

CHAPTER I

MAIN ECONOMIC DEVELOPMENTS

Economic developments in 1974 do not reveal a uniform picture, either for the year as a whole or in the various spheres of the economy. In the first six months business activity recovered rapidly from the effects of the war, but the next six months witnessed a downturn in the growth rate, due mainly to the slackening of demand. The deceleration affected many branches of the economy, but was especially striking in construction and allied industries, in manufacturing industries particularly hard hit by export market reverses, and in the tourist trade. The flagging of demand left its stamp mainly on production and employment, but by year's end it had not yet been fully reflected by a reduction in the import surplus and the checking of the uptrend in prices and costs. Both the balance of payments and the rate of inflation still showed the cumulative effect of two factors: the excess demand and inflationary pressures of the previous year and the first half of 1974 and the precipitate rise in import prices, which severely jolted the Israeli economy because of the high proportion of imports and their composition.

The adverse balance on goods and services account reached \$ 3.4 billion. Only half this sum was covered by unilateral transfers, while one-third (\$ 1.1 billion) was financed by drawing down the economy's foreign exchange reserves and by heavy short-term borrowing abroad. The result was the swelling of Israel's net foreign currency debt by \$ 1.8 billion. The devaluation expectations, which began to appear at the beginning of the year reviewed, aggravated the negative balance of payments trends, but implementation of the devaluation in November warded off a further deterioration for a time. The consumer price index jumped 56.2 percent in 1974, with most of the increase taking place in February and March, when numerous subsidies were pared, and in the last two months of the year, in the wake of the devaluation of the IL and the further trimming of subsidies.

The gross national product expanded by 4.7 percent at constant prices, while the gross domestic product of the private economy was up 3.7 percent, after gains of 6.6 percent in the first nine months of 1973 and 11.6 and 14 percent in 1971 and 1972 respectively. The import bill, excluding direct defense imports and ships and aircraft, rose 8.8 percent at current prices, compared with 23.1 percent in the first nine months of 1973. The product rebounded strongly in the first half of the year to

Table I-1
MAIN ECONOMIC INDICATORS, 1966-74^a
 (percent annual increase)

	Average 1961-65	1966	1967	1968	1969	1970	1971	1972	1973		1974
									Jan.- Sept.	Entire year	
Resources and uses											
(at constant prices)											
Total domestic uses	10.5	-0.8	3.7	16.6	15.2	11.4	7.7	7.1	11.8	18.5	2.9
Gross domestic product ^b	10.0	1.4	2.5	14.7	12.8	8.9	10.1	12.0	6.9	6.5	4.3
Gross domestic product — private economy (excl. residential rents) ^c											
Total	10.9	-0.6	0.4	19.1	15.0	9.7	11.6	14.0	6.6	3.9	3.7
Per employed	6.1	0.7	6.7	7.5	10.2	8.1	6.8	6.3	1.7	3.0 ^d	3.4 ^d
Private consumption											
Total	10.3	3.1	1.5	11.3	10.5	3.4	4.9	9.1	13.6	9.5	7.2
Per capita	6.1	0.5	-1.7	7.6	7.7	0.6	1.8	5.6	10.0	6.0	4.1
Public consumption	10.6	8.3	36.1	8.9	16.7	26.3	1.3	-1.9	-0.1	46.4	1.4
Gross investment	11.3	-16.1	-22.0	48.2	26.2	13.4	21.6	12.7	19.7	9.3	-3.1
Balance of payments,^e excl. trade with administered areas											
(in dollars)											
Imports	12.0	3.8	10.6	24.5	20.8	21.1	16.3	5.8	45.1	63.3	28.5
Exports	15.6	16.6	6.5	21.7	11.7	7.6	33.3	17.4	32.6	24.7	29.5
Import surplus	8.8	-14.4	18.4	29.0	35.6	39.7	-1.6	-10.7	68.9	136.0	27.6
Foreign currency debt	13.7	7.7	17.9	22.2	11.7	23.4	30.8	19.0	25.1	24.8	22.8
Foreign exchange reserves ^f	27.7	-3.5	13.7	-7.2	-46.0	6.6	59.2	86.0	56.0	58.7	-36.9

