNP. The change of trend must therefore be ascribed to the slower rise in aggregate demand, after a long period of excess demand—especially during the years 1961–64—which led to the widening of the balance of payments deficit on current account and pushed up prices. The growth of GNP during this period was determined by the existing production system, as limited by the available productive factors, and was accompanied by full employment and a steady rise in productivity, prices, and wages.

(b) *Changes in demand*

The first signs of the arresting of the upward trend in demand appeared in 1965, when domestic resource uses increased by about 6 percent as compared with approximately 15 percent per annum during the period 1960–64. The deceleration in 1965 was reflected by a decline of 8 percent in the import surplus, which had expanded by some 30 percent in 1964 (see Table II–3), whereas GNP was affected to only a limited degree. In 1966 domestic demand declined by 1.4 percent, the import surplus shrank by 17 percent, and the growth of the national product slowed down from 8 percent in 1965 to a mere 0.5 percent approximately.

The slackening of demand, like the previous upsurge, was partly self-accent-

[1] The higher participation rate presumably reflects the worsening of employment conditions as well.

[2] The stock of fixed productive assets was 9.6 percent larger at the beginning of 1966 than at the beginning of the previous year.

uated; in other words, after the first manifestations appeared in various parts of the economy, the trend was reinforced by expectations that it would continue, which in turn further deterred purchases. The reasons for this development, which was quite pronounced in 1966, must be sought in exogenous factors, the lagged effect of developments in previous years, and changes in fiscal and monetary policy and in price trends.

Israel's economy is more susceptible than others to the influence of external factors, owing to its special structure: the existence of immigration and large-scale capital imports relative to available resources. To these must be added the important role played by the public sector: its decisions and economic behavior are not governed solely by commercial considerations, and hence it too may be regarded as an "exogenous" factor influencing economic activity out of political motives.[1]

The effects of previous years' developments on the deceleration of current economic activity are very ramified. Two have already been referred to above: the impact of fluctuations in construction activity on various industries and the decisions of the Government and other public institutions concerning the implementation of development and employment projects. A further significant factor is the lagged effect of changes in incomes on consumption. The level of consumption in 1966 presumably was determined not only by the level of incomes in that year but also by their development in the past, especially during the preceding two to three years. Accordingly, the slower growth of incomes in 1966 may be expected to affect consumption also in 1967 and 1968.

Investment is one sphere of economic activity that is marked by considerable time-lags between the different stages—the original decision, planning, the launching of the project, and its completion. Hence the reasons for the stability of investment in 1965 and its contraction in 1966 must be sought in developments that occurred earlier, and particularly in the exceptionally high level of investment during the years 1962–64, which apparently resulted in surplus production capacity, excess supply of housing, and lower profitability because of steep wage hikes.

The decline in investment in 1966 was one of the major causes of the reduction of the import surplus during the year. The import component of investment amounts to one-third, and the smaller volume of investment was responsible for much of the decrease in imports in 1966 (see Ch. III, "The Balance of Payments"). The remaining two-thirds came from domestic pro-

[1] This designation of factors as "exogenous" does not imply that they are not seriously affected by internal developments. This applies especially to public sector operations, and to a certain extent also to capital imports and immigration. However, it seems that they are influenced by internal factors to a smaller degree than are private consumption or imports, or that such influence is neither direct nor automatic.

Table II-3

RESOURCES, USES, AND NATIONAL INCOME, 1960–66

(IL million)

	1960	1961	1962	1963	1964	1965	1966	Percent increase or decrease (–) as against previous year					
								1961	1962	1963	1964	1965	1966
At current prices													
Private consumption	3,101	3,654	4,416	5,255	6,122	7,185	8,000	17.8	20.9	19.0	16.5	17.4	11.3
Public consumption	829	1,030	1,384	1,568	1,755	2,185	2,585	24.2	34.4	13.3	11.9	24.5	18.3
Gross investment	1,208	1,555	2,102	2,348[a]	2,979	3,056	2,518	28.7	35.2	11.7	26.9	2.6	–17.6
Total domestic demand	5,138	6,239	7,902	9,171	10,856	12,426	13,103	21.4	26.7	16.1	18.4	14.5	5.4
Imports	1,206	1,504	2,699	2,979	3,521	3,674	3,740	12.5	79.5	10.4	18.2	4.3	1.8
Exports	633	744	1,383	1,763	1,917	2,181	2,500	17.5	85.9	27.5	8.7	13.8	14.6
Import surplus	573	760	1,316	1,216	1,604	1,493	1,240	32.6	73.2	–7.6	31.9	–6.9	–16.9
Gross national product	4,565	5,479	6,586	7,955	9,252	10,933	11,863	20.0	20.2	20.8	16.3	18.2	8.5
Total taxes (net)[b]	563	752	915	1,041	1,218	1,347	1,451	33.6	21.7	13.8	17.0	10.6	7.7

