CHAPTER III

THE BALANCE OF PAYMENTS—GENERAL SURVEY

Israel's balance of payments position deteriorated more than ever in 1974. The erosion began in the early part of the previous year and reached very disturbing proportions even before the October war, but in the final quarter of 1973 it worsened further. The problem has become exceedingly grave, both in the long run because of the widening gap between imports and exports, and in the short run because the expectation of a devaluation of the Israeli pound hastened the depletion of foreign exchange reserves. The implementation of devaluation in November 1974 arrested the short-run factors, staunching the outflow of foreign currency and even reversing it, a trend that carried over into the first part of 1975. However, there are as yet no signs of the structural changes required for reducing the gap between imports and exports and the resort to capital imports.

1. Financing the Deficit

The gravity of the problem is reflected in the bulging of the current deficit and the greatly diminished ability to finance it by unilateral receipts. There was also a sharp contraction in 1974 in the convenient sources of financing the deficit: investments from abroad, Development Loan (State of Israel Bonds), and U.S. government loans. Whereas the deficit soared from $ 1.1 billion in 1972 and $ 2.6 billion in 1973[1] to $ 3.4 billion in the year reviewed, the share covered by unilateral transfers dipped from an average of 66 percent in 1968-72 to 57 percent in the first three quarters of 1973 and 50 percent in 1974.

The proportion of total convenient sources of finance plunged from a 97 percent average in 1968-72 and 90 percent in the first three quarters of 1973 to 61 percent in 1974. The significance of this drastic change can be seen in another comparison: whereas the share of the deficit not covered from such sources averaged 5 percent of total exports in 1968-72 and 7 percent in the first three quarters of 1973, it jumped to 38 percent in 1974. This portion of the deficit was equal to 14 percent of the year's gross national product and 22 percent of private consumption.

[1] Or an annual $ 1.8 billion rate in the first three quarters of 1973.

These changes in the size and the financing of the deficit have serious implications in several areas. One is the sharp rise in the external debt and a disturbing change in its composition, with a mounting reliance on short-term capital movements, which this year became one of the major sources of financing the deficit.

Another short-term source which played a central role this year was the drawing down of the country's foreign exchange reserves. The extensive use of this source implies *inter alia* that the country's net foreign liabilities grew by more than indicated by the data on the foreign currency debt.

Table III–1

FINANCING OF THE CURRENT DEFICIT, 1971–74

($ million)

	Current deficit	Unilateral transfers	Deficit not covered by transfers	Other convenient sources of financing[a]	Deficit not covered by convenient financing
1972	–1,101	1,052	–49	531	482
1973[b]	–1,793	1,016	–777	591	–186
1974	–3,356	1,674	–1,682	373	–1,309

Sources of Financing as a Percent of Deficit

	Transfers	Total convenient financing	Surplus of deficit over transfers/ exports (%)	Surplus of deficit over convenient financing/exports (%)
Average 1968–72	66.3	96.9	23.7	5.5
1971	63.3	100.3	24.5	–1.7
1972	95.5	143.8	2.3	–22.6
1973[b]	56.7	89.6	28.4	6.8
1974	49.9	61.0	49.0	38.1

[a] Net foreign investment in Israel, Development Loan, and U.S. government loans. Several other types of convenient financing are not included here, but they account for only a small share of the total and do not vary greatly in magnitude from year to year; hence their exclusion does not affect the general picture.

[b] The first three quarters of the year, at annual rates.

In addition, there was a greater resort this year to funds raised by Israeli banks abroad. This led to the swelling of their net foreign liabilities; the increase far outpaced that in foreign assets and in some months was even accompanied by a contraction of the latter. Not all the credit raised in this manner was reflected in the foreign debt data, so that the growth of net foreign liabibilities was probably greater than indicated by the former.

The rising share of short-term sources of finance implies an increase in the country's future debt repayments. Another consequence of the huge growth of the net external debt and the change in its composition is a soaring volume of interest payments in the years ahead.