Population and employment											
Average population	3.9	2.6	3.3	3.4	2.6	2.8	3.0	3.3	3.3	3.3	3.0
Number of Israeli employed	4.8	-0.6	-4.3	9.0	3.8	1.8	3.5	5.0	3.9	3.9	0.1
Unemployment rate (as a percent of civilian labor force) — absolute figures	3.6	7.4	10.4	6.1	4.5	3.8	3.5	2.7	2.4	2.6	3.0
Prices and national income (nominal)											
Average monthly earnings per employee post ^a	13.6	19.1	0.4	3.2	6.1	9.0	16.4	14.4	24.9	27.6	34.6
GNP price deflator	8.0	8.3	1.4	2.8	2.4	8.1	12.7	14.2	20.3	20.9	33.5
Import prices ^b	9.7	2.5	1.7	12.9	6.2	4.2	16.2	20.2	17.2	20.4	41.1
Consumer price index (annual average)	7.4	8.0	1.6	2.1	2.5	6.1	12.0	12.9	18.5	20.0	39.7
National income	18.8	9.0	4.0	18.7	15.9	16.4	24.2	28.6	28.5	28.4	36.6
Disposable private income ^c	18.4	7.8	8.4	15.3	17.0	9.2	21.6	32.9	31.9	32.2	37.2
Finance (annual average)											
Money base ^d	18.9	5.1	22.8	22.6	4.0	9.0	34.6	47.5	21.8	24.0	5.4
Money supply	17.6	7.3	20.3	19.0	7.1	5.0	22.4	30.1	22.6	25.3	19.8
Other liquid assets of the public ^e	32.5	20.7	26.7	32.6	23.9	23.3	29.8	27.6	22.2	21.3	20.9
Bank credit to the public and bill brokerage credit	19.6	22.9	19.0	12.4	17.4	18.3	24.1	17.4	26.6	26.8	49.0

^a Until 1968 the percentage changes were calculated on the basis of the previous year's prices, but since 1969 the rates of real change have been calculated on the basis of constant 1970 prices.

^b Valued at the effective rate of exchange.

^c Defined as the total product, less public sector and nonprofit institution services.

^d Per effective employed; i.e. excluding private sector employed called up for active or reserve duty.

^e Goods and services (imports c.i.f. and exports f.o.b.).

^f Net foreign currency balances in the Bank of Israel at the end of the year.

^g Israeli employee posts, including part-time and supplemental work. Since 1969 a new series based on National Insurance Institute data, which includes *inter alia* East Jerusalem.

^h Including changes in foreign prices and in the effective exchange rate of the Israeli pound.

ⁱ Gross disposable private income from domestic sources, net of compulsory loans.

^j Currency in circulation with the public, plus total liquid assets of the banking institutions.

^k Time deposits in Israeli and foreign currency, saving scheme deposits, bill brokerage, and the government Short-Term Loan.

regain its prewar level, and may even have surpassed it a bit. In the second half the uptrend was checked, and the curve apparently fell to its level in the third quarter of 1973.

Final uses (excluding direct defense imports and the ships and aircraft item) rose 6 percent, as against 11.2 percent in the first nine months of 1973 and 8.4 percent for the year as a whole.

The more sluggish growth of economic activity should be viewed against the slackening of demand—the 8.1 percent expansion of the capital stock and that of 3 percent in the working-age population would have permitted a bigger GNP gain. Besides the deceleration of aggregate demand, there were two secondary factors that help to explain the smaller percentage increase in the product. First was the irregular pattern of demand growth: whereas some branches experienced a much heavier demand for their output—which they could not fully meet, at least in the first half of 1974—other branches suffered a weakening of demand, with a resulting creation of hidden unemployment and spare capacity. The second factor was the smaller supply of manpower, due to the extensive call-up of reserves (especially in the first part of the year), the expansion of the standing army, and other reasons which are not yet very clear but seem to be connected with the diminished desire of potential labor force members to actively seek work.

The economic slowdown did not cause any significant rise in recorded unemployment; rather, it depressed the labor force participation rate and the growth of GNP per man-hour, for the labor force does not quickly adjust to a change in business activity.

The average population of Israel was up 3 percent in 1974, compared with 3.3 percent in both 1972 and 1973. The slight decline stemmed chiefly from the reduction of gross immigration from 51,700 in 1973 to 31,400, and also from a larger emigration. The smaller expansion of the total population led to a slightly smaller expansion of the working-age population. The most prominent change, however, was the fact that the 3 percent increase in the latter, instead of pulling up the number of employed or resulting in a significant rise in the number of job-seekers, depressed the labor force participation rate from 49.7 percent in 1973 (49.6 percent in 1972) to 48.5 percent.