Depreciation	364	438	631	765	878	1,022	1,144	20.3	44.1	21.2	14.8	16.4	11.9
National income = net national product at factor prices	3,638	4,289	5,040	6,149	7,156	8,564	9,268	17.9	17.5	22.0	16.4	19.7	8.2
						At 1966 prices[c]							
Private consumption	4,737	5,239	5,821	6,426	7,165	7,752	8,000	10.6	11.1	10.4	11.5	8.2	3.2
Public consumption	1,526	1,785	1,983	2,114	2,216	2,451	2,585	17.0	11.1	6.6	4.8	10.6	5.5
Gross investment	1,853	2,187	2,458	2,588	3,139	3,086	2,518	18.0	12.4	5.3	21.3	–1.7	–18.4
Total domestic demand	8,116	9,211	10,262	11,128	12,520	13,289	13,103	13.5	11.5	8.4	12.5	6.1	–1.4
Imports	2,126	2,651	3,083	3,219	3,718	3,774	3,740	24.7	16.3	4.4	15.5	1.5	–0.9
Exports	1,223	1,429	1,683	1,976	2,100	2,283	2,500	16.8	17.8	17.4	6.3	8.7	9.5
Import surplus	903	1,222	1,400	1,243	1,618	1,491	1,240	35.3	14.6	–11.2	30.2	–7.8	–16.8
Gross national product	7,213	7,989	8,862	9,885	10,902	11,798	11,863	10.8	10.9	11.5	10.3	8.2	0.6

[a] After the Hebrew edition of the Annual Report went to press, gross investment in 1963 at current prices was revised downward by IL 20 million. This reduces the growth rate for that year at constant prices to 4.4 percent, while increasing the rate for 1964 to 22.4 percent. In addition, it reduces GNP by about 0.25 percent in 1963 and increases it to the same extent in 1964; it also necessitates an adjustment in the productivity calculations.

[b] Total indirect taxes on domestic production and imports, less subsidies on domestic production and exports.

[c] The consumption and investment series have been calculated according to the annual rates of change at constant prices, with the data for each year being computed at the prices of the previous year. The import surplus and GNP figures cited in this table were obtained on the basis of 1966 prices, and differ from the figures based on component weights in the preceding year. The divergences are very small, except for the years 1961, 1963, and 1964, when the change in the import surplus, according to the series based on 1966 prices, was 1.2 percent smaller than according to the calculation based on the previous year's weights. The differences between this table and Table II–1 are due to the same reason.

SOURCE: Central Bureau of Statistics (see note to Table II–1).

duction, mainly construction.[1] This explains why the weakening of demand was felt most in the construction sector, as already described.

The Government has been responsible for a major share of investment activity—over half in the 1962–64 period. The reference is to direct investments in public development projects through public sector companies, and to some extent also through nonprofit institutions, as well as indirectly by the granting of credit to private investors.

Direct Government investment did not expand in 1966, while that of public sector companies and of nonprofit institutions even declined. The gross amount of investment finance supplied by the public sector did not increase in 1966, after having risen considerably in 1965. As the Government mobilized a much larger sum from the public in the form of loans during the year reviewed, the net volume of Government credit to the economy decreased, and this apparently had a contractionary effect on domestic investment.

The reduction of investment, especially in buildings, accorded with the Government's policy as formulated at the end of 1964 but actually reflected in the acitivities of the Government and public institutions only in 1966. Thus, no new development projects were launched, and the execution of other projects or various stages thereof was postponed, despite the fact that in several cases work carried out on a large scale in 1964 and 1965 was nearing completion (e.g. Ashdod Port and the Dead Sea Works).

The policy of moderating investment activity can be mainly attributed to the fact that the Government concluded that the worsening of the country's balance of payments position—which was further aggravated in 1964—was an inevitable outcome of the high level of economic activity. The latter led on the one hand to a rapid rise in incomes, followed by competitive demand from the domestic market for export goods and by increased imports, and on the other hand to higher production costs and the diminished ability of Israeli products to compete abroad. These trends did not accord with the forecast of capital imports in the coming years.