To sum up, the general picture of the balance of payments deficit and its financing highlights two features: a jump in the proportion of short-term funds, which in the past had been a marginal factor in financing the deficit for limited periods and this year became one of the foremost sources; and a steep rise in the share of the deficit, and in that part not financed by convenient sources of funds, relative to total resources available to the economy. The significance of these developments is that the economy will be able to continue financing the deficit in this manner for only a limited period, and that the change called for in the use of the economy's resources and their allocation is now more pressing than ever before.

2. The Current Account

The deterioration in the balance of payments in 1974 was partly an outcome of trends that were quite pronounced the year before, even before the war. The situation was further aggravated in 1974 by a whole series of new developments, some of which began to appear in 1973 but made their full impact felt in 1974. The principal negative factors in 1973 were as follows:

(a) the buoyant domestic demand;

(b) insufficient encouragement of exports and the damaging effect which the changing domestic economic conditions had on the competitiveness of Israeli-made goods abroad;

(c) a reversal of the short-term influences, which induced the renewed buildup of inventories and the advancing of imports in anticipation of price increases abroad and the upping of the effective rates of exchange in the face of the growing balance of payments strain;

(d) a turn for the worse in the country's terms of trade due to the primary commodity price explosion.

The huge growth of the import surplus in 1973 was partly due to developments unconnected with the domestic economy,[2] but it also reflected an adverse change in

[2] Such as the much larger import of ships and rough diamonds (the latter due to the world boom in this industry).

Table

CURRENT ACCOUNT,[a]

($

	Imports				
	Goods	Services	Goods and services	Defense imports	Total, incl. defense imports
A. $ million					
At current prices					
1971	1,759	768	2,527	555	3,082
1972	1,900	871	2,771	490	3,261
1973					
Jan.–Sept.[a]	2,930	1,153	4,083	471	4,554
Entire year	2,896	1,176	4,072	1,253	5,325
1974	4,096	1,596	5,692	1,152	6,844
At 1972 prices					
1971	1,863	798	2,661	583	3,244
1972	1,900	871	2,771	490	3,261
1973					
Jan.–Sept.[a]	2,405	1,068	3,473	437	3,910
Entire year	2,261	1,053	3,314	1,127	4,441
1974	2,329	1,169	3,498	913	4,411
B. Index of quantitative growth					
1971	98	92	96	119	99
1972	100	100	100	100	100
1973					
Jan.–Sept.[a]	127	123	125	89	120
Entire year	119	121	120	230	136
1974[b]	123	134	126	186	135
I	107	133	116	176	124
II	133	135	133	217	146
III	120	142	127	184	136
IV	130	129	130	174	143
C. Prices indexes					
1971	94	96	95	95	95
1972	100	100	100	100	100
1973	128	112	123	111	120
1974	176	137	163	126	155
I	168	139	154	116	146
II	174	133	161	124	153
III	180	137	165	128	157
IV	182	144	170	133	163

[a] At annual rates.
[b] Quarterly data are at annual rates.
SOURCE: Central Bureau of Statistics.

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1971–74

million)

Exports			Deficit			
Goods	Services	Total	Trade balance	Services	Goods and services	Total, incl. defense imports
900	914	1,814	–859	146	–713	–1,268
1,082	1,047	2,129	–818	176	–642	–1,132
1,422	1,310	2,732	–1,508	157	–1,351	–1,822
1,366	1,288	2,654	–1,530	112	–1,418	–2,671
1,703	1,733	3,436	–2,393	137	–2,256	–3,408
966	935	1,901	–897	137	–760	–1,343
1,082	1,047	2,129	–818	176	–641	–1,132
1,211	2,385	2,385	–1,231	143	–1,088	–1,525
1,114	1,141	2,255	–1,147	88	1,059	–2,186
1,170	1,175	2,345	–1,159	6	–1,153	–2,066
89	89	89	110	77	119	119
100	100	100	100	100	100	100
109	116	112	150	81	170	135
103	109	106	140	50	165	193
108	112	110	142	3	180	183
114	106	110				
108	118	114				
94	114	97				
116	109	113				
93	98	95				
100	100	100				
123	113	118				
146	148	147				
134	141	137				
148	145	146				
150	147	158				
151	160	155				