While the unemployment rate was still low enough to make 1974 a year of full employment, the excess demand for workers apparently subsided, particularly in the final months of the year and the first part of 1975. Average earnings per employee were up about 35 percent, and hourly earnings rose to a similar extent. This is attributable to the awarding of three cost-of-living allowance increments during the year and the hiking of basic pay in conformity with the wage policy; there was also the usual wage drift, but under-the-table payments did not seem to be on any

significant scale this year. The share of wages in national income held steady, but the figures cited here may not reflect various increments that were not fully measured. The stability of the share of wages in GNP suggests that labor costs were only a minor factor in the acceleration of inflation in 1974.

The slackening of economic activity in the second half of the year can be ascribed to the measures taken by the government to dampen domestic demand, as well as to balance of payments developments: the faltering advance of exports, the livelier demand for imports, and some deterioration in the terms of trade, which reduced the purchasing power of income proportionally more than that of incremental wages and profits. Monetary developments were in line with the slower growth of demand for domestic output. The sizable liquidity injection by the government and the Bank of Israel (mainly through the export funds) was partly offset by the shrinkage of foreign exchange reserves and a real decrease in the money supply. These changes reflected a heavier demand for financial assets linked to the consumer price index or the foreign exchange rate, in anticipation of a devaluation of the Israeli pound and the further spiralling of the general price level.

The much more laggard headway made by exports, for the second year running, had a pronounced moderating effect on the product of the private economy: whereas in 1972 overseas sales directly accounted for 2.3 percentage points of the product gain, in 1974 the figure came to only half a point. This also indirectly led to a slower growth of consumption, through its effect on income originating in the export branches. The sluggish export advance is explained by the continued buoyant demand in the home market, the slump in world commerce, and the zero increase in export profitability. While the prices received by exporters were up by a respectable 42 percent in 1974, this was surpassed by the rise in domestic production costs and prices. Besides the effect of the export standstill on GNP, there was a renewed buildup of stocks of imported commodities, in anticipation of a further price advance and perhaps also because of anxiety about their regular supply.

The policy of cooling domestic demand, aimed at blunting the inflationary pressures and easing the balance of payments strain, operated on several planes at one and the same time. First was the reduction of disposable private income through the stiffening of direct taxes and in particular compulsory loans. As a consequence, disposable private income from domestic sources rose 37.2 percent, a notch below the 37.9 percent gain in gross private income from economic activity. This stands out more when compared with the opposite trend in 1972-73, when disposable income outpaced the growth of gross income. Two other factors dampened the purchasing power of disposable private income: the hiking of net indirect taxes proportionately more than the growth of income, mainly through the lifting of numerous subsidies, and a jump in import prices. All told, per capita disposable

income from domestic sources was down 3.6 percent from 1973, the steepest drop recorded since the 1966-67 recession.

Secondly, this policy put a damper on investment activity, reflected primarily by a 3 percent cutback in capital spending by the public sector itself (the government, local authorities, and National Institutions). The bulk of such investment is made in construction, and its decrease was directly due to government policy. Capital outlays by the nonprofit institutions fell off by a steeper 15 percent, with the sharpest drop being recorded by the country's universities, over whose budgets the government has the main say. The government was also responsible for the restraining of private investment, expanding unlinked loan capital to a smaller extent this year. Such financing was up 36 percent, while nondwelling investment prices rose 38 percent, making a real decline of 1.4 percent. But its contractionary effect was partly offset by an increase in the subsidy element of unlinked public financing with the rise in the general price level. In contrast to the more sluggish growth of financing for nondwelling investment purposes, that made available by the public sector for the purchase of homes was stepped up appreciably. The volume of directed credit rose by a resounding 90 percent, despite the precipitate drop in immigration. This moderated the contraction of housing demand in 1974, as the increase in the subsidy element of unlinked credit lowered the price of dwellings to the buyer.

The restrictive impact of these developments in private income and investment was partially counterbalanced by the strong expansionary effect of the public sector's domestic spending. The lion's share of such expenditure went on defense. In 1973 the mass call-up of reserves and the mobilization of civilian transport after the outbreak of war accounted for most of the defense burden, besides reducing the supply of productive factors. In 1974, on the other hand, most of the demand was in the form of procurement orders placed locally, notably with the manufacturing and construction industries. Domestic purchases were up 25 percent in 1974 (16 percent the year before), and this explains about half the gain in the private sector product.