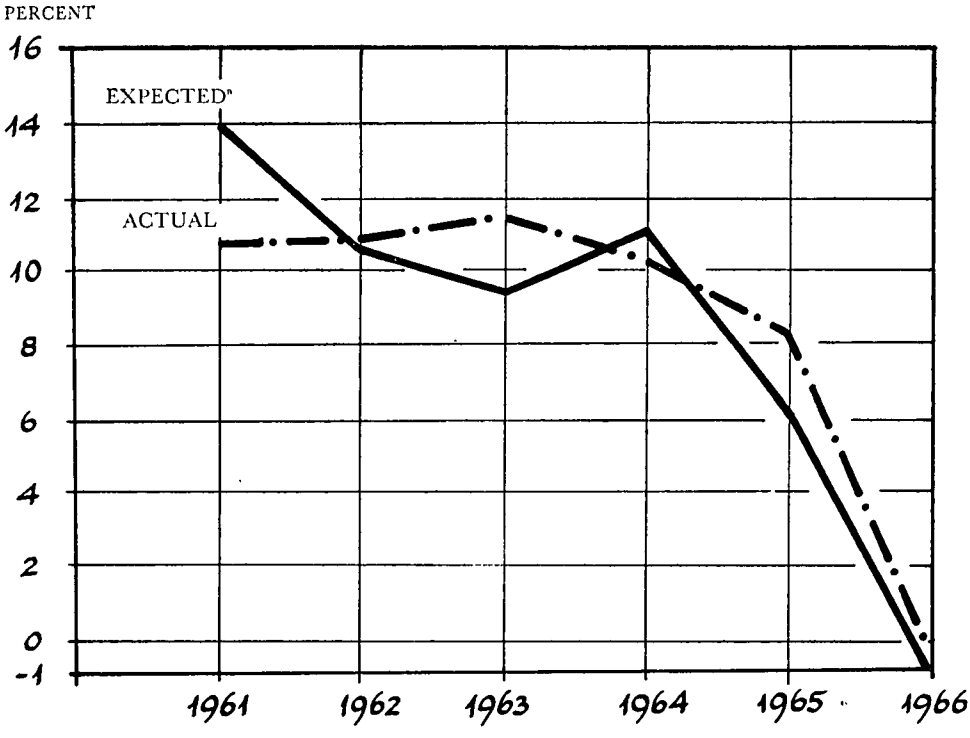
The policy of curtailing investment also accorded with the situation in the residential construction market, where a large stock of empty dwellings had accumulated. In view of the smaller scale of immigration, the Government saw no useful purpose in continuing with large-scale building activities. The steps taken by the Government in 1965 and early 1966, together with its campaign to explain the reasons for the policy of economic restraint, apparently affected entrepreneurs' expectations, prompting them to reduce their investments.

Another sphere where Government activities had a moderating, even if not a contractionary, effect on the growth of domestic demand was that of

[1] See Tables V–1 and V–4 below.

Diagram II–2

ANNUAL REAL GROWTH OF GNP, 1961–66



[a] As determined by investment, public consumption, and export.

current consumption. Real public consumption expanded by only 5.5 percent in 1966, about half as fast as in 1965. Even after taking into account changes in the growth of tax revenue, it emerges that the public sector was responsible for checking the rise of aggregate consumption demand.[1]

The only factor that did not tend to arrest the growth of aggregate demand or to reduce it was export,[2] which expanded at a somewhat faster rate than in 1965.

In 1966 these primary determinants—investment, public consumption,

[1] The public sector's demand surplus on current account increased in 1966 by approximately 6 percent at constant prices, after having risen by some 20 percent the year before. The demand surplus referred to here is defined somewhat differently from that in Chapter VII, "Public Sector Operations".

[2] Exports may be regarded as an exogenous, autonomous factor if their volume is determined by marketing possibilities abroad at the effective exchange rate fixed by the Government. This assumption, of course, is not entirely accurate since the growth of exports is also affected by changes in the factor shares of income (especially wages) and by the competition of domestic demand, which are both endogenous factors. For a detailed analysis of the factors that influenced exports, see Chapter III, "The Balance of Payments".

and export—together totalled approximately IL 300 million less than in the preceding year, but even so the national product did not decrease. Presumably this must be ascribed to two main causes. First, part of the decline in demand was felt in imports, both of finished goods for investment and consumption purposes, and of raw materials for production for the local market. Second, the average propensity to consume from current income apparently increased in 1966—a development explained by the lagged effect of the growth of incomes in previous years and the changed distribution of national income. The share of the self-employed and employers—who tend to be better than average savers —in disposable income fell in 1966. Moreover, several population groups apparently showed a higher propensity to consume. This is particularly true of two groups—workers losing their jobs, who of course could not cut their consumption to the same extent as their income, and nonemployees, who did not adjust their consumption level to the decline in their income.[1]

However, these changes in consumption could not neutralize the dominant effect of the factors slowing down the GNP growth rate in the last two years, and especially in 1966. This may be seen in Diagram II–2 and in the statistical appendix (in Hebrew only), which show the quantitative calculation of the influence of the exogenous factors on GNP growth during the period 1961–66.

(c) *Prices*

During the last two years the price level rose by some 8 percent per annum. Apart from the accelerated advance at the beginning of 1965, which was still due partly to demand pressure and the relaxation of administrative restraints, the price increases were caused by factors on the costs side.

Wages rose steeply in most economic sectors during this period. There was a particularly big increase in public service payrolls at the beginning of 1966, following the job reclassification of 1965 and the resulting revision of salary scales. In view of the Government's policy of balancing the budget, this necessitated the raising of municipal and Government tax rates at the beginning of the 1966/67 financial year. This was one of the factors pushing up prices.