the basic balance of payments determinants: the ebullient domestic demand and the rapid mounting of production costs, which arrested a four-year respectable advance in overseas industrial sales. The impressive headway made by exports, which began when the economy pulled out of the slump of 1966-67, can be credited to the energetic promotion policy on the one hand and the absence of strong domestic demand pressures and a mild rise in production costs on the other. This pulled up export profitability considerably and made the country's goods much more competitive abroad. The overheating of the economy and the ensuing strong domestic demand pressure drove up production costs sharply, checking the uptrend in export profitability and increasing the competition of the home market. The upping of export incentives during this period was insufficient to improve profitability in the face of the growing attraction of the home market, as borne out by the sharp downturn in the industrial export growth curve—from an average of 20 percent in real terms in 1967-71 to 9 percent in 1972 and 4 percent in the first three quarters of 1973. The booming world market in 1972 and the first half of 1973 blunted somewhat the negative impact of the domestic demand pressure and averted a greater slowdown in overseas sales.

The acceleration of imports in 1973 is largely ascribable to the renewed accumulation of stocks after a lull and perhaps even an opposite trend in 1972. This was due to expectations of both a continued soaring of commodity prices abroad and a further increase in the effective exchange rate of imports because of the eroding balance of payments position. Added to this was an anticipated hiking of taxes, which induced a much larger import of consumer goods. The commodity price explosion had a very adverse effect on Israel's terms of trade.

In the year reviewed several developments exogenous to the domestic economy greatly aggravated the balance of payments position. At the same time, in those areas falling within the orbit of government policy—export profitability and the competitiveness of domestic goods on the one hand and the regulation of domestic demand on the other—the government failed to bring about such changes as would blunt the impact of the harmful external developments. These were as follows:

(a) The mounting defense burden. The most striking manifestation of this was the virtual doubling of the real volume of direct defense imports from their 1972 level; this contributed 40 percent to the growth of the deficit and 30 percent to the rise in the import bill during this period.

(b) The worsening of Israel's terms of trade. The soaring of world commodity prices at the end of 1972 and throughout 1973 sharply drove up Israel's average import prices compared with its export prices, a development greatly exacerbated at the end of 1973 by the quadrupling of fuel prices within a very brief period.

With the change of trend in the world economy and the subsiding of demand, prices began to soften in the fourth quarter of the year, with most raw materials being affected. On the other hand, industrial prices continued upward, with a consequent narrowing of the gap between commodity export and import prices. At the end of 1974 the index of the terms of trade[3] in commodity imports and exports stood at 83 compared with the base level (the average for 1972), as against 80 in the first quarter of 1974. This means that in order to maintain the 1974 import volume at the fourth-quarter prices, exports had to be stepped up by $ 700 million in comparison with 1973 prices—a sum equivalent to 8 percent of the gross national product. On the other hand, the year reviewed saw an improvement in Israel's terms of trade in the services account (including defense imports), which earned the economy an extra $ 200 million. But two qualifications must be noted: First, the reliability of the relevant data is much lower, rendering our conclusions much less certain. Secondly, there is a slight optical illusion here: the improvement partly reflected the acceleration of domestic inflation, which pushed up the prices paid by tourists and others in Israel; these price increases reflected a real decline in exports of invisibles. The expansion of such exports, which is so vital to the economy, can be achieved only if there is a reduction of relative prices; therefore the improvement attributable to this factor turns out to be illusory when its implications for Israel's balance of payments are examined.