The action taken by the government to curtail demand did not find full expression in the year reviewed, for the private sector did not adjust its behavior for the contraction of disposable income. This can apparently be ascribed to the feeling that this policy would be pursued for only a limited time, and to the sector's attempt to cushion itself against a prospective hiking of taxes and a change in the effective rate of exchange of the IL, which spurred the advancing of purchases of durables and even other commodities.¹ In fact, private consumption per capita continued to rise

¹ The decline in the saving rate in the first half of 1974 was probably a reaction to the pent-up demand that had built up during the period of hostilities and immediately thereafter, when consumer spending dragged.

despite the dent in real disposable private income, with the result that the rate of private saving fell off, albeit by a relatively small 4 percent per capita. All the consumption growth took place in the first half of the year, with the per capita level turning downward in the second half.

A similar development apparently took place in capital formation. The real decrease in low-interest public financing made available for nondwelling capital spending by the private sector failed to depress such investment; on the contrary, excluding ships and aircraft, the level was actually up 10 percent, with the proportion of equity financing rising. As in 1973, the growth of such investment outstripped that of output.

Dwelling investment fell off 5 percent, after advancing 28 percent in 1972 and 17 percent in the first nine months of 1973. All the decrease was in private building, which was down 11 percent, while publicly sponsored housing registered a 6 percent increase. Private building mainly reflects the influence of market forces, while that by the public sector chiefly reflects government policy decisions.

The volume of private building starts contracted sharply, whereas that by the public sector rose, even after allowing for the effect of the war. Overall, the volume of starts was about the same as in 1973 but fell short of the 1972 peak. This was due to the subsiding of housing demand and an apparent buildup of a stock of vacant flats since 1972. Dwelling prices only slightly outpaced the rise in the consumer price index in the year reviewed.

All told, gross domestic fixed investment (excluding ships and aircraft) was 2 percent down on 1973, shaving off about 1 percent from the national product in the initial round.

The escalation of prices side by side with the slowdown of economic activity is explained by the lagged effect of the excess demand that had built up since 1971, which mainly pushed up the prices of government-controlled goods and services and of imports. The easing of demand, after a prolonged period of overheating and inflationary pressures, could not be expected to immediately brake the advance of prices. Many displayed a lagged response to the factors at work in 1973 and perhaps even before, and were also influenced by an expected renewal of the economic boom upon the release of the bulk of the reserves and by the vigorous upturn in demand (relative to productive capacity) at the beginning of 1974. But cost-push played an important part in the climb of prices in the year reviewed. First of all, many controlled commodity and service prices rose sharply in 1974, after the government had refused to authorize adjustments in 1973 despite the jump in import prices and mounting local production costs. Secondly, import prices continued to move up strongly in 1974: from the beginning of 1973 until the end of 1974 the dollar price of imports soared 72 percent, to which has to be added another 26

percent due to the hiking of import levies and customs tariffs and the devaluation of the Israeli pound in November 1974.

Because of the big import component in the economy's bill of goods, the import price increases were rapidly transmitted to domestic production costs via the cost-of-living allowance arrangement, and prompted branches producing import substitutes to up their prices too.

The cost-push on prices was greatest in two subperiods, in February-March and in November-December, when the rises were exceptionally steep. But the level also moved up, although at a more sluggish pace, during the rest of the year. Despite the easing of demand pressure, apparently it was still sufficiently high, especially in the first half of the year, to permit the passing on of the extra costs without causing any unemployment. In the second half of 1974 the cost factors were apparently dominant, and the climb of prices was accompanied by the sagging of output and employment in some branches of the economy.

The transition from a demand to a cost inflation was not sharp, and many branches enjoyed a lively demand, originating mainly in the procurement orders placed by the Defense Ministry and in the waves of speculative purchases that recurred several times during the year. This offset the slackening of activity and diminished profitability in other branches. As a result, profits did not lag behind the growth of wages, and the share of the latter in national income remained unchanged for the second consecutive year.