The rise in the pay of public servants was accompanied by big wage hikes in all other sectors. Claims for such increases were put forward mainly during the period preceding the economic slowdown, when boom conditions and overemployment still prevailed. Acceptance of these claims also occurred before the recession became a reality, but their implementation took place when demand had fallen substantially. This presumably is the main reason why

[1] The consumption of many nonemployees displays a downward rigidity, made possible in part by their drawing on past savings. On the other hand, the propensity to consume apparently declined among gainfully employed wage and salary earners. This stemmed partly from the payment in 1966 of nonrecurrent retroactive wage adjustments, the propensity to save from which is higher than in the case of current pay.

in a year marked by a decline in demand and economic activity wages and prices went up sharply. At any rate, this development depressed demand still further, as profitability decreased and affected investment activity accordingly. These changes in demand made themselves felt on prices only in the second half of 1966, when the price rise virtually tapered off.

(d) *Influence of monetary developments*

The slower growth of demand since 1964 may also be largely ascribed to the influence of monetary expansion, which in the main has displayed a similar trend. In 1962 and 1963 monetary expansion was rapid, the money supply soaring by nearly 30 percent per annum and total financial assets of the public by more than 20 percent. This was due primarily to the accumulation of foreign exchange reserves and the larger volume of bank credit. In 1964 foreign currency accumulation fell off considerably owing to the widening of the deficit on goods and services account, and the expansion of means of payment slowed down. In 1966 too, monetary expansion was relatively moderate. This development led to the gradual disappearance of the surplus liquidity existing in the economy, and during the course of 1965 (especially at the end of the year) the surplus gave way to a tight money situation. The last quarter of 1965 and the first quarter of 1966 saw the usual contraction of the money supply. The slackening of demand was apparently felt quite strongly during these six months, and as a result stocks were accumulated. The difficulty of financing them during this period was another factor tending to reduce output.

Since the middle of 1966 the Bank of Israel has taken a number of steps to ease credit conditions and increase the liquidity of the economy. However, as foreign exchange reserves continued downward throughout the year, these measures were not reflected by a significant rise in the money supply in 1966. The growth amounted to less than 6 percent between the beginning and end of the year and to 7.3 percent on an annual average. This slow expansion under conditions of cost inflation and the absence of surplus liquidity was insufficient to stimulate the growth of demand. The small percentage rise of the money supply can apparently be ascribed also to the tendency of the public to prefer highly liquid financial assets other than money, which manifested itself in 1966. Total financial assets expanded by some 12 percent, about the same as in 1965. However, the growing preference for financial assets bearing a fixed rate of interest, such as promissory notes bought through banks (bill brokerage), the Government Short-Term Loan, and time deposits (the return on which was raised during the year), was mainly due to the recession, which generated expectations of stable prices and smaller profits on investments in fixed assets.

4. Some Consequences of the Slower Growth of Demand

(a) *Unemployment, wages, and factor incomes*

The decline in demand and the national product was reflected by a contraction of employment and a rapid rise in the number of jobless. Between the beginning and the end of 1966, about 6 percent of the labor force was added to the number of persons seeking work. The changes in the employment situation began to show up sharply only as from the second quarter of the year. Consequently, they were not taken into account in the national wage policy, which was adopted at the beginning of 1966 when the country was still enjoying boom conditions and big pay increases had been awarded or promised in the public services. Only as the year progressed and the employment situation rapidly deteriorated did its effects began to be felt on wages, there being a certain disparity between the wage increments called for in the cost-of-living allowance agreement and in the agreements to raise basic pay rates in various economic sectors on the one hand, and the actual increases granted on the other (see Chapter X, "Wages"). Despite these developments, the year reviewed was marked by the most rapid rise in wages per employee for some time, the level going up 19 percent.[1] At the same time, there was a decline in the income of nonemployees and a big decrease in that of persons losing their jobs.

The rapid growth of 19 percent in the economy's wage bill far exceeded the increase in national income, which came to only 8 percent—the smallest in many years. As a result, the share of wages in national income moved up from 59 percent in 1965 to 65 percent—a striking rise following its stability during the years 1962–65 (see Table II–4). Nonwage incomes, on the other hand, declined not only proportionally, but also in absolute terms—by 7.2 percent following gains of 19.2 percent in 1965 and 15.9 percent in 1964. Income per non-wage-earning gainfully employed decreased by 7.3 percent, averaging some IL 13,350, as compared with approximately IL 9,500 per wage earner. In this connection it must be pointed out that in previous years the level of such income had increased more rapidly than that of wage earners.

If wages are imputed to the self-employed at the same average rate as for employees, the balance, representing return on capital, declined by IL 630 million, or 40 percent approximately, as compared with 1965. On the other hand, the net capital stock increased by nearly 7 percent, so that the return per unit of capital decreased by about 45 percent.[2]

[1] The rise in the average wage level partly reflects the upward trend in wages during 1965.

[2] The assumption underlying the imputing of wages to self-employed at the same average rate as for employees is not very valid in a period of mounting unemployment, and probably produces an upward bias. But even if we assume that the return on the labor of self-employed remained unchanged in 1966, there was still a decrease in the return per unit of capital.