(c) The recession in Israel's export markets. In the second half of 1973 business began to fall off in the industrial countries, the principal customers for Israel's goods. This trend grew more pronounced in the course of 1974, reaching its trough at the end of the year; this of course sharply depressed the demand for Israeli goods abroad. The expansion of Israel's export markets (measured by the real increase in the relevant countries' imports) slowed from 14 percent in 1972 and 10 percent in 1973 to a mere 1 percent in 1974. This was the foremost cause of the poorer export performance in the year reviewed. A large percentage of the country's industries failed to make any headway or even suffered a drop in overseas sales; coinciding with the ebbing of domestic demand, this left them with spare capacity, apparently because of the lack of any significant improvement in export profitability in recent years.

(d) The continued buildup of stocks of imported goods. The year reviewed was marked by expectations of a further worsening of the global inflation and the raising of the effective exchange rate of Israel's imports because of the deterioration in the balance of payments. The result was an import volume far exceeding current production requirements. A secondary factor was the revising of credit arrangements,

[3] The index of export prices divided by the index of import prices.

with the possibility of obtaining credit for maintaining stocks of imported raw materials being increased.

The expectational changes with regard to import prices and the post-devaluation rate of exchange ought to reduce current imports even if there is no long-run change in the major determinants of the economy's commodity imports. If no expectational changes take place in the near future with respect to import prices, the very ending of the process of stock accumulation, and perhaps even a shift to a lower level, could reduce imports next year by several million dollars. Hence the importance of preventing the renewal of devaluation expectations, which would add another superfluous source of pressure on the balance of payments. The sharp downturn in imports in March 1975 apparently heralded the expected postdevaluation slowdown of imports.

(e) The growing burden of interest payments to the foreign sector with the steep rise in the economy's net foreign currency liabilities. This found only partial expression in 1974, and will probably be felt more strongly next year. This is a separate problem from that of the swelling volume of principal repayments, which is liable to make it hard to find the wherewithal to finance the deficit.

It is against the backdrop of the erosion of the country's basic balance of payments position, due to the protracted impairment of the relative profitability of exports with the changing domestic economic conditions and the lack of a sufficiently energetic policy of export promotion on the one hand and the very disturbing external developments on the other, that the policy measures adopted up to the devaluation of the IL in November 1974 should be examined. Both of these developments called for a more resolute effort to stimulate exports.

The exogenous developments—the turn for the worse in Israel's terms of trade and the growing security burden—in themselves called for greater stress on overseas sales, even if the relative profitability of exports had not been impaired and they continued to forge ahead at the same pace as in 1972. But even were it not for these exogenous factors, the slackening of the growth rate, which began at that time as a result of the mounting pressure of domestic demand and soaring production costs, also necessitated the pursuance of a more determined export policy, even if only to maintain the existing level and to avert a further deterioration in the balance of payments. The economic slowdown in Israel and the weakening of foreign demand also constrained the expansion of exports. The steps taken at the end of 1973 and in the course of 1974—the raising of export incentives and the devaluation of the IL—were capable of improving export profitability to only a minor extent. The November devaluation was followed by an upturn in profitability, but it was insufficient in view of the faltering of foreign demand. On the other hand, domestic demand pressure apparently let up a bit as a result of the policy of restraint introduced in 1974. But it seems that here too what was achieved was far from adequate. It should be stressed that an economic slowdown is not an end in itself but a necessary condition for improving the country's balance of payments. But an important factor in the slight deceleration of total demand in the economy was the weakening of overseas demand for Israeli goods. Had the latter remained at its average level of the past few years and exports advanced a little faster, there probably would not have been any slackening of aggregate demand in 1974. The degree to which domestic demand has to be reined in must be determined in consonance with the export targets, which are much higher than the prevailing growth rates; assessing the current position without allowing for a sizable expansion of exports is liable to lead to misleading conclusions.