The deterioration in the balance of payments in 1974 was reflected both by the growth of the current deficit and by a big increase in the portion covered by long-term loans and the contraction of foreign exchange reserves. The current deficit rose from \$ 1.1 billion in 1972 and an annual \$ 1.8 billion rate in the first nine months of 1973 (\$ 2.7 billion for the year as a whole) to \$ 3.4 billion in 1974. Only about half of the 1974 deficit was covered by unrequited receipts, compared with a long-run average (1968-72) of two-thirds. Another 17 percent was financed by medium- and long-term loans and foreign investment, while 34 percent (\$ 1.1 billion) was covered through short-term borrowings and the drawing down of foreign exchange reserves. The \$ 740 million increase in the current deficit stemmed from the higher international prices and a real growth of the import surplus exclusive of direct defense items, while the latter actually fell off in constant price terms.

The foremost cause of the growth of the current deficit between 1972 and 1974 was the global inflation. This had a very damaging effect on the Israeli economy, both because its imports are almost double its exports and because import prices outran those of exports. Fuel and other primary commodities account for a large share of Israel's overseas purchases, and their prices rocketed, whereas a fairly large percentage of the country's exports consists of items demand for which slumped in

the wake of the business slowdown in Israel's leading markets. In 1973-74 import prices went up 54 percent and export prices by only 46 percent. During this period the dearer cost of imports added \$ 1,340 million, or 58 percent, to the deficit. The effect of the price rises was most marked in 1974, when they accounted for \$ 855 million of the incremental adverse balance, compared with \$ 485 million the year before. Since the middle of 1974 the upsurge of import prices has slacked off, and in many commodities they have even slipped appreciably.

The second development responsible for the growth of the current deficit in the last two years was the swelling of defense imports after the Yom Kippur War. Of the \$ 2.3 billion increase in the deficit during this period, \$ 662 million (29 percent) stemmed from the larger direct defense import. Its influence was confined entirely to 1973, for in the year reviewed the level fell off. But it is important to note that the incremental noncivilian import was accompanied by the receipt of grants and loans for financing its purchase, which mitigated its immediate impact on economic activity and the country's foreign exchange reserves.

But even after allowing for the effect of the price changes and direct defense imports, the current deficit (in constant 1972 dollars) rose from \$ 641 million in 1972 to \$ 1,059 million in 1973 and \$ 1,153 million in 1974. In other words, in real terms the deficit nearly doubled during this period, and although most of the growth occurred in 1973, the trend continued upward in the year reviewed. While the worldwide inflation and the expansion of defense imports were factors exogenous to the Israeli economy, the real growth of the deficit net of direct defense imports reflected the failure to pursue a policy called for by these external developments. Thus, for example, the adjustment of the domestic prices of numerous imported commodities to their higher international level took place quite belatedly, thereby staving off the dampening effect of the higher prices on demand for these items. The adjustment of prices upon the devaluation of the IL was a step in the right direction, and consumer spending on these goods dipped noticeably. The rise in the real current deficit reflected, first of all, a marked slowdown in export growth: in the last two years the level moved up only 8 percent, with commodities advancing 6 percent and services by 12 percent. This is well below the 12 percent average annual gain registered in 1968-72.

Two factors caused the export drive to drag: the pressure of domestic demand and the slump in world commerce. The surging domestic market and the escalation of production costs checked the rise in export profitability despite the higher prices fetched abroad, the raising of export incentives, and the devaluation of the Israeli pound, which pushed up the average return on commodity exports by some 80 percent. In mid-1973 the developed countries, which take the bulk of Israel's goods, were hit by a recession, which deepened progressively in the course of 1974. In the

year reviewed Israel's export markets expanded by a mere 1 percent, compared with a 10-11 percent average in 1968-72.

Imports rose more rapidly than exports: excluding defense items and ships and aircraft, they were up 15 percent in 1973 and 9 percent in 1974. They also outpaced the growth of economic activity, even though their prices advanced faster than the implicit GNP price deflator (about 9 percent). The heavier volume of overseas purchases is explained by the renewed buildup of stocks of imported goods in anticipation of a worsening of the global inflation and of the imposition of import levies or the devaluation of the IL. This process was facilitated by the liberal policy in issuing permits for import finance credits. Purchases of foreign consumer goods did not increase in 1974, after having risen greatly the year before, but investment goods expanded more rapidly in the year reviewed, apparently because of the decline in the relative price of imported equipment compared with that produced locally.