Table II–4

NATIONAL INCOME AND RETURN ON PRODUCTIVE FACTORS, 1963–66

	1963		1964		1965		1966	
	IL m.	Weight or percent change[a]	IL m.	Weight or percent change	IL m.	Weight or percent change	IL m.	Weight or percent change
1. National income = net national product at factor prices	6,149	100.0	7,156	100.0	8,564	100.0	9,268	100.0
2. Total wage bill[b]	3,600	58.5	4,200	58.7	5,040	58.9	5,998	64.7
3. Nonwage incomes (1–2)	2,549	41.5	2,956	41.3	3,524	41.1	3,270	35.3
4. Return on capital[c]	1,113	40.9	1,309	17.6	1,579	20.6	549	–39.9
5. Income per wage earner[d] (IL per annum)	6,033	11.3	6,846	13.5	7,945	16.1	9,473	19.2
6. Income per nonemployee (IL per annum)	10,706[e]	22.6[e]	12,286	14.8	14,395	17.2	13,347	–7.3

[a] Lines (1) to (3) show weights, lines (4) to (6) show percentage changes.
[b] This is a rough estimate and differs from that appearing in Chapter X, "Wages", as it consists of the entire wage outlay of employers, including fringe benefits, as well as imputed wages of cooperative members and service workers in kibbutzim, and the pay of the armed forces.
[c] On the assumption that average earnings of nonemployees are equal to those of wage earners.
[d] Based on the number of wage earners shown in manpower surveys, which differs from that cited in Chapter X, "Wages".
[e] Based on the number of nonemployees shown in manpower surveys, after adjusting for new definitions introduced in 1964.

Table II-5

PRIVATE INCOME, 1960-66

(IL million, at current prices)

	1960	1961	1962	1963	1964	1965	1966	Percent increase or decrease (–) as against previous year					
								1961	1962	1963	1964	1965	1966
1. National income	3,638	4,289	5,040	6,149	7,156	8,564	9,268	17.9	17.5	22.0	16.4	19.7	8.2
2. Public sector income from property	92	101	129	145	184	198	283	9.8	27.7	12.4	26.9	7.6	42.9
3. Private income from economic activity (1–2)	3,546	4,188	4,911	6,004	6,972	8,366	8,985	18.1	17.3	22.3	16.1	20.0	7.4
Less:													
a. Income tax	316	376	490	641	815	993	1,146	19.0	30.3	30.8	27.1	21.8	15.4
b. National Insurance contributions	103	126	146	162	181	234	334	22.3	15.9	11.0	11.4	29.3	42.7
4. Total compulsory payments (a+b)	419	502	636	803	966	1,227	1,480	19.8	26.7	26.3	24.0	23.2	20.6
5. Transfer payments (net)	233	263	325	402	476	610	765	12.9	23.6	23.7	18.4	28.2	25.4
6. Total compulsory payments less transfer payments (4–5)	186	239	311	401	520	617	715	28.5	30.1	28.9	29.7	18.7	15.9
7. Disposable private income from domestic sources (3–6)	3,360	3,949	4,600	5,603	6,452	7,749	8,270	17.5	16.5	21.8	15.2	20.1	6.7
8. Private transfers from abroad	332	374	758	788	836	733	726	12.7	102.7	4.0	6.1	–12.3	–1.0
9. Total disposable private income (7+8)	3,692	4,323	5,358	6,391	7,288	8,482	8,996	17.1	23.9	19.3	14.0	16.4	6.1

NOTE: This table contains two conceptual changes as compared with data cited in previous Annual Reports:
1. National income has been measured here according to the GNP approach (the production account), whereas in previous years it was measured according to the income approach (the appropriation account).
2. Taxes do not include the Absorption Loan and compulsory saving. For an explanation of this, see Chapter VII, "Public Sector Operations", and Chapter XIX, "Saving".

SOURCE: Line 1—Table II-3; lines 2, 3, 4, and 5—data cited in Chapter VII, "Public Sector Operations" (for details of calculation, see the appendix to this chapter—in Hebrew only); line 8—unilateral transfers as shown in the balance of payments, net of public sector transfers.

The expansion of net tax revenue[1] at a faster rate than national income resulted in total disposable private income from domestic sources lagging somewhat behind the growth of national income (see Table II–5). A slight decrease in transfers from abroad was responsible for the even slower increase in disposable private income from all sources. However, it should be noted that the decline in foreign transfers occurred solely in those of the nonprofit institutions.