3. The Capital Account

Long-term capital imports fell far below their level in 1973, when there was a steep jump in the capital inflow to the public sector in the final quarter. But compared with the volume in the three prewar quarters of 1973 at annual rates, there was an increase of 24 percent in the year reviewed—from $ 1.8 billion[4] to over $ 2.2 billion. This growth rate, which on the face of it seems to be fairly high, was actually slow if examined according to two other yardsticks. First of all, assets and incomes appreciated greatly in money terms because of the inflation, which was reflected *inter alia* by a 45 percent jump in commodity import prices and an 18 percent advance in export prices. But a much more significant yardstick is the share of long-term capital imports in financing the balance of payments deficit. Between the two periods discussed the current deficit soared 90 percent due to a combination of three factors: real changes (a result of the much heavier defense import and excess demand), accelerating inflation, and a worsening of the country's terms of trade. These developments depressed the share of long-term capital imports from a level equal to the current deficit in the first three quarters of 1973 to 68 percent in 1974. The downturn encompassed all component items: total funds from convenient sources (investments from abroad, the Development Loan, and U.S. government loans) fell off from 90 percent of the deficit in 1973 to 61 percent, while unilateral transfers moved down from 57 to 50 percent. Since both the deficit and the capital inflow increased strongly compared with other economic aggregates, these declines, which in themselves might appear modest enough, had a drastic effect on the balance of payments: that part of the deficit not covered by unilateral transfers was equal to

[4] Capital imports in the first three quarters of 1973 totalled $ 1,350 million, or $ 1.8 billion at annual rates.

Table

CURRENT DEFICIT, TRANSFERS, AND

($ milion, at

	1968	1969	1970	1971	1972	1973	1974
Balance on current account	–648	–869	–1,234	–1,209	–1,101	–2,642	–3,356
Thereof: Defense imports	–249	–334	–624	–555	–490	–1,253	–1,152
Unilateral transfers	435	459	649	765	1,052	2,173	1,674.
Foreign investment in Israel, net	–4	—	–2	64	142	173	61
Long-term loans, net	168	168	559	624	580	815	539
Total long-term capital imports	**599**	**627**	**1,207**	**1,453**	**1,775**	**3,161**	**2,275**
Surplus of long-term capital over current deficit	–49	–242	–27	244	674	518	–1,08[illegible]
Short-term capital of nonfinancial sectors[a]	–25	–57	–36	–54	–75	56	141
Net foreign liabilities of banks[a]	10	–34	83	20	–87	–58	384
Central monetary authority reserves[a]	94	324	–22	–235	–539	–522	777
Bank of Israel — other items[b]	–11	48	19	–21	–22	–22	63
Errors and omissions	–28	–36	–18	46	45	29	–282

[a] A minus sign (–) denotes an increase in assets or a decrease in liabilities; a positive value denotes a decrease in assets or an increase in liabilities.
[b] SDRs, credit transactions with IMF, and balances in clearing accounts..

49 percent of total exports in 1974, compared with 28 percent in the first three quarters of 1973 and a 24 percent average in 1968-72; while that part of the deficit not covered by favorable sources of financing rose from 7 percent in the first three quarters of 1973 to 38 percent in 1974. This change strikingly underscored the importance of the recent balance of payments developments and their implications for the near future and the economic policy targets.

The principal manifestations of this development were the growth of the external debt and the change in its composition, with a rise in the share of short-term sources of funds, the economy's foreign currency liabilities, and its future debt servicing burden. The capital inflow to the nonbank private sector fell off appreciably in money terms in 1974, and of course even more in real terms. In the first three devaluation quarters of 1974 long-term capital imports of the private sector totalled

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CAPITAL ACCOUNT (SUMMARY), 1968-74

current prices)

1972, quarterly				1973, quarterly				1974, quarterly			
I	II	III	IV	I	II	III	IV	I	II	III	IV
-211	-289	-289	-312	-285	-488	-572	-1,297	-661	-924	-912	-860
-117	-118	-123	-132	-102	-115	-136	-900	-250	-330	-289	-283
274	260	221	298	241	268	253	1,411	349	500	414	411
19	47	34	42	40	51	62	19	-1	11	17	33
185	95	130	171	126	126	169	394	114	108	70	247
476	**402**	**385**	**511**	**407**	**445**	**484**	**1,824**	**462**	**620**	**501**	**692**
265	113	96	199	122	-43	-88	527	-199	-303	-411	-169
-64	39	-22	-27	-3	68	-44	35	76	10	31	24
-3	-50	-26	-8	-77	9	17	-7	-20	85	70	248
-276	-62	-20	-143	-117	-28	-41	-336	226	245	290	16
1	-72	8	7	-38	-8	18	6	19	-2	-4	50
77	32	-35	-29	112	3	138	224	-102	-35	24	-170