Along with the soaring of the current deficit in general and of defense imports in particular, the last two years saw a heavier inflow of long-term capital, notably nonrecurring receipts: these amounted to \$ 2,173 million in 1973 and \$ 1,674 million in 1974, as against \$ 1,052 million in 1972 and only \$ 765 million in 1971. In 1973 this source covered 82 percent of the deficit, and together with long-term loans, which also rose, long-term capital imports surpassed the deficit by \$ 518 million. By contrast, in 1974 the further growth of the deficit was accompanied by a shrinkage of long-term funds. Short-term sources—credits and the drawing down of foreign exchange reserves—which in previous years had been of marginal importance and then only for limited periods, became a central factor in financing the deficit in 1974, with all the negative implications involved.

The devaluation expectations, which began to appear at the beginning of the year, reinforced the unfavorable balance of payments trends. They induced the advancing of speculative imports, but even more important, they resulted in a smaller inflow of capital: a contraction of unilateral receipts and investments, a reluctance to take on new loans, the early repayment of loans, the advancing of payments for imports, and even the deferral of the transfer of export proceeds to Israel. The devaluation radically transformed this situation, and even led to an improvement in the country's reserve position.

Monetary developments during the year were consistent with the slackening of aggregate demand and domestic economic activity, which became more pronounced in the course of 1974. To be sure, the government and the Bank of Israel pursued a strongly expansionary monetary policy in 1974. They injected considerable liquidity, and there was a diminished demand for money and other unlinked liquid assets, as might have been expected in a period of hyperinflation. But these developments did not result primarily in a more buoyant demand for locally

produced goods in general and for real estate in particular. Part of the incremental liquidity was absorbed as a result of the marked shrinkage of the economy's foreign exchange reserves, while another part was siphoned off by sales of index-linked government bonds to the public, both directly and through commercial banks and financial institutions. Working in the same direction was the cost-push on prices, particularly the rise in import prices, the trimming of subsidies, and the hiking of indirect taxes, which reduced linked liquid asset holdings in general and real money balances in particular. The latter rose 18 percent over the year as a whole and by a 20 percent monthly average, as contrasted with a 36 percent increase in prices of domestic uses.

Businesses and households used part of their extra funds to buy bonds—in anticipation of a continuation of the government's fiscal measures and an acceleration of the domestic inflation—as well as foreign currencies and assets linked to the foreign exchange rate—in anticipation of a devaluation of the Israeli pound and the intensification of global inflation. The absorption of excess liquidity through sales of linked bonds and approved saving scheme deposits did not have any detrimental side effects (assuming that the government's incremental proceeds from these sources did not increase its expenditure), but the speculative demand for foreign currencies and imported raw materials and consumer durables hastened the contraction of foreign exchange reserves. There was a danger that the introduction of a more stringent monetary policy with a view to discouraging speculation might affect productive activity. The speculative demand was fueled by the recurring expectations of a steep appreciation of assets linked to the consumer price index and the foreign exchange rate.

From the viewpoint of monetary policy the year reviewed falls into two main subperiods. The first was from January to June, which witnessed a continuation of the expansionary policy introduced during the period of fighting, mass mobilization, and gradual release of reservists until April. The aim was to prevent the creation of liquidity shortages so as to head off any disruption of economic activity during the national emergency and the ensuing rapid restoration of normal business activity. At the same time the government also adopted an expansionary fiscal policy, in contrast to its usual absorption of liquidity in the first months of the calendar year (the final months of the fiscal year). When it became clear that the economy was returning to normal too speedily, the Bank of Israel took action to check the injection of liquidity. But the commercial banks went on expanding their credit operations, at the price of incurring large liquidity deficiencies despite the hiking of the penalty rates in May. During this half of the year the government pumped in some IL 1 billion despite the massive sale of linked bonds. Bank credit to the public was stepped up by IL 2.4 billion, of which IL 1.3 billion was nondirected credit, IL 500 million

directed credit by the Bank of Israel, and \$120 million foreign currency credits supplied outside the various funds.

In the second half of 1974 the government and the Bank of Israel tightened their policies, but this failed to reduce the liquidity injection. In contrast to the first half of the year, the money supply again began to expand, running 3 percent higher on a monthly average. This was connected with the turnabout in the bond market in August, when the freezing of nondirected credit by the Bank of Israel and the raising of the bank rate on the one hand and the mild advance of prices on the other forced the public to unload part of its index-linked bond holdings. Nevertheless, it continued to buy foreign currency and assets linked to the foreign exchange rate until the devaluation of the IL at the beginning of November 1974. This was followed by the conversion of foreign currency into Israeli pounds and the renewed purchase of index-linked bonds on a large scale, along with the swelling of the money supply. This trend carried over into the first quarter of 1975.