No detailed data are available on changes in income distribution in 1966 and their effect on the inequality of incomes. From the aforegoing it is obvious that there was a significant change in 1966, in contrast to the situation in the previous year, when no radical changes occurred in the economy and the Lorenz index of inequality in the gross income of the urban population remained stable, as expected. In 1965, and previously, this index stood at 0.36–0.37 for the entire urban population and 0.31–0.32 for urban wage earners. Fiscal policy did not lead to any significant difference in income distribution in 1965, as reflected by the fact that the index of inequality in the net income of the entire urban population was 0.28 in 1964 and 0.27 in 1965.[2]

This stability in the degree of inequality in income distribution in a year when incomes expanded appreciably indicates that the majority of income groups shared in the marked rise in private incomes that year. As may be seen from Table II–6, the weight of the group with an annual income of under IL 5,000 per annum (at 1964 prices) fell from 48 percent in 1964 to 40 percent in 1965. On the other hand, there was a corresponding increase in the combined weight of the groups with an income of IL 7,500 or more. In the case of urban wage earners, the weight of the under-IL 5,000 group declined from about 41 percent in 1964 to 31 percent in 1965.

The changes in income levels were accompanied by a rise of 5 to 6 percent in average net worth per unit for the population as a whole, and of some 7 percent for the wage-earning population.[3] The changes in income distribution and the moving of units from lower to higher income groups accounted for the decline in average net worth per unit in most groups in 1965 as compared with the preceding year. However, these changes were not of such a degree as to invalidate the assumption of a strong connection between income level and net worth[4] which is reflected by the data for these two years.

[1] After deduction of transfer payments.

[2] This index stands at 0 when there is perfect equality of income distribution, and at 1 when there is perfect inequality. The data cited were published in the Central Bureau of Statistics Bulletin No. 4, April 1967.

[3] Net worth, as measured in saving surveys, refers to assets owned by households, and in the main reflects the value of housing. For a fuller explanation of definitions and details of the findings, see the 1963/64 Saving Survey, Special Publication No. 217, published jointly by the Central Bureau of Statistics and the Research Department of the Bank of Israel, Jerusalem, 1967.

[4] The coefficient of correlation between income and net worth is 0.5.

Table II–6

CHANGES IN THE DISTRIBUTION OF INCOME AND NET WORTH OF JEWISH URBAN POPULATION, 1964–65

Net income group[a] (IL per annum)	Weight of group in population		Net income per unit[b]			Net worth per unit[c]		
	1964	1965	1964	1965	Percent change	1964	1965	Percent change
			Total population					
Up to 3,499	28.3	23.2	1,907	2,236	17.3	8,821	8,551	–3.1
3,500–4,999	19.9	17.1	3,953	4,588	15.3	12,993	13,712	5.5
5,000–7,499	28.6	28.4	6,112	9,658	8.9	17,000	16,067	–5.9
7,500–9,999	13.5	17.9	8,535	9,278	8.7	25,813	23,366	–9.5
10,000 +	9.7	13.4	13,047	14,515	11.3	39,709	38,731	–2.5
Total	100.0	100.0	5,586	6,790	21.5	17,289	18,250	5.6
			Wage earners					
Up to 3,499	19.8	13.7	2,299	2,689	17.0	7,079	7,522	6.3
3,500–4,999	20.9	17.5	4,305	4,567	1.1	10,855	10,717	–1.3
5,000–7,499	31.8	31.5	6,015	6,599	8.1	16,241	13,952	–14.1
7,500–9,999	16.5	21.3	8,535	9,247	8.3	24,901	21,847	–12.2
10,000+	11.0	16.0	12,761	14,129	10.7	38,147	37,083	–2.8
Total	100.0	100.0	6,101	7,483	22.7	16,752	16,906	6.9

[a] At 1964 prices. Net income—after deducting income tax, National Insurance contributions, and compulsory loans—amounted to 84 percent of gross income in 1964 and 85 percent in 1965 in the case of the entire population and to 85 and 86 percent respectively for wage earners.

[b] An investigation unit is sometimes other than a "household", since family members over the age of 18 who live together but retain for themselves more than IL 1,200 of their income have been treated as separate units. The number of units is about 5 percent greater, on an average, than the number of households. For details and definitions, see the 1963/64 Saving Survey, published jointly by the Central Bureau of Statistics and the Bank of Israel Research Department, Jerusalem, 1967.

[c] Net worth is defined here as the total value of all salable assets less liabilities. One-sixth has been deducted from the value of rented housing, this being the owner's share of the "key money". For details see M. Landsberger, "The Distribution of Net Worth in Israel in 1963/64", Bank of Israel Bulletin No. 28, February, 1967.

SOURCE: Saving surveys carried out jointly by the Bank of Israel and the Central Bureau of Statistics for 1963/64 and 1964/65. The survey for 1963/64 covered 3,200 units and that for 1964/65 covered 1,200 units.

(b) *Credit and interest*

The monetary situation changed drastically toward the end of 1966. The supply of bank credit expanded, especially that given at low interest rates, so that the average interest paid on such credit declined. There was also a substantial growth in bank-negotiated bill credits and an accompanying drop in the interest rate.[1] At the end of 1966 and the beginning of 1967, there was even a surplus of bank credit, reflected by the higher liquidity of several banking institutions. This depressed interest rates at the beginning of 1967, in respect of both the Short-Term Loan and the bill brokerage trade.