$ 650 million, as against $ 900 million in the first three quarters of 1973—down 25 percent. Adjusting for the effects of the global inflation shows that the real capital inflow of the private sector in 1974 came to only about half or even less of that in the first three quarters of 1973.

Most of the contraction occurred in three items: immigrant transfers (down 50 percent), investment (70 percent), and long-term loans (75 percent). These decreases can be ascribed to several factors. One was the expectation of an economic slowdown in the face of the mounting balance of payments strain and growing recognition of the need to adopt a policy of economic restraint. This was reflected first and foremost by a deep dent in foreign investment. The second factor was of a short-term nature, namely the expectation of a devaluation of the Israeli pound, which led to the deferment of transfers to this country and to an outflow of capital.

It apparently also induced a much heavier foreign borrowing, although this item was also influenced by the smaller investment this year in ships and aircraft.

A third factor was the more precarious security situation and the mounting tension in the wake of the war. In the final quarter there was apparently some change of trend, primarily in immigrant transfers and foreign loans, but the period for which data are available is too brief to draw conclusions about a possible turnabout after the November devaluation.

The sagging weight of long-term capital imports, coupled with the jump in the current deficit, forced the economy to rely much more heavily in 1974 on short-term financing. In the first three quarters the main source was the drawing down of the country's foreign exchange reserves by $ 760 million; another essentially short-term source was the foreign liabilities of Israeli banks. The commercial banks' foreign currency transactions include several categories in which they play a completely passive role, serving as a conduit for the flow of foreign currency from the public to the Bank of Israel, and vice versa. But in some types of transactions the banks play an active role, procuring foreign currency both abroad (deposits of foreign banks and nonresidents) and in Israel (government deposits and certain types of deposits of the public), for use both in Israel (for granting loans to the government and local residents) and abroad (loans to foreign residents and bank deposits).

The year reviewed saw a structural change in the sources and uses of such funds. In the first nine months the amount raised from foreign banks fell noticeably, but at the same time there was an even sharper drop in overseas assets of Israeli banks. The net outcome was a larger volume of funds available for domestic lending. The decrease in foreign bank funds can be attributed to the tremors felt by the international financial system after the entanglement of several institutions and the more cautious attitude adopted toward small banks and countries on the periphery of the financial system. With the brightening of the international financial outlook, the capital inflow from foreign banks turned upward. In the last three quarters of 1974 the foreign liabilities of Israeli banks grew by $ 420 million and their assets abroad by only $ 20 million. The $ 400 million balance was used for granting foreign currency loans to the Israeli public and the government.

These two short-term sources of finance—foreign exchange reserves and the net foreign liabilities of Israeli banks—yielded the economy more than $ 1.1 billion in 1974; the total amount of short-term funds apparently ranged between $ 1.2 billion and $ 1.3 billion.

The structural changes in Israel's capital inflow in 1974 led to a change in its net foreign currency liabilities. To these must be added the decrease in foreign exchange reserves and part (for which no data are available) of the liabilities to foreign banks which do not seem to be reflected in the external debt. According to this calculation, the economy's net foreign currency debt grew by $ 1.8 billion, as against $ 300-400 million in 1973.[5]

The changes in the country's capital imports will also affect the future debt servicing burden. Principal repayments of long-term liabilities in 1975 are estimated at $ 400 million, but in the past actual repayments invariably ran $ 100-150 million above the forecast. To this must be added the short-term obligations. True, these need not necessarily be fully repaid next year, and very likely there will be some rollover, but the huge growth in the year reviewed cannot be ignored.

[5] This is only a partial estimate, but it is indicative of the general trend.