The increase in the money supply lagged behind that in prices, while other unlinked liquid assets—IL time deposits and the Short-Term Loan—declined from the end of 1973 to September 1974 at an accelerating rate in real terms. This is explained by the failure to adjust the yields on such assets at a time of hyperinflation, while linked assets promised a high return, even for short holding periods. Along with their failure to up credit interest rates, the banks made no attempt to revise the interest rate on bank credit for the steep rise in the price level, with the result that unlinked credit was in very heavy demand. In responding to this demand, the banks sank into huge liquidity deficiencies in the second quarter of 1974; it was only after the freezing of credit and the hiking of interest rates in August and the generation of expectations of a slower rise of prices that demand for bank credit eased, with a consequent slight narrowing of the linked-unlinked asset yield differential.

The modification of interest rates in August and the change in inflationary expectations were a salient factor in the decline of nondirected credit after the imposition of the freeze in the middle of July. The downturn was accentuated by the strong expansion of directed credit and the increased liquidity injection after the devaluation. Between the end of June and the end of December nondirected credit held fairly steady, while directed credit soared by IL 1.8 billion (IL 700 million of this constituted devaluation increments) and foreign currency credits grew by \$190 million.

The movement of the money supply, bank credit, and linked assets in both subperiods indicates that much of the sizable liquidity injection was channelled to value-linked assets. Until mid-year there was a surge in sales of assets linked both to the consumer price index and to the foreign exchange rate and a sharp real contraction of the money supply; subsequently the public's preferences alternated

between these two types of linked assets, and the money supply shot up. These sharp swings in the money supply—a sluggish growth during the period of monetary expansion and a faster rise after the introduction of a tighter policy—reflect more the shifting of the public's preferences between money and linked assets than between money and locally produced commodities (whose recovery tapered off in the first half of 1974 at its prewar level).

The main economic policy target since the middle of 1974 is to reduce the country's adverse balance on goods and services, which has become too big for the economy to finance for any length of time. A precondition for achieving this aim is to rein in demand—principally consumption and investments which do not directly help to improve the balance of payments—and to blunt the inflation. This policy has already begun to leave its mark in various areas of the economy, with the trend turning downward in real disposable private income, investment in services and construction, and employment in the building trades and numerous manufacturing industries producing for the domestic market, while the growth of imports has tailed off after having accelerated strongly since the beginning of 1973.

Nevertheless, the slowdown by itself does not seem to have wrought the required changes in the structure of the economy: the diversion of labor and establishments from production from the home to the export markets and the dampening of demand for imports. The November devaluation of the IL, intended to make imports more expensive and to increase the profitability of exports, was expected to hasten this process and to staunch the outflow of foreign exchange reserves. The stabilization, and even reduction, of the country's import bill (in dollar terms) since the devaluation and the upturn in foreign exchange reserves (which, to be sure, is partly due to special factors) point to a change in the short-run trend. However, there are as yet no signs that the cardinal objective of economic policy is being achieved, namely the stepping up of export growth after it had virtually come to a halt in the last two years in real terms, nor was there any significant improvement in export profitability until the devaluation.

It seems that the restraining measures have so far been regarded by many as only a temporary expedient rather than signalling the end of the period of overheated domestic demand. There is a danger that this policy will run into opposition, which in turn will lead to its watering down. It is imperative to encourage and to consolidate the start made so far in healing the economy through a coordinated policy of fiscal and monetary restraint.

Without a steady improvement in export profitability there will unquestionably be insufficient incentive to shift productive factors to export industries and to bring about the required structural changes. The world economic outlook—the renewal of business growth and the expansion of commerce in Israel's principal export

markets—creates a favorable atmosphere for a policy of continued leashing of domestic demands and expediting the requisite structural changes. Implementation of such a policy offers good prospects for easing the country's balance of payments strain and reducing its economic dependence.

Economic policy should not be planned on the assumption that the large-scale inflow of capital will be sustained for long. The only way to assure full employment while reducing the balance of payments deficit is to transfer factors of production from industries working mainly for the home market to those producing for overseas. Toward this end domestic demands must be cooled and exports made more worthwhile, both by ensuring a fair profitability level and by making Israel's goods more competitive.