These developments in employment, production, prices, and the monetary sphere add up to a recession and deflation. As already pointed out, when these signs appeared in the second half of the year, especially toward the end, and when it became clear that the decelerated growth of demand and the national product had turned into a decline, the Government reverted to a policy of encouraging economic activity. The new policy, however, did not yield immediate results as regards demand or GNP, being reflected mainly in the improved liquidity of the economy at the end of the year.[2] This can be partly attributed to the increase in the relative profitability of holding financial assets as compared with real assets, due to expectations that prices would remain stable or even fall. Another factor operating in the same direction was the public's preference for liquid assets, induced by the prevailing uncertainty as to future business trends.[3]

(c) *Exports and structural changes in production and employment*

As expected, the economic slowdown did not affect branches or concerns producing primarily for export. Several of them, such as the diamond industry, which during the years of full employment found it difficult to obtain labor for expanding output, did not encounter problems of this kind in 1966.

A number of branches and enterprises which sold the bulk of their output locally were hit by the decline in productivity and tried to divert a larger portion of their output to the overseas market. For this reason, and also because of a certain increase in export incentives, the real growth of exports accelerated slightly, reaching 9.5 percent as compared with 8.7 percent in 1965.

Nevertheless, it was evident that the conditions created by the recession were

[1] In the form of concessions regarding collateral, the nominal interest rate remaining unchanged.

[2] This general picture of the liquidity situation does not contradict the fact that several sectors of the economy and individual enterprises which had accumulated large stocks (especially those connected with the building industry) encountered financial difficulties and the number of bankruptcies increased, in particular at the beginning of 1967.

[3] For a more detailed discussion see Chapter XV, "Money Supply, Credit, and the Banking Institutions", and Chapter XIX, "Saving".

insufficient to bring about any marked change in 1966 in the structure of production, factor uses, and employment in particular. Capital and labor released from production for the domestic market were not channelled to export on any significant scale. There were two main reasons for this. First, the profitability of export in existing enterprises did not increase to an extent that would have rendered worthwhile the greater exploitation of available capital and the hiring of unemployed workers for export production. In view of the big wage hikes granted in most export enterprises, their profit on exports was presumably even smaller than in 1965, though it may not have decreased relative to that of production for the domestic market.

Secondly, the easier terms and lower price of financing, together with the existence of a reservoir of unemployed labor, probably led to the initiation of investment projects which previously were regarded as unprofitable. But this is of necessity a protracted process which yields results only in the more distant future—after entrepreneurs have become convinced of the stability of the new conditions. It could not be expected to significantly alter the structure of employment and output as early as 1966.[1]

(d) *Productivity*

The decine in output during the year was in many cases not accompanied by a parallel decrease in employment. This was due to several reasons, among which the following should be mentioned: The conditions of organized labor, which apply in most places of employment in Israel, make the dismissal of workers both difficult and expensive, especially in view of the high percentage of permanent employees. Secondly, the fact that many concerns had invested fairly large sums in training a large percentage of their workers in special skills, or had devoted considerable effort to finding workers with suitable qualifications, encouraged a tendency to hold on to such personnel in the expectation that the recession would prove temporary. To these must be added the pressure on enterprises from various public bodies to delay dismissals for humanitarian reasons, as the prospects of finding other work were poor.

As long as there are hopes for the renewed expansion of production within a relatively short time, employers tend to retain their skilled labor, even if it contributes little or nothing to output in the short run. Hence it may be expected that, during a period of slump or of stability in output, even should labor work harder or display greater devotion than before, the enterprise concerned and the economy as a whole will suffer from the underexploitation of productive factors, while output and product per gainfully employed and factor productivity will either increase more slowly or decline. This trend can be found in other countries as well. It was discernible to some extent in Israel in 1965, but

[1] For a detailed analysis of these problems, see Chapter III, "The Balance of Payments".

Table II–7

CHANGES IN REAL PRODUCT, EMPLOYMENT, CAPITAL STOCK, AND PRODUCTIVITY, 1961–66

(percentages)

	1961	1962	1963	1964	1965	1966
Real GNP	10.8	10.9	11.5	10.3	8.2	0.6
No. of gainfully employed	6.4	5.7	5.1	4.6	3.0	–0.1
GNP per gainfully employed	4.1	4.9	6.1	5.4	5.0	0.7
Fixed nondwelling capital stock at beginning of year	10.7	11.2	11.6	10.4	10.9	9.6
Factor productivity[a]	3.6	4.0	5.1	4.4	3.7	–0.9

[a] Calculated according to the relative shares of the return on capital and on labor during the preceding year. The return on labor includes imputed wages of nonemployees, based on the average earnings per employee.

grew stronger in 1966, when productivity did not advance at all—for the first time in many years. As may be seen from Table II–7, productivity tends to rise rapidly when there is a big expansion of output. Under such conditions it is possible to increase the rate of factor utilization even without any special exertion on the part of labor.[1] And indeed, the year when productivity rose most rapidly was also the year of the fastest increase in the national product.

The standstill in the national product in 1966 thus led to greater concealed unemployment in various sectors and enterprises, which was reflected by a decline in productivity, following a steady rise in previous years.

(e) *Factor utilization*

It is of interest to compare the actual growth of the economy with the rate that could have been achieved had there been a fuller utilization of available factors of production. Such a comparison is found in Diagram II–3 (data are presented in the appendix—in Hebrew only).

The difficulty of determining unambiguously the most valid set of assumptions for defining "full utilization of productive factors" must be stressed. This is due to the interdependence of the assumptions[2] and their wider economic repercussions. For instance, a fall in unemployment below a certain point may generate strong upward pressure on wages and thus lead to inflation, as actually happened in 1964 when unemployment was at its lowest point—3.3 percent.

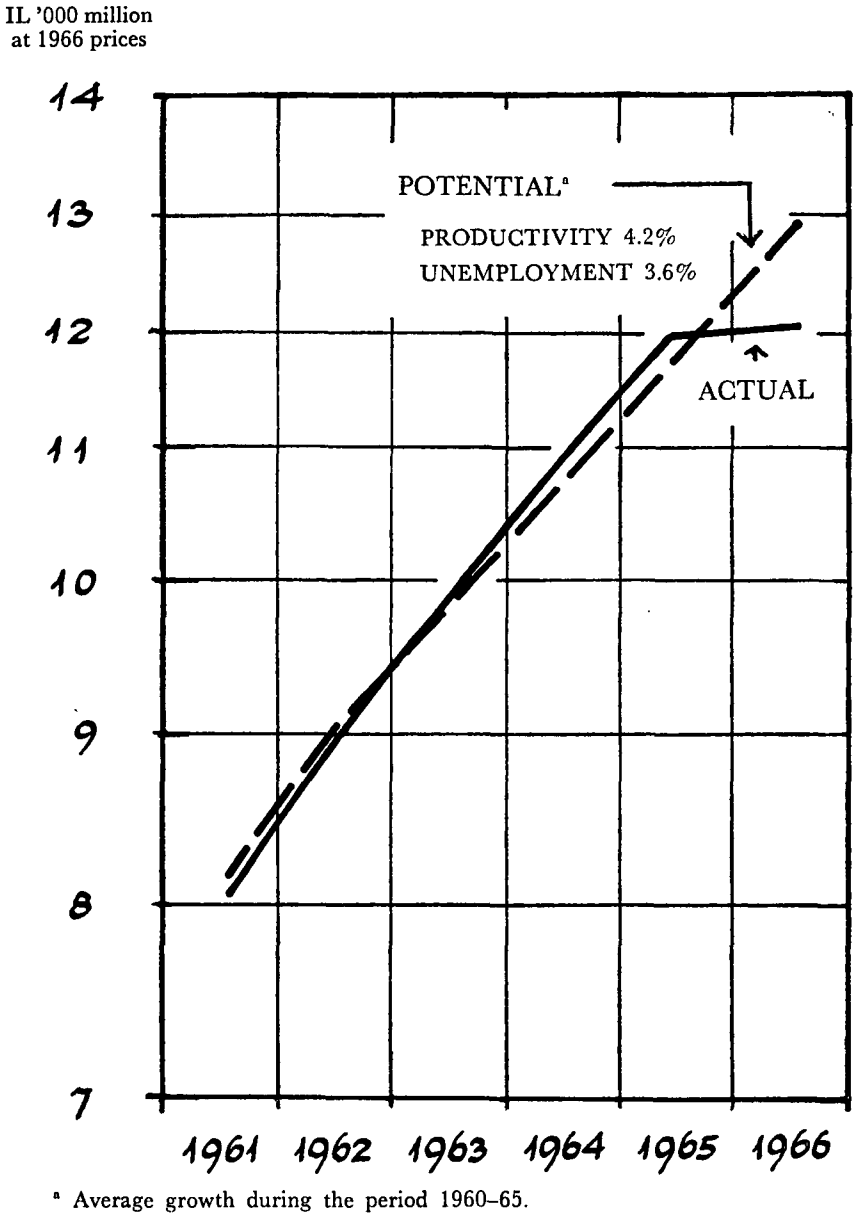
In the period 1960–65, when unemployment averaged 3.6 percent, inflationary pressures were at work, and they may have stemmed from the high rate

[1] As a rule, during boom periods there is a shortage of labor, and this leads to a decline in workers' devotion and in work morale in general.

[2] E.g. the aforementioned connection between the rates of increase in the product, unemployment, and productivity.

Diagram II-3

ANNUAL ACTUAL AND POTENTIAL GROWTH OF GNP, 1961–66



[a] Average growth during the period 1960–65.

of factor utilization. Obviously such pressures will lead to a worsening in the balance of payments—a trend which actually began to appear in 1964—and greatly diminish the chances of maintaining a high rate of factor utilization in the long